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The Practice Management Minute...

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CFP®, CLU®, ChFC®, is the owner of CG Financial Group, one of the fastest growing annuity, life, and long term care IMOs in the industry. Gipple's passion is to fill the educational void left by the reduction of available training and prospecting programs that exist for agents today. Gipple is personally involved with guiding and mentoring CG Financial Group agents in areas such as conducting seminars, advanced sales concepts, case design, or even joint sales meetings. Gipple believes that agents don't need "product pitching," they need mentorship, technology, and somebody to pick up the phone…

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Converting A GLWB Annuity To A Roth: What Value Is Taxed?

With the hundreds of billions of dollars that are currently sitting in annuities that have guaranteed lifetime withdrawal benefits that are also IRA money, I think it's important that I point something out that many financial professionals are unaware of. It has to do with Roth IRA conversions. It also has to do with required minimum distributions.

Let's use an example and say that "John" rolled over $100,000 of IRA money into an annuity 10 years ago. That annuity has a GLWB benefit base that has grown to $200,000 because of the guaranteed roll ups. However, John's annuity contract value is only $120,000. If he were to trigger the GLWB this year, he could get around $15,000 per year, just as an example. Wouldn't it be a great concept if he could convert that IRA to a Roth IRA prior to taking that income that would later come in **tax free**? Before we answer that question, we should also ask the question, "**What value is it that he is taxed on when he converts the entire IRA to a Roth IRA**?"

Let's use an extreme—and slightly ridiculous—example. Extreme examples help demonstrate the point. Let's say the benefit base has grown to $1 million. And if John were to trigger the income after that 10th year, he would get $70,000 per year, even though his contract value was only $120,000. Wouldn't it be a fabulous idea if he can convert that entire traditional IRA into a Roth IRA and only be taxed on his $120,000 contract value, and then get $70k

per year tax-free? Of course, that would be a great idea. So great that the IRS has already addressed this with a rule back in 2006 that many people are unaware of. However, as Roth IRA conversions become more prominent, I believe many folks will become more aware of this. Since you are reading this article, you will **certainly** be aware of the "IRS Entire Interest Rule."

What is the answer?

So, let's get back to the question. What value is it that determines the amount that is taxable to John in the year that he makes the Roth IRA conversion? It is neither the contract value, nor the benefit base. **It is the "fair market value" of the annuity**. The fair market value equals the accumulation value plus the net present value of future additional benefits (GLWB income) on that annuity. The IRS has not given carriers much guidance on the actual calculation of the net present value other than that the carrier should abide by the "reasonableness standard." That fair market value is then put into a letter that the carrier will send your clients every year. It is usually called a "Fair Market Value Letter." Very original, I know.

If the Roth IRA scenario sounds kind of far out and that Charlie is just doing mental gymnastics for no reason, I promise you that you will come across it eventually. Either by the Roth IRA scenario I mentioned previously or the other two scenarios below:

1. *Required Minimum Distributions: That "fair market value" which is usually larger than the contract value is also what determines the required minimum distributions on a policy that has a GLWB! Not the contract value and not the benefit base. (Note: there are a couple of exceptions to the use of the "fair market value" rule. One such example is, if the present value of the additional benefit does not exceed the contract value by 20 percent or more, then it can be disregarded.)*
2. *"What the heck is this letter I received?" Eventually a client will call you up and say, "I got a fair market value statement in the mail and what does that mean?" They might be very happy because that fair market value statement will show a number larger than their current accumulation value.*

The scenario in bullet point #2 is likely what you will run into the most; your clients will get these letters. At the end of last year, a client of mine called in because he got a fair market value letter stating he had a fair market value of almost $230,000. He was ecstatic because the year before he put $185,000 of IRA money into his indexed annuity. He was surprised because the stock market had been horrible, and he didn't know how he received so much growth. I explained to him that the $230k value didn't apply to him yet because: 1. He will not be converting it anytime soon; and, 2. He is 10 years away from his first required minimum distribution. I also told him that the present value of the GLWB benefits must have been around $45,000 ($230k minus $185k).

The last thing I mentioned to him was that the $230,000 number is nothing to get excited about, just as we should not jump for joy when the county sends us a large "assessment value" on our house. The fair market value on an annuity and the assessment value on a house are very similar and for similar purposes. **Taxes**.

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