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Determining the Value of a Life Insurance Contract: Revenue Procedure 2005-25

by Christian DesRochers

Introduction

To most observers, the value of a life insurance contract is the cash surrender value. However, when it comes to life insurance and the Internal Revenue Code, things are seldom as simple as they appear on the surface. While the answer may still be it is the cash surrender value, recent guidance tempers that response.

In April, the IRS published Revenue Procedure 2005-25, providing guidance on determining the fair market value of a life insurance contract in the context of distributions from qualified pension plans. Under section 402(a), amounts distributed to a plan participant are taxable in the year in which they are paid to the employee. Regulations provide that the cash value of any retirement income, endowment or other life insurance contract is includible in gross income at the time of the distribution.[1] Typically, individuals who receive an insurance policy as a distribution from a qualified plan use the stated cash surrender value of the policy as its fair market value for purposes of determining the amount includible in their gross income.

Regulations under section 72 indicate that the reserve accumulation in a life insurance contract constitutes the source of and approximates the amount of such cash value.[2] Moreover, the IRS has noted that the use of the cash surrender value may not be appropriate where the policy reserves represent a much more accurate approximation of the fair market value of the policy than does the policy's stated cash surrender value. In recent years, the IRS has become increasingly concerned that neither the reserve nor the cash surrender value are the correct measure of the fair market value.

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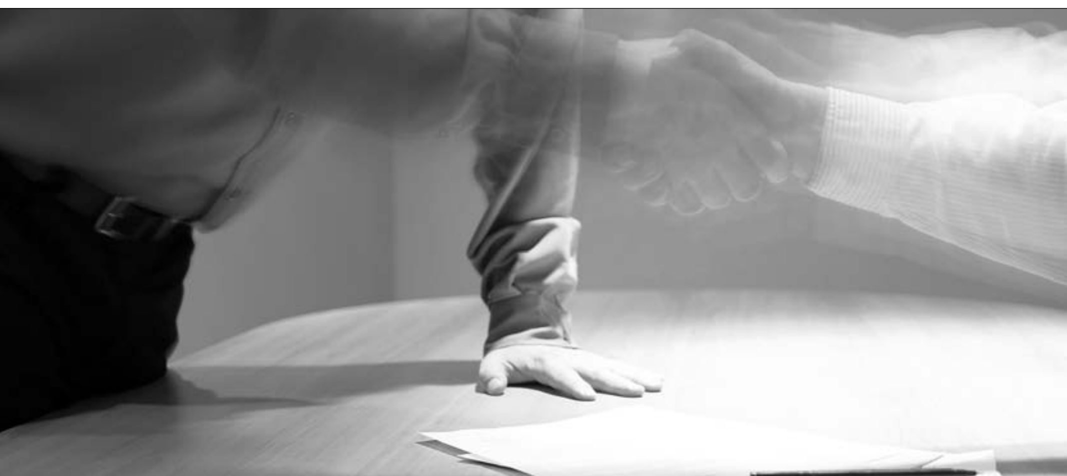
[1] Section 1.402(a)-1(a)(2).

[2] Section 1.72- 16(c)(2)(ii).



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The revenue procedures were issued in connection with proposed regulations under section 402(a) of the Code addressing the valuation of a life insurance contract distributed from a qualified retirement plan.[3] While the issue of the fair market value of a life insurance contract has been the subject of litigation and regulation over many years, Revenue Procedure 2005-25, and Revenue Procedure 2004-16, which it superseded, are the first attempts by the Service to introduce a formulaic approach to valuation.

Springing Cash Values

Revenue Procedures 2005-25 and 2004-16 are primarily intended to address the valuation of distributions from 412(i) pension plans, under which the plan assets are life insurance or annuity contracts. Of particular interest to the IRS was the springing cash value plan, a policy in which "for the first few years, the cash surrender value of the policy is much lower than the value of the premiums paid or the reserve accumulations."[4] In their news release accompanying the release of Revenue Procedure 2004-16 and the proposed regulations, the IRS noted that the "guidance targets specific abuses with section 412(i) plans."[5]

Some of the plans were marketed to sole proprietors and small business owners with the intention of distributing the life insurance policy out of the plan while the policy cash value was low. Noting that "when the policy was distributed, the policy's cash surrender value was reported as the amount of the distribution to the employee," the IRS was concerned that "participants might be seeking not to be taxed on the full value of the policy."[6] The methodology set forth in the revenue procedures is not limited to "springing cash values," nor is it limited to 412(i) plans, but broadly applies to all life insurance policies distributed from qualified plans. However, the effect of the guidance has been to eliminate the perceived abuse of valuing a life insurance policy at the cash surrender value "during the period the cash surrender value is depressed."[7]

Historical Valuation Issues

The question of whether the cash surrender value is the proper measure of the value of a life insurance policy is not a new one. More than 60 years ago, in a case involving the valuation of a gift, the United States Supreme Court said:

> "Surrender of a policy represents only one of the rights of the insured or beneficiary. The owner of a fully paid life insurance policy has more than the mere right to surrender it; he has the right to retain it for its investment virtues and to receive the face amount of the policy on the insured's death. That these latter rights are deemed to be valuable by purchasers of insurance to have substantial value are clear from the difference between the cost of a single premium policy and the immediate or early cash surrender value."[8]

The concept that the policy reserve may be a more appropriate value than the cash surrender value appears in a tax court case,[9] as well as a Revenue Ruling 59-195, which held:

> "Where an employer purchases and pays the premiums on an insurance policy on the life of one of its employees and subsequently sells such policy, on which further premiums must be paid, to the employee, the value of the

[3] Amendments to the regulations under section 402 were proposed on Feb. 13, 2004 (REG-126967-03, 2004-10 I.R.B. 566) to clarify that the fair market value standard controls when such a contract is distributed. While proposed regulations under sections 79 and 83 clarify that the amount includible in income under those sections is based upon the fair market value of the insurance contract rather than its cash value, the proposed regulations do not provide any guidance as to what constitutes fair market value. Thus, the methodology set forth in the revenue procedures applies to determinations under those sections as well.

[4] IRM 4.72.8.5.3 Springing Cash Value Life Insurance, See also Announcement 94-101, 1994-35 I.R.B. 53.

[5] Treasury and IRS Shut Down Abusive Life Insurance Policies in Retirement Plans IR-2004-21 Feb.13, 2004.

[6] IRM 4.72.8.5.3.

[7] IR-2004-21.

[8] *Guggenheim v. Rasquin*, 312 US 254 (February 3, 1941).

[9] *Charles Cutler Parsons v. Commissioner*, 16 T.C. 256 (January 31, 1951).

policy, for computing taxable gain to the employee in the year of purchase, is its interpolated terminal reserve value at the date of the sale, plus the proportionate part of any premium paid by the employer prior to the date of the sale which is applicable to a period subsequent to the date of the sale."[10]

> ... the IRS noted that "the life insurance reserves (if any) computed under section 807(d), together with any reserves for advance premiums, dividend accumulations, etc., represent a much more accurate approximation of the fair market value of the policy ...

Under section 807, in determining the taxable income of a life insurance company, the allowable reserve deduction is the greater of the net surrender value of the contract or the tax reserve, where the net surrender value is the cash value reduced by any surrender charge. The relationship between the cash surrender value and the federally prescribed reserve was applied in a different context in Notice 89-25,[11] posing the question of the amount "included in a plan participant's gross income when the participant receives a distribution from a qualified plan, that includes a policy issued by an insurance company, with a value substantially higher than the cash surrender value stated in the policy."

In response, the IRS noted that "the life insurance reserves (if any) computed under section 807(d), together with any reserves for advance premiums, dividend accumulations, etc., represent a much more accurate approximation of the fair market value of the policy than does the policy's stated cash surrender value."[12]

In its recent discussion of the proposed regulations under section 402(a), the Service commented that since Notice 89-25 was issued, life insurance contracts have been structured in a way that, for some period, neither the reserves nor the cash surrender value represent the fair market value of the contract, citing the example of a contract with a large surrender charge or other charges which are expected to be eliminated or reversed in the future. The IRS was conerned that if the contract is distributed prior to the elimination or reversal of those charges, both the cash surrender value and the reserve under the contract could significantly understate the fair market value of the contract, concluding that it would not be appropriate to use either the net surrender value (i.e., the contract's cash value after reduction for any surrender charges) or, because of the unusual nature of the contract, the contract's reserves to determine the fair market value of the contract.[13]

Revenue Procedure 2004-16[14]

In sympathy to the "many taxpayers [who] could have difficulty determining the fair market value of an insurance contract" in light of the IRS's comments that "Notice 89-25 should not be interpreted to provide that a contract's reserves are always an accurate representation of the contract's fair market value," the revenue procedure provides interim rules under which the cash value (without reduction for surrender charges) of a life insurance contract distributed from a qualified plan may be treated as the fair market value of that contract.

For a contract which is not a variable contract, the cash value (without reduction for surrender charges) may be treated as the fair market value of a contract as of a determination date, provided such cash value is at least as large as the aggregate of:

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[10] Rev. Ruling 59-195, 1959-1 C.B. 18.

[11] Notice 89-25, 1989-1 C.B. 662.

[12] Notice 89-25, 1989-1 C.B. 622, Question 10.

[13] REG-126967-03, 2/17/04.

[14] I.R.B. 2004-10.

- The premiums paid from the date of issue through the date of determination, plus
- Any amounts credited (or otherwise made available) to the policyholder with respect to those premiums, including interest, dividends and similar income items (whether under the contract or otherwise), minus
- Reasonable mortality charges and reasonable charges (other than mortality charges), but only if those charges are actually charged on or before the date of determination and are expected to be paid.

For a variable contract, (as defined in section 817(d)) cash value (without reduction for surrender charges) may be treated as the fair market value of the contract provided such cash value is at least as large as the aggregate of:

- The premiums paid from the date of issue through the date of determination, plus
- All adjustments made with respect to those premiums during that period (whether under the contract or otherwise) that reflect investment return and the current market value of segregated asset accounts, minus
- Reasonable mortality charges and reasonable charges (other than mortality charges), but only if those charges are actually charged on or before the date of determination and are expected to be paid.

Revenue Procedure 2004-16 was effective on Feb. 13, 2004.

Revenue Procedure 2005-25[15]

To show that no good deed goes unpunished, the IRS received comments that the formulas in Rev. Proc. 2004-16 did not work well for certain types of traditional life insurance policies. Among the concerns raised were the potential for double-counting of policyholder dividends, the lack of adjustment for surrender charges and the non-recognition of withdrawals or distributions in the formulas. This led to the issuance of Revenue Procedure 2005-25, which supersedes Revenue Procedure 2004-16. It introduces the concept of a PERC amount, and provides an anti-abuse provision, warning that "the formulas set forth in . . . this revenue procedure must be interpreted in a reasonable manner, consistent with the purpose of identifying the fair market value of a contract."

The safe harbor for non-variable contracts defines that the fair market value of an insurance contract, retirement income contract, endowment contract, or other contract providing life insurance protection may be measured as the greater of:

- The sum of the interpolated terminal reserve and any unearned premiums plus a *pro rata* portion of a reasonable estimate of dividends expected to be paid for that policy year based on company experience, and
- The product of the PERC amount and the applicable Average Surrender Factor.

The PERC amount is the aggregate of:

1. The premiums paid from the date of issue through the valuation date without reduction for dividends that offset those premiums, plus
2. Dividends applied to purchase paid-up insurance prior to the valuation date, plus
3. Any amounts credited (or otherwise made available) to the policyholder with respect to premiums, including interest and similar income items (whether credited or made available under the contract or to some other account), but not including dividends used to offset premiums and dividends used to purchase paid up insurance, minus
4. Explicit or implicit reasonable mortality charges and reasonable charges (other than mortality charges), but only if those charges are actually charged on or before the valuation date and those charges are not expected to be refunded, rebated or otherwise reversed at a later date, minus
5. Any distributions (including distributions of dividends and dividends held on account), withdrawals, or partial surrenders taken prior to the valuation date.

[15] I.R.B. 2005-17.

For variable contracts, the fair market value may be measured as the greater of:

- The sum of the interpolated terminal reserve and any unearned premiums plus a pro rata portion of a reasonable estimate of dividends expected to be paid for that policy year based on company experience, and
- The product of the variable PERC amount and the applicable Average Surrender Factor.

A surrender charge is permitted to be taken into account only if it is contractually specified at issuance and expressed in the form of nonincreasing percentages or amounts.

The variable PERC amount is the aggregate of:

1. The premiums paid from the date of issue through the valuation date without reduction for dividends that offset those premiums, plus
2. Dividends applied to increase the value of the contract (including dividends used to purchase paid-up insurance) prior to the valuation date, plus or minus
3. All adjustments (whether credited or made available under the contract or to some other account) that reflect the investment return and the market value of segregated asset accounts, minus
4. Explicit or implicit reasonable mortality charges and reasonable charges (other than mortality charges), but only if those charges are actually charged on or before the valuation date and those charges are not expected to be refunded, rebated or otherwise reversed at a later date, minus
5. Any distributions (including distributions of dividends and dividends held on account), withdrawals, or partial surrenders taken prior to the valuation date.

The Average Surrender Factor for purposes of sections 79, 83 and 402(b) (for which no adjustment for potential surrender charges is permitted) is 1.00. In the case of a distribution or sale from a qualified plan, if the contract provides for explicit surrender charges, the Average Surrender Factor is the unweighted average of the applicable surrender factors over the 10 years beginning with the policy year of the distribution or sale. For this purpose, the applicable surrender factor for a policy year is equal to the greater of:

- 0.70, and
- A fraction, the numerator of which is the projected amount of cash that would be available if the policy were surrendered on the first day of the policy year (or, in the case of the policy year of the distribution or sale, the amount of cash that was actually available on the first day of that policy year) and the denominator of which is the projected (or actual) PERC amount as of that same date.

The applicable surrender factor for a year in which there is no surrender charge is 1.00. A surrender charge is permitted to be taken into account only if it is contractually specified at issuance and expressed in the form of nonincreasing percentages or amounts.

The revenue procedure clarifies that dividends held on deposit with respect to an insurance contract are not included in the fair market value of the contract. However, such dividends are taxable income to the employee or service provider at the time the rights to those dividends are transferred to that individual. It also addresses the treatment of policy loans, noting that, if a loan (including a loan secured by the cash value of a life insurance contract) is made to an employee to the extent the debt is terminated upon distribution or transfer of the collateral, the terminated loan or debt amount constitutes an additional distribution to the employee or service provider at that time.

Revenue Procedure 2005-25 applies to distributions, sales and other transfers made on or after Feb. 13, 2004. However, for periods before May 1, 2005, taxpayers may rely on the safe harbors of this revenue procedure and for periods on or after Feb. 13, 2004, and before May 1, 2005, taxpayers may also rely on the safe harbors in Revenue Procedure 2004-16. ◂

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