SOCIETY OF ACTUARIES

Article from:

Taxing Times

May 2006 – Volume 2, No. 1

Rev. Proc. 2006-13: Valuation of Deferred Annuities in Roth IRA Conversions

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Roth IRA Conversions

Recent guidance in the form of Rev. Proc. 2006-13 provides a general safe harbor for the fair market value of a deferred-annuity contract when determining the amount includible in income on conversion of a traditional IRA to a Roth IRA. Generally, where property is involved in such a conversion, the amount includible for the property is its fair market value at the time the property is considered distributed from the traditional IRA. (See A-14 of §1.408A-4T.)

The subject of the valuation of deferred annuities and their additional benefits is never easy. Avid followers of *Taxing Times* may recall an article by Joe McKeever and Mark Griffin in Vol. 1, Issue 2 (Sept. 2005), on the valuation of deferred annuity contracts held in qualified trusts for purposes of determining the amount of the required minimum distribution (RMD) under section 401(a)(9), and Treas. Reg. §1.401(a)(9)-6, Q&A-12. Generally, for RMD purposes, the "entire interest" under a deferred annuity contract is the sum of the "dollar amount credited" to the employee or beneficiary, not reduced by any applicable surrender charge, plus the "actuarial present value" of any additional benefits provided under the contract. In the RMD case, certain benefits ("Pro-Rata reduction" benefits, which reduce in an at least pro-rata fashion when there is a distribution from the annuity account, and Return of Net Premium on death benefits) may, in certain circumstances, be disregarded in the valuation. (See the McKeever-Griffin article for details.)

The general safe harbor offered by Rev. Proc. 2006-13 is provided by a modification of the method under A-12 of §1.401(a)(9)-6 for RMDs. This safe harbor will be allowed at least until further guidance is issued. The modifications presumably reflect the differing purposes of the valuations. A-12 of §1.401(a)(9)-6 is for purposes of determining the amount of a required distribution, with the intent of liquidating the entire interest of the employee over the life expectancy of the employee (or, perhaps, of the employee and a designated beneficiary). On the other hand, Rev. Proc. 2006-13 seeks to determine the full fair market value for current taxation. RMD valuation treats favorably some benefits that reduce when distributions are made and ignores "sunk costs" such as front-end loads, where full fair market valuation would not do this. The modifications are:

1. Front-end loads and other non-recurring charges assessed in the 12 months preceding conversion must be added to the account value.

2. Future distributions are not to be assumed in determining the actuarial present value of additional benefits.

3. The exclusions under paragraphs (c)(1) and (c)(2) of A-12 (limited pro-rata reduction benefits and return of net premium on death benefits) are not to be taken into account.

Finally, a simplified safe harbor applies for conversions that occurred in 2005. In this case, modifications two and three above may be disregarded, but modification one must still be made.

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