WEALTH MANAGEMENT:

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POLICY VALUATIONS - NO EASY ANSWERS

A recent Tax Court decision once again highlights the importance and difficulty of valuing life insurance policies for tax purposes.

WHAT IS "FAIR MARKET VALUE"

Determining a policy's fair market value ("**FMV**") for federal tax purposes has become significantly more complicated with the development of new products and the life settlement market, coupled with the use of life insurance in a variety of innovative planning techniques and the lack of IRS guidance regarding appropriate valuation standards. The complexity is best illustrated by the "simple" planning case of a gift of a life insurance policy.

In most cases, the gift tax FMV of an existing policy is its interpolated terminal reserve value plus unapplied premiums ("**adjusted ITR**"). A client making a gift of such a policy requests a Form 712 from the carrier, on which the carrier reports the policy's adjusted ITR value. That Form 712 would be attached to any required federal gift tax return to report the policy's value. In the past, there were generally few issues with the policy valuation provided. Now, however, carriers may provide multiple values in response to a gift tax valuation request, which can vary significantly.

For example, a recent valuation request regarding a $10 million universal life policy yielded two carrier-provided values: an adjusted ITR of $158,500 and an alternate "PERC" value $232,700 (derived from a formula based on based on premiums, earnings, and reasonable charges, multiplied by an average surrender factor). The difference of $74,200 certainly is not insubstantial from the client's perspective. Probably even more surprising are the potential valuation disparities regarding term policies. An initial valuation request regarding a gift of a $2 million, 10-year level term policy returned a value of over $36,000, apparently based on the statutory reserve. A discussion with the carrier clarifying the purposes of the valuation resulted in a final value of $1,800, based on a correctly calculated adjusted ITR.

As evidenced by these examples and the case below, policy valuations may vary considerably depending on the tax purpose for the valuation and the product involved.

LOWE V. COMMISSIONER

The *Lowe* case involves the valuation of a life insurance policy distributed from a nonexempt employee trust to an employee. In 2002, the taxpayer's company established a welfare benefit plan under Code Sections 419 and 419(A), using a trust funded with a variable universal life ("**VUL**") insurance policy insuring the taxpayer. In

2003, the company terminated the plan, resulting in distribution of the policy to the taxpayer. At distribution, the accumulated cash value of the policy was $140,901, and its cash surrender value was $0. The taxpayer did not report any income from the policy distribution on his 2003 return.

The IRS took the position that the taxpayer had unreported income equal to $140,901 (the policy's accumulated cash value), based on the application of Code §§402(b)(2) and 72. Under Code §402(b)(2), "the amount actually distributed" by a nonexempt employee trust is taxable to the distributee, as provided in Code §72. Code §72(e) generally provides that any nonannuity amount received under a life insurance contract before the annuity starting date is includable in gross income to the extent it exceeds the excess of "the cash value of the contract (determined *without regard to any surrender charges*)" reduced by the taxpayer's "investment in the contract" (*e.g.,* premiums and other consideration paid). In this case, the policy cash value was $140,901, and the taxpayer's investment in the contract was $0, because the taxpayer did not pay any consideration for the policy.

Although the Tax Court agreed that Code §402(b) applied to tax distributions from nonexempt employee trusts, it disagreed with the taxable policy value of $140,901. The Tax Court stated that Code §72 does not determine the "amount actually distributed" for purposes of Code §402(b), but only determines how much of that amount is taxable. The Regulations under Code §402(b)(2) indicate that the amount actually distributed is the "entire value" of the contract, not the "entire cash value" of the contract (which applies to a distribution of a policy from a *qualified* plan under Code §402(a)). Accordingly, the Lowe court concluded that while the "entire cash value" of a life insurance policy is determined without regard to surrender charges, the "entire value" of a life insurance policy is determined by its fair market value ("**FMV**"), which *may include surrender charges*.

Following its earlier decision in *Schwab v. Commissioner* (Feb. 2011), a similar case involving the distributions of VUL policies from a multi-employer nonexempt welfare benefit trust, the *Lowe* court rejected the proposition that surrender charges should never count, instead reading Code §402(b) to require a court to consider the payment of surrender charges as part of a more general inquiry into a policy's FMV.

THE BIGGER PICTURE

Lowe clearly illustrates the complexity associated with the valuation of modern life insurance products, which has created significant uncertainty and led to challenges and disputes. Advisors must be able to identify the factors that will impact policy valuations, including the purpose of the valuation, the applicable valuation standard, if any, specified by the Code, Regulations or IRS guidance, the carrier that issued the product, and the type of product being valued, or have their clients endure the unexpected.

Purposes and Standards

The purpose for ascertaining the FMV of a life insurance policy will impact the valuation standard used. Where a value is required for estate and gift tax purposes, Regulations specifically provide that the FMV of the policy is the actual cost of a comparable contract, or if the policy has been in force for some time and calls for further premiums, the policy's interpolated terminal reserve value plus unapplied premiums ("**adjusted ITR**"). The Regulations state, however, that if the adjusted ITR does not provide an amount reasonably close to the full value of the policy, due to the policy's unusual nature, that value may not be used.

Generally, the standards for determining the FMV of a policy for income tax purposes are the same as those for estate and gift tax purposes. The IRS, however, has issued Rev. Proc. 2005-25, which provides certain valuation safe harbors for policies distributed from qualified plans. Unlike the estate and gift tax rules, Rev. Proc 2005-25 provides that a

policy's FMV generally equals the *greater* of: (1) the policy's adjusted ITR, and (2) the PERC value. The IRS has not provided similar guidance with regard to the distributions of policies from nonqualified trusts. Accordingly, cases such as *Lowe* set the valuation standards for such policies, including allowing the use of surrender charges to reduce the value of a distributed policy.

Note that the growth of the life settlement market may also impact the FMV determination for certain "marketable" life insurance policies (*e.g.,* those on older or chronically ill individuals). In these cases, there may be a significant disparity between the price a seller could obtain for a policy on the secondary market and the value of a policy as determined by applying the valuation standard under federal gift, estate and income tax principles. Thus, the emergence of the secondary life insurance market may impact the valuation standards developed by the IRS for transactions involving the gift or sale of such policies.

Products & Carriers

The relatively recent development of universal life (UL), VUL, no-lapse guarantee universal life (NLGUL) and other interest rate-sensitive life contracts has made the valuation of these products extremely difficult, given the limited and outdated valuation guidance provided by the Code, Regulations and IRS releases. The reserve values associated with these newer products are not subject to interpolation, as required by the adjusted ITR standard. Thus, due to the "unusual nature" of these contracts, an adjusted ITR value may not be available or respected.

In addition, several different types of reserve values now exist, including tax reserves (reported on a carrier's federal tax return); statutory reserves (required by state insurance departments); and, for policies with secondary guarantees, AG 38 reserves (for NLGUL policies, typically higher than tax or statutory reserves due to long-term guarantees); and deficiency reserves (excess of minimum reserves over the AG 38 basic reserves). Without specific guidance, carriers must select the reserve value to apply, which can dramatically alter their FMV determinations. Thus, policy values may vary significantly depending on the type of product (*e.g.,* UL, NLGUL) and the reserve value and valuation method applied by the carrier. Even similar products may have dramatically different values if issued by different carriers.

PRACTICAL CONSIDERATIONS

Given the uncertainty surrounding policy valuations for tax purposes, advisors should understand that requesting policy values is no longer a simple formality. Depending on the case, significant leg-work may be required to obtain a proper valuation for the client's tax planning purposes. Accordingly, advisors should consider the following when requesting policy value from carriers:

- Understand the purpose for the valuation (qualified plan distribution, gift, sale to the insured's grantor trust, etc.) and clearly communicate it to the carrier.
- Inquire as to the carrier's valuation methodology (*e.g.,* the reserve value used, the valuation standard applied, etc.). Ask what the other reserve values are, and review whether they are higher or lower than the one used.
- Obtain a preliminary value from the carrier prior to the issuance of any formal valuation or Form 712. This initial value will allow you to get a sense of how the carrier applies its methodology and whether the value is in an acceptable range without being locked into a final number.
- Work with the carrier's advanced sales or legal department to adjust preliminary valuations that appear inaccurate for the purpose or do not comply with the applicable tax standard. For example, some carriers may issue an adjusted PERC value in a gift case where the adjusted ITR standard should apply.

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