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How to Value an "Additional" Annuity Benefit (Whatever That Is)

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The income tax regulations under section 401(a)(9)[1] require that required minimum distributions (RMDs) from a deferred annuity contract for calendar years beginning after 2005 must be increased for the "actuarial present value" (APV) of "any additional benefits" that will be provided under the contract. As a practical matter, the responsibility for calculating these values required under the regulations will fall on annuity issuers. In the case of an IRA annuity contract, the issuer of the contract must either inform the owner of the amount of any RMD required for the year or offer to calculate the amount of the RMD.[2] With respect to other types of annuity contracts that are subject to the section 401(a)(9) minimum distribution requirements, the individuals for whose benefit the arrangements are maintained realistically cannot be expected to apply the APV requirement to their arrangement and, likely, will look to the issuers to apply the requirement in any event.

Questions about how to apply the APV requirement have resulted in a significant amount of uncertainty on the part of tax practitioners, actuaries, and insurance company personnel responsible for modifying administrative procedures and systems to implement the requirement by the end of 2005. It appears that neither the Internal Revenue Service (IRS) nor the Treasury Department are currently contemplating issuing any guidance on the subject.[3] Nevertheless, the regulations provide a fair amount of flexibility in applying the APV requirement, and thus permit a range of acceptable actuarial present values with respect to a benefit under a deferred annuity contract.

This article considers the types of "additional" benefits that might be covered by the APV requirement, certain assumptions that might be used in computing the actuarial present value of these benefits, and certain methods of performing the computation. As discussed below, there might be a number of different assumptions and methods for computing the actuarial present value of a benefit that are reasonable.

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[1] Unless otherwise indicated, all section references are to the Internal Revenue Code of 1986, as amended.

[2] *See* I.R.S. Notice 2002-27, 2002-1 C.B. 814.

[3] As of the date this article was written, a working group created by the Taxation Section of the Society of Actuaries was preparing a discussion paper on the APV requirement in an effort to provide annuity issuers with some helpful guidance on the requirement.

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Section 401(a)(9) and the Actuarial Present Value Requirement

Section 401(a)(9) sets forth certain minimum distribution requirements that apply to qualified plans under section 401(a), tax-sheltered annuity contracts and custodial accounts under sections 403(b)(1) and 403(b)(7), individual retirement accounts and annuity contracts under sections 408(a) and 408(b), Roth IRAs under section 408A and eligible deferred compensation plans under section 457(b). The regulations under section 401(a)(9) provide one set of rules for applying the minimum distribution requirements to arrangements that are in the form of individual accounts and another set of rules for defined benefit plans and annuity contracts that have annuitized. With respect to an individual account, the regulations provide that if a minimum distribution is required for a calendar year, the amount of the required distribution for the year is equal to the quotient obtained by dividing the account balance, as of the last valuation date in the immediately preceding calendar year, by the applicable distribution period determined under the regulations.[4]

In the case of a deferred annuity contract, Treas. Reg. section 1.401(a)(9)-6, Q&A-12, states that prior to the date that an annuity contract under an individual account plan is "annuitized," the interest of an employee or beneficiary under the contract is treated as an individual account for purposes of section 401(a)(9). In applying the individual account rules to a deferred annuity contract, the "entire interest" under the contract as of Dec. 31 of the relevant valuation calendar year is treated as the account balance for the valuation calendar year. The "entire interest" under a deferred annuity contract is equal to the sum of (1) the "dollar amount credited" to the employee or beneficiary under the contract, also referred to in the regulations as the contract's "notional account value," plus (2) the "actuarial present value" of "any additional benefits (such as survivor benefits in excess of the dollar amount credited to the employee or beneficiary) that will be provided under the contract."[5]

The preamble to the regulations states that the IRS and the Treasury Department believe it is generally appropriate to reflect the value of additional benefits under an annuity contract, "just as the fair market value of all assets generally must be reflected in valuing an account balance under a defined contribution plan."[6]

Benefits Expressly Excluded from the APV Requirement

Q&A-12 sets forth three special rules providing that additional benefits under a deferred annuity contract may be disregarded, and thus not subject to the APV requirement, if they fall within what is referred to herein as (1) the "120 percent exclusion," (2) the "ROP benefit exclusion" or (3) the "IRS guidance exclusion," discussed next:

1. The 120 percent exclusion

The APV of any additional benefits provided under an annuity contract may be disregarded if "the sum of the dollar amount credited to the employee or beneficiary under the contract and the actuarial present value of the additional benefits" (i.e., the "entire interest" under the contract) is no more than 120 percent of the dollar amount credited to the employee or beneficiary under the contract and "the contract provides only for the following additional benefits:"

a. Additional benefits that, in the case of a distribution, are reduced by an amount sufficient to ensure that the ratio of such sum (i.e., the entire interest) to the dollar amount credited does not increase as a result of the distribution ("Pro-Rata Reduction" benefits),[8] or

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[4] Treas. Reg. § 1.401(a)(9)-5, Q&A-1.

[5] The APV requirement does not apply for periods after annuity payments have commenced under the contract. Instead, the rules applicable to defined benefit plans and annuitized contracts apply. *See* Treas. Reg. § 1.401(a)(9)-6.

[6] 69 Fed. Reg. 33292 (June 15, 2004).

[7] Treas. Reg. § 1.401(a)(9)-6, Q&A-12(c)(1).

[8] Treas. Reg. § 1.401(a)(9)-6, Q&A-12(c)(1)(i). The preamble to the regulations describes the 120 percent exclusion generally as applying when there is a pro-rata reduction "in the additional benefits for any withdrawal." 69 Fed. Reg. 33292 (June 15, 2004).

b. An additional benefit that is the right to receive a final payment upon death that does not exceed the excess of the premiums paid less the amount of prior distributions (an "ROP" benefit).[9]

It is unclear whether a Pro-Rata Reduction benefit under the 120 percent exclusion can include a benefit that, in the case of a distribution, is reduced by an amount equal to the dollar amount of the distribution (a so-called "dollar-for-dollar" benefit). Depending on the facts and circumstances at any time, a distribution from an annuity contract with a dollar-for-dollar benefit could reduce the benefit at that time by a percentage that is less than, equal to, or greater than the percentage reduction in the entire interest under the contract as a result of the distribution. Under one interpretation of the 120 percent exclusion, a dollar-for-dollar benefit could never qualify as a Pro-Rata Reduction benefit merely because it is *possible* for a distribution to reduce a dollar-for-dollar benefit by a percentage that is less than the resulting percentage reduction in the entire interest under the contract. Under an alternative interpretation, a dollar-for-dollar benefit (1) would constitute a Pro-Rata Reduction benefit for a year if, at the time the RMD for the year is to be calculated, a distribution would reduce the benefit by a percentage that is equal to or greater than the resulting percentage reduction in the entire interest under the contract, and (2) would not constitute a Pro-Rata Reduction benefit for a year if, at the time the RMD for the year is to be calculated, a distribution would reduce the benefit by a percentage that is less than the resulting percentage reduction in the entire interest under the contract. It is unclear which interpretation is correct. The authors believe that the second interpretation is consistent with the regulations and hope that the IRS will eventually clarify that it is the proper interpretation of the exclusion.

2. The ROP Benefit Exclusion

If the only additional benefit provided under a deferred annuity contract is an ROP benefit, its value need not be taken into account in computing RMDs, regardless of its value in relation to the dollar amount credited to the employee or beneficiary under the contract.[10]

> The APV requirement applies by its term to "any" additional benefits under a deferred annuity contract ... however, neither the regulations nor the preamble thereto provide any indication as to the types of other benefits that should be covered by this requirement.

3. The IRS Guidance Exclusion

The IRS may issue revenue rulings, notices or other guidance published in the Internal Revenue Bulletin that identify additional benefits that may be disregarded for purposes of applying the APV requirement.[11] As of the date this article was written, no such guidance has been issued.

Types of Benefits Covered by the APV Requirement

The APV requirement applies by its terms to "any" additional benefits under a deferred annuity contract. Q&A-12 states that the requirement applies to benefits "such as survivor benefits in excess of the dollar amount credited to the employee or beneficiary" that will be provided under the contract. Beyond this statement, however, neither the regulations nor the preamble thereto provides any indication as to the types of other benefits that should be covered by this requirement.

The two examples set forth in Q&A-12(d) treat as an additional benefit a death benefit that is provided until the end of the calendar year in which the owner attains age 84 equal to the greater of the current "notional account value" and the largest notional account value at any previous policy anniversary reduced proportionally for subsequent partial distributions (a "high water mark" benefit). Presumably, the APV requirement also

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[9] Treas. Reg. § 1.401(a)(9)-6, Q&A-12(c)(1)(ii).

[10] Treas. Reg. § 1.401(a)(9)-6, Q&A-12(c)(2).

[11] Treas. Reg. § 1.401(a)(9)-6, Q&A-12(c)(3).

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applies to other types of death benefits that are payable upon the employee's death and are in excess of the amount credited to the employee or beneficiary under the contract, such as: (1) a death benefit that generally pays the greater of the contract's cash value on the date of death and the net premiums paid for the contract plus interest at a stated rate (often called a "rollup" benefit), and (2) a death benefit that generally pays a stated percentage of the excess of the cash value over the unrecovered premiums paid under the contract (often called an "earnings enhancement" benefit).

Notwithstanding requests by commentators on the APV requirement set forth in proposed regulations issued in 2002[12] that the requirement should not apply to lifetime benefits, Q&A-12 is not limited to death benefits. The language in Q&A-12 indicates that "any" benefit that can provide amounts payable in excess of the amounts credited under the contract might be treated as an additional benefit subject to the APV requirement. Hence, the APV requirement almost certainly applies to certain lifetime benefits, such as: (1) guaranteed minimum income benefits providing a stream of annuity payments guaranteed to be at least some minimum amount regardless of the contract's actual cash value, (2) guaranteed minimum withdrawal benefits providing the right to withdraw a certain stated percentage of contributions each year for a specified duration regardless of the contract's actual cash value, and (3) guaranteed minimum accumulation benefits providing a guaranteed minimum cash value at certain specified times.

There is some uncertainty about whether and how Q&A-12 applies to various provisions under a deferred annuity contract. Although it is unclear, presumably the IRS and Treasury Department did not intend for the benefits associated with certain contract provisions that historically have been integral features of annuity contracts, such as annuity purchase rate guarantees and minimum interest rate guarantees, to be treated as "additional benefits" in excess of the amount credited under the contract for this purpose. After all, these benefits are not "additional" to the annuity contract in that they comprise basic elements of the contract. However, there is more uncertainty regarding the treatment of some other features of deferred annuities, such as equity-indexed adjustment (EIA) provisions, market value adjustment (MVA) guarantees under a contract, waiver of premium provisions, and waiver of surrender charge provisions.

It is unclear whether such features should be: (1) taken into account under Q&A-12 as part of the "dollar amount credited" under the contract, (2) treated as additional benefits subject to the APV requirement, or (3) viewed as neither part of the dollar amount credited nor additional benefits, and thus ignored for purposes of Q&A-12. In addition, if such a feature is subject to the APV requirement, questions exist regarding the treatment of negative values (such as a negative MVA) that might arise in certain cases.

Methods of Computing the Actuarial Present Value of Additional Benefits

The preamble to the regulations states that the examples set forth in Q&A-12(d) illustrate "an acceptable method" of determining the value of an additional benefit that is a guaranteed death benefit.[13] In general, the examples apply certain assumptions, discussed below, to arrive at the actuarial present value of the additional benefit by: (1) determining the value of the benefit for each year the benefit might be payable under the contract, (2) arriving at the actuarial present value with respect to each year's benefit, and (3) summing the actuarial present values for all the years the benefit might be payable. The value of an additional benefit for a year is determined generally in the examples as the product of: (1) the amount of the benefit payable during the year, (2) the probability that the employee or beneficiary, whichever is applicable, will survive to the year, and (3) the probability that the benefit will be paid in the year.

Accounting for Charges

For purposes of determining the APV with respect to an additional benefit for a year, the examples apply a discount rate to the value of the benefit for the year. Although it is not addressed in Q&A-12 or the examples thereunder, and the answer is unclear, it seems appropriate to reduce the present value of the additional benefit by the present value of the charges for

[12] *See* Prop. Treas. Reg. § 1.401(a)(9)-6, Q&A-12.

[13] 69 Fed. Reg. at 33292.

purposes of determining RMDs. If the present value of future charges is ignored, the RMD that is calculated for a year could be overstated.

> Under the factor approach, certain characteristics of a pool of contracts could be assigned an actuarially determined numerical factor that could be applied to the contract … to produce a number representing the actuarial present value of additional benefit(s) provided under a contract.

For instance, assume that a deferred annuity contract provides an additional benefit equal to a constant amount that does not change from year to year. Assume further that the additional benefit can be purchased with a single premium at issuance of $2,000 or can be funded through periodic charges imposed against the cash value under the contract. Presumably, the actuarial present value of the benefit at issuance should be equal to the $2,000 that it would cost to purchase the benefit with a single premium at that time.

Consider an individual who uses $100,000 to purchase a contract with this benefit on Dec. 31 of year 1. In accordance with Q&A-12, the amount of the RMD for year 2 should be determined under the individual account rules as an amount equal to the quotient obtained by dividing (1) the account balance as of Dec. 31 of year 1, i.e., the "entire interest" in the contract as of that date, by (2) the applicable distribution period determined under the regulations.

If the individual applies $2,000 of the $100,000 to pay the single premium for the benefit, there will be no future charges under the contract for the benefit. At the time the contract is issued, the amount credited under the contract of $98,000 ($100,000 - $2,000), plus the actuarial present value of the additional benefit ($2,000), less the present value of the future charges for the benefit ($0), equals the $100,000 consideration paid for the contract. This total amount arguably is appropriately viewed as the fair market value of the contract on Dec. 31 of year 1 and the amount on which the RMD for year 2 should be determined.

Alternatively, the individual could choose to pay for the benefit through periodic charges imposed against the contract's cash value. At the time the contract is issued, the amount credited under the contract ($100,000), plus the actuarial present value of the additional benefit ($2,000), less the present value of the future charges for the benefit ($2,000), equals the $100,000 consideration paid for the contract. Again, this total amount arguably is appropriately viewed as the fair market value of the contract on Dec. 31 of year 1, and the amount on which the RMD for year 2 should be determined. If the present value of the future charges is not accounted for, the RMD for year 2 would be determined based on the sum of the amount credited under the contract and the present value of the benefit (i.e., $102,000), even though that would exceed the fair market value of the contract at that time.

The "Factor" Approach

The examples under Q&A-12 compute the actuarial present value of the additional benefit under a contract based on the characteristics specific to that contract (i.e., under a "contract-by-contract" approach). Alternatively, it might be appropriate to compute the actuarial present value of additional benefits under a contract using factors based on the characteristics of a group of contracts with similar benefits, provisions, features and guarantees (i.e., under a "factor" approach).

Under the factor approach, certain characteristics of a pool of contracts could be assigned an actuarially determined numerical factor that could be applied to the contract (e.g., to the cash value or the amount of the benefit) to produce a number representing the actuarial present value of additional benefit(s) provided under a contract. Relevant characteristics might include the type of benefit(s) provided under the contract, the issue date of the contract, the owner's age at issue, and the amount of any benefit in excess of the amount credited under the contract, to name a few. Each characteristic might be divided into ranges, each assigned its own factor. For example, separate factors might be provided for the owner's issue age depending on whether owner's age at issue is 35-40, 40-45, 45-50 and so on.

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Obviously, the success of this approach turns on making sure that the relevant characteristics and subcategories are identified and the appropriate factors are assigned to each characteristic and subcategory.

Ultimately, whether the factor approach is appropriate may depend on how close the values produced under this approach are to the values properly computed under a contract-by-contract approach like that used in the examples in Q&A-12.

Reasonable Actuarial Assumptions

The regulations state that the actuarial present value of any additional benefits described in Q&A-12 are to be determined using "reasonable actuarial assumptions, including reasonable assumptions as to future distributions, and without regard to an individual's health."[14] Issuers might need to defend their assumptions as reasonable in the event they are questioned by the IRS, a court or even a contract owner. Accordingly, issuers will want to document the basis for using whatever assumptions they utilize. It is possible that certain assumptions could be viewed as reasonable for purposes of determining the actuarial present value of certain additional benefits under particular annuity contracts issued by an insurance company and, at the same time, not viewed as reasonable when applied to different benefits or contracts offered by the company.

In this regard, the examples set forth in Q&A-12(d) involve a deferred variable annuity contract that permits the assets thereunder to be invested in a fixed account at a guaranteed rate of 2 percent. The following assumptions are used in the examples for purposes of determining the actuarial present value of the death benefit provided under the contract:

- The investment return on the "notional account value," *i.e.*, the amount credited to the employee or beneficiary under the contract, is 2 percent per annum.

- The amount of the death benefit for a year is the amount that would be payable if the owner died mid-year.

- The mortality rate is determined using the mortality table provided in Rev. Rul. 2001-62.[15]

- The mortality rate during the year is equal to a blended rate taking into account one mortality rate for the number of months in the year prior to the owner's birthday and a separate mortality rate for the number of months in the year after the owner's birthday.

- RMDs are made at the end of each year.

- Values are discounted at a rate of 5 percent.

Given that the IRS and Treasury Department view the examples as providing an acceptable method of calculating the actuarial present values of the death benefits involved, annuity issuers should take comfort that if they use these same actuarial assumptions in determining the APVs for such death benefits, the assumptions would be viewed as reasonable for purposes of Q&A-12. However, issuers are free to use different assumptions with respect to these items so long as they are reasonable. In addition, issuers should be sensitive to the possibility that due to changing facts and circumstances (e.g., a change in the interest rate environment or the issuance of guidance), assumptions that are reasonable at the time the actuarial present value of an additional benefit is computed in one year might not be viewed as reasonable when the computation is performed in a subsequent year.

Also, depending on the terms of a contract, it might be reasonable to make additional assumptions regarding such things as future distributions under the contract and the probability that any additional benefits will be paid under the contract. For instance, it might be appropriate to make certain assumptions regarding the following:

- ***Withdrawals and surrenders.*** The examples in Q&A-12(d) assume that RMDs are taken at the end of each year. Depending on the facts and circumstances, including such things as the terms of the contracts involved and the issuer's experience, it may be appropriate for the issuer to make a

[14] Treas. Reg. § 1.401(a)(9)-6, Q&A-12(b).

[15] 2001-2 C.B. 632.

different assumption about when RMDs are taken each year and to make certain assumptions regarding the likelihood that distributions other than RMDs might be made in the form of partial withdrawals and/or complete surrenders.

- ***The excess of an additional benefit over the amount credited.*** The amount by which an additional benefit exceeds the amount credited to the employee or beneficiary under a contract might affect the probability that the benefit will be paid, and thus could affect the actuarial present value of the benefit. For instance, as described above, (1) a guaranteed minimum income benefit generally provides a stream of annuity payments guaranteed to be at least some minimum amount regardless of the contract's actual cash value, and (2) a guaranteed minimum withdrawal benefit generally provides the right to withdraw a certain specified percentage of contributions for a specified duration regardless of the contract's actual cash value. It might be reasonable to assume that there will be some greater probability that such a benefit will be elected, and thus that the benefit will have greater value, at a time when the amount of the benefit exceeds the cash value under the contract, as compared to when the benefit is less than the cash value under the contract.

- ***Annuitization.*** The APV requirement, by its terms, applies only prior to the date that an annuity contract is annuitized, (i.e., prior to the date annuity payments commence). Some additional benefits, such as certain death benefits, are payable only in the event of death prior to the annuity commencement date. Other benefits, such as a guaranteed minimum income benefit, described above, become payable once the contract is annuitized. Hence, in determining the APV of additional benefits under annuity contracts, it would seem appropriate for an issuer to make some assumptions about whether and when the contracts will be annuitized.

- ***Multiple additional benefits.*** It may be appropriate to make different actuarial assumptions with respect to an additional benefit under a contract depending on whether certain other additional benefits also are provided under the contract. For instance, it might be reasonable to assume that relatively few withdrawals will be made under an annuity contract if it provides a death benefit that is reduced by any distributions from the contract. On the other hand, it might be reasonable to assume greater and more frequent withdrawals will be made under the contract if it provides that same death benefit together with a guaranteed minimum withdrawal benefit.

The APV requirement, by its terms, applies only prior to the date that an annuity contract is annuitized … Some additional benefits, such as certain death benefits, are payable only in the event of death prior to the annuity commencement date.

Conclusion

As discussed above, there is a significant amount of uncertainty on the part of tax practitioners, actuaries and insurance company personnel regarding how to apply the APV requirement. It appears that neither the IRS nor the Treasury Department currently are contemplating issuing any guidance on the subject. Nevertheless, the regulations provide a fair amount of flexibility in applying the APV requirement. There might be a number of different assumptions and methods for computing the actuarial present value of a benefit that are reasonable. Thus, Q&A-12 permits a range of acceptable actuarial present values with respect to a benefit under a deferred annuity contract.

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