Life Insurance Valuation and Policy Transfers

Whether an existing life insurance policy is transferred by gift, sale or as some form of compensation, it is important to provide an accurate valuation of the policy in order to determine the income, gift, generation-skipping transfer (GST) or estate tax consequences of the transfer.

When valuing a life insurance policy, a number of factors must be considered, including the type of transaction, type of policy, how long the policy has been in force, whether the policy has ongoing premiums and whether there has been a change in health of the insured(s) since issue.

This white paper will provide an overview of the current state of policy valuation for income, gift and estate tax purposes. Every client should rely on his/her own qualified tax advisor for a determination as to the appropriate reportable fair market value of any policy transfer.

Fair Market Value

The general rule for valuing property is that the proper value of the property is its "fair market value" (FMV).[1] For most types of property, that FMV is "the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of the relevant facts."[2] However, the FMV of a life insurance policy depends on the context of the transaction. The IRS has promulgated various rules for determining policy value depending on whether the valuation is for income or transfer taxes and whether the policy is new or pre-existing, as well as the type of policy involved. The issue is that these rules apply a different valuation method, depending on the type of transfer involved. This lack of consistency makes it challenging to determine what the actual FMV of the policy is, particularly if the transfer is not one covered by a specific rule.

When requesting a policy valuation from an insurance carrier, advisors should be cognizant that the IRS' multiple valuation rules allow the carrier to employ a variety of methods for valuing a life insurance contract. When an insurance company responds to a request for a valuation of the policy for gift and estate tax purposes, it provides a Form 712 ("Life Insurance Statement") as supporting documentation for an estate or gift tax return; the requestor should be aware that Form 712 does not allow the insurance carrier any discretion as to the method of valuation. Form 712 requires the insurance company to provide a calculation of the policy's interpolated terminal reserve (ITR) value, and the insurance company is required to provide a copy of the Form 712 to the IRS. Where the transaction involves a new policy, a single premium or paid-up policy, or a policy recently acquired in a Section 1035 exchange, it is up to the tax return preparer to follow IRS regulations and determine if the value for the gift tax return (IRS Form 709) may be based on the policy's purchase price.

When the existing policy is a whole life contract with ongoing premiums, the reserve value at the next anniversary is known, and the terminal reserve value may then be interpolated to reflect a value prior to the next anniversary. An annual renewable term (ART) policy has no reserve value. The value of an ART policy is the unearned premium to the next anniversary. Where the transaction does not involve an existing whole life or ART policy, the Form 712 ITR value provided will likely not reflect the applicable IRS rule or regulation, because the Form 712 does not include unearned premium.

ITR is at the crux of the issue on how to value life insurance policies. Insurance carriers are required to reserve assets to meet their future contractual obligations. The type of policy being reserved for can impact the amount that the carrier has to set aside as a reserve, for example, guaranteed level term policies are supported by reserves, often making their value significantly greater than the remaining unearned premium.

The valuation of reserve values is further complicated by the manner in which different carriers calculate their reserve values:

- **Tax reserve** – The reserve value used by a carrier on its corporate income tax return
- **Statutory reserve** – The reserve value required to be filed on a carrier's financial statements with the state insurance regulator
- **A.G. 38 reserve** – The reserve value used to value policies with a secondary no-lapse guarantee (e.g., no-lapse guarantee UL). This method's reserve value is generally higher than either the tax or statutory reserve, due to the long-term death benefit guarantees.
- **Minimum deficiency reserve** – Sometimes used by carriers to calculate their A.G. 38 reserve, this method generates even greater reserves.

Income Taxable Transfers

When property is transferred from an employer to an employee in conjunction with the performance of services, the employee must recognize as ordinary income the amount by which the fair market value of the property exceeds the amount, if any, the employee has paid for the property.[3] Similarly, when a life insurance policy held in a qualified retirement plan is distributed to the participant, "the fair market value of the contract at the time of distribution must be included in the distributee's income in accordance with the provisions of Section 402(a)."[4]

Transfers of property in the employment context have been governed by IRC Section 83 since June 30, 1969. For transfers prior to Feb. 13, 2004, the valuation of life insurance was based on its cash surrender value:

> "In the case of a transfer of a life insurance contract, retirement income contract, endowment contract, or other contract providing life insurance protection, only the cash surrender value of the contract is considered to be property."[5]

As life insurance products evolved, this FMV definition for life insurance contracts became subject to manipulation and abuse. Insurance companies delivered life insurance products that were designed to suppress cash values in the early years, returning to normal cash values, often referred to as "springing cash values," several years into the contract. A transfer of the policies to the employee was usually planned during the years in which the policy cash value was suppressed, allowing employees to purchase or receive distribution of policies from qualified plans and nonqualified employee's trusts for significantly less than premiums paid. Later, the policy cash values returned and were available to the policyowner without appropriate economic recognition.

In 2005, the Treasury Department issued final regulations regarding the valuation of a life insurance policy when it is transferred from a qualified plan to a participant, from an employer to an employee, or for taxation of permanent benefits under a group term life insurance plan.[6]

The IRS also issued Revenue Procedure 2005-25, which provides two safe-harbor formulas for determining the FMV of a life insurance policy, retirement-income contract, endowment contract or other contract providing life insurance protection for purposes of applying the rules of IRC Sections 402, 79 and 83(a). Under Rev. Proc. 2005-25, the FMV safe harbor for a non-variable life insurance contract is the greater of:

- ITR, or
- PERC (Premiums plus Earnings minus Reasonable Charges) times the Average Surrender Factor (for which the IRS supplies a formula)

Determining ITR Value

  Interpolated terminal reserve

\+ Unearned premiums

\+ Reasonable estimate of dividends expected to be paid for the policy year based on company experience

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= ITR for valuation purposes

Determining PERC

  Premiums paid from date of issue

\+ All earnings (for variable policies includes "all adjustments…that reflect the investment return and market value of segregated asset accounts")[7]

\- Reasonable charges, equal to the sum of:

- Reasonable mortality charges and charges actually charged, plus any distributions, withdrawals or partial surrenders

x Average surrender factor, which for everything other than qualified plans is 1 (i.e., no adjustment or discount for potential surrender charges is permitted), but for qualified plans is the greater of:

- 0.70 (i.e., the maximum discount for potential surrender charges is 30%), or
- A fraction, the numerator of which is the projected amount of cash that would be available if the policy were surrendered the first day of the policy year or, for the policy year of the distribution or sale, the amount of cash that was actually available on the first day of that policy year, with the denominator being the projected (or actual) PERC amount as of the same date.

= PERC

Other Circumstances

Does the ITR or PERC methodology properly reflect the value of a policy for income tax purposes where: (1) the health of the insured has deteriorated since issue, resulting in a reduced life expectancy or (2) the policy includes additional features such as no-lapse guarantees? The rules for income tax valuation appear to allow use of the PERC calculation even in these circumstances. The IRS, in Rev. Proc. 2005-25, offers the PERC method of valuation as a "safe harbor" formula. Thus, it would appear that as long as the transfer in question is one that falls under IRC Sections 79, 83 or 402, then the taxpayer may rely on the values produced by the PERC calculation as sufficient for income tax purposes.

The following table summarizes the appropriate values to use when valuing a life insurance policy for income tax purposes:

Income Tax Valuations	
New Policies/§ 1035 Exchanges	Purchase price of the policy (Guggenheim v. Rasquin, 312 US 254 (1941))
Transfer or Distribution from a Qualified Retirement Plan (IRC § 402(a))	**Greater** of ITR or PERC amount multiplied by the Average Surrender Factor (Rev. Proc. 2005-25, Treas. Reg. § 1.402(a)-1)
Transfer in Connection with Performance of Services (IRC § 83)	**Greater** of ITR or PERC amount (Rev. Proc. 2005-25, Treas. Reg. § 1.83-3)
Permanent Benefits in Conjunction with a Group-term Plan (IRC § 79)	**Greater** of ITR or PERC amount (Rev. Proc. 2005-25, Treas. Reg. § 1.79-1)
Sale of Policy to Employee	**No definitive rule** Depending on circumstances, may want to use ITR, PERC or value of paid-up policy based on then-existing cash surrender value (See, *Schwab v. Commissioner*, 136 TC 6 (2011))

Estate and Gift Taxable Transfers

The basic principles for life insurance valuation as promulgated by the IRS in the estate and gift tax regulations are:

> "The value of a life insurance contract or of a contract for the payment of an annuity issued by a company regularly engaged in the selling of contracts of that character is established through the sale of the particular contract by the company, or through the sale by the company of comparable contracts. As valuation of an insurance policy through sale of comparable contracts is not readily ascertainable when the gift is of a contract which has been in force for some time and on which further premium payments are to be made, the value may be approximated by adding to the interpolated terminal reserve at the date of the gift the proportionate part of the gross premium last paid before the date of the gift which covers the period extending beyond that date. If, however, because of the unusual nature of the contract such approximation is not reasonably close to the full value, this method may not be used."[8]

For transfer tax purposes, the gift tax value of a policy depends on the timing of the gift and whether additional premiums are due on the policy.

New Policies

In the case of new policies that are transferred shortly after purchase and on which additional premiums are due, the value of the policy is the price paid for the policy.[9]

> **Example:** For the benefit of another, a donor purchases from a life insurance company a life insurance contract or a contract for the payment of an annuity. The value of the gift is the cost of the contract.[10]

The "new policies" rule should also apply where a life insurance policy is acquired in a Section 1035 exchange. Here the FMV is determined by the price the insurance company would charge for the contract.[11]

Existing Single Premium or Paid-up Policies

The regulations look to the replacement cost of life insurance contracts as of the date of transfer when establishing the value of a single premium policy or a policy on which no further premium payments are due.[12] Replacement cost is the cost of a single premium policy of the same face amount on the life of a person of the same age as the insured as of the date of transfer.[13]

> **Example:** A donor, owning a life insurance policy on which no further payments are to be made to the company (e.g., a single premium or paid-up policy), makes a gift of the contract. The value of the gift is the amount that the company would charge for a single premium contract of the same specified amount on the life of a person of the age of the insured.[14]

Because the FMV of the policy is based on the purchase price for a similar policy, the insured's existing health could have a significant impact on the policy's FMV. If the insured has had a change of health, the purchase price of a replacement policy could be significant, which would drive up the FMV of the existing life insurance policy.

Existing "Whole Life" or "Permanent" Policies on Which Additional Premiums Are Due

For "permanent" (or "whole life") policies that have been "in force for some time and on which further premium payments are to be made," valuation is based on the "interpolated terminal reserve" of the policy at the date of the gift plus a proportionate share of the premium last paid that covers the period extending beyond the date of the gift transfer, so long as this provides an approximation of the policy's "full value."[15] In other words, the value of the policy at the time of transfer is the policy's ITR plus unearned premiums.

Example: A gift is made four months after the last premium due date of an ordinary life insurance policy issued nine years and four months prior to the gift thereof by the insured, who was 35 years of age at date of issue. The gross annual premium is $2,811. The computation follows:

Terminal reserve at the end of 10th year	$ 14,601.00
Terminal reserve at the end of ninth year	12,965.00
Increase	**1,636.00**
One-third of such increase (the gift having been made four months following the last preceding premium due date) is	545.33
Terminal reserve at end of ninth year	12,965.00
Interpolated terminal reserve at date of gift	**13,510.33**
Two-thirds of gross premium ($2,811)	1,874.00
Value of the gift	**15,384.33**[16]

Existing Policies: Other Types of Contracts

The regulations adopting the interpolated terminal reserve method of policy valuation were enacted in 1963, at a time when the only types of life insurance policies available were whole life and annual renewable term.[17] Whole life, or "ordinary life," insurance is a permanent product wherein the policyowner pays level premiums for life or until the policy accumulates a reserve or cash value that equals the face amount of the policy, i.e., until it endows. The interpolated terminal reserve calculation provides an appropriate measure of policy value based on the design of whole life policies.

However, there is some question as to whether the interpolated terminal reserve method of policy valuation is appropriate for newer types of life insurance contracts. Such a possibility may have been foreshadowed by the regulations, which state: "If, however, because of the unusual nature of the contract such an approximation is not reasonably close to the full value of the contract, this method may not be used."[18] While the original intent of this provision is unclear, its inclusion in the transfer tax regulations may have application today to life insurance contracts that are not term or whole life contracts. This is because UL, VUL, IUL and no-lapse guarantee (NLG) life insurance contracts are not subject to the terminal reserve concept, which is unique to whole life contracts. Given that feature, some practitioners argue that these types of contracts should be considered "unusual" and thus not subject to the ITR plus unearned premium standard of the gift tax regulations. On the other hand, there are practitioners who argue that, because UL, VUL, IUL and NLG contracts are the most common types of contract, and life insurance carriers can approximate the ITR calculation, the gift tax regulations can still be used to value UL, VUL, IUL and NLG contracts.

The question remains whether this statement should be applied to some or all of the various types of life insurance contracts that have been developed since the regulations were first issued:

Universal life – First introduced in 1979, UL insurance introduced flexible premiums and cash values that can increase based on policy crediting rates greater than the policy's guaranteed interest rate. The combination of these two factors offers the possibility that the policyowner may not have to pay the original planned level of premium for the entire life of the contract. The policyowner has the option to select between having the death benefit structured as a level or increasing death benefit. Additionally, universal life insurance allows partial withdrawal of cash values without requiring a policy loan.[19]

Guaranteed death benefits – A more recent development for life insurance products is the addition of a "no-lapse guarantee" or a "guaranteed death benefit." This feature was designed to combat the problem of policy termination due to poor policy performance (i.e., a UL policy where the actual credited interest rates fall below illustrated crediting rates). A guaranteed death benefit product generally promises that the policy death benefit will remain in force for a certain term or the life of the insured so long as a specified premium is paid on time. This coverage is guaranteed regardless of the interest rates actually credited for UL policies. The guarantee is based on the financial strength and claims paying ability of the issuing insurance company.

Each of these newer life insurance product types offers features that add additional value to the contract. The question becomes whether the interpolated terminal reserve method of calculation provides an adequate valuation for the various types of life insurance products developed since the regulations were first adopted. As discussed in Income Taxable Transfers, the IRS adopted a new methodology for valuing life insurance contracts in employment and employee benefit settings.[20] To date, the IRS has not issued any similar guidance for valuing policies for estate and gift tax purposes.

There is a strong argument to be made that policy valuations for estate and gift tax purposes should follow the guidance the IRS has given for income tax situations. First, the regulations themselves anticipate situations in which contracts cannot be valued using the interpolated terminal reserve method. Second, the new guidance from the IRS on the income tax side is directed at the greater variety of life insurance products available in the market today. And third, the IRS has shown interest in the past in achieving consistency in valuations of life insurance for both income tax and transfer tax purposes.[21]

On the other hand, there is an equally strong argument to be made that policies for gift and estate tax purposes should continue to be valued under the gift tax regulations. The IRS used ITR value as a guide in the gift tax regulations as well as in the income tax situations. The release of Rev. Proc. 2005-25 clearly indicates that the IRS is aware of changes to life insurance policies, but to date, the IRS has chosen not to change the gift tax regulations to match the valuation rules proscribed by Rev. Proc. 2005-25 for income tax situations.

Given the conflict between the IRS' rulings for gift and estate taxes and the rulings for income taxes, practitioners could find themselves in a situation in which they have a different value for the same life insurance policy, just based on the tax regime that applies to a particular situation. In that context, practitioners providing valuations of life insurance policies for gift or estate tax purposes may want to consider which guidance they follow, with the ultimate goal of avoiding two different fair market values for the same life insurance policy.

Existing Policies: Other Circumstances — Insured No Longer Insurable

The interpolated terminal reserve method of policy valuation may not adequately reflect a policy's full value where it is not a whole life or term policy.[22] Where an insured's health has deteriorated and his/her life expectancy is considerably less than for others of the same age, the life insurance policy may be seen as irreplaceable, and the standard rules of valuation would not apply.

The leading case involving such a policy is *Estate of Pritchard v. Commissioner*.[23] In that case, the insured, who had been diagnosed with cancer, sold his policy for its cash surrender value 30 days before his date of death. The gift was thus in contemplation of death, and the Tax Court held that the known imminent approach of death affected the value of the policy, so that the transfer was not for adequate and full consideration.[24]

Given that the leading case in this context does predate the gift tax regulations as well as the recent rulings for income taxes, many practitioners try to obtain a value from the life insurance settlement market. They approach a life insurance settlement company with the hope that this third party could provide a value for the life insurance policy under the willing buyer/willing seller method of asset valuation. And while this is a defensible idea in theory, in many cases, even though the insured has had a change in health and is no longer insurable, there is not a market for the policy. This does not mean that the life insurance policy has no value—far from it. It just means that the policy does not currently fit into the settlement company's book of assets.

This should leave practitioners asking themselves, what would someone pay for a life insurance policy on an individual who can no longer buy one? This brings the practitioner back to the discussion in *Estate of Pritchard* and the provision in the gift tax regulations that ITR plus unearned premium is not available for valuing life insurance policies due to their "unusual nature." A one-of-a-kind item should be considered "unusual" and should be valued accordingly.

Thus, where the insured's health is such that there is a significantly diminished life expectancy, valuation of the policy must account for the likelihood of mortality. Where an insured's health is so impaired that s/he is no longer insurable, the policy should be valued at an amount significantly higher than would be produced by using the interpolated terminal reserve calculation.

The following table summarizes the appropriate values to use when valuing a life insurance policy for estate and gift tax purposes:

Estate and Gift Tax Valuations	
New Policy/§ 1035 Exchange	Purchase price of policy (Treas. Reg. § 25.2512-6(a), Example (1))
Existing Single Premium or Paid-up Policy	Purchase price of a new single premium policy for the same death benefit for person of insured's attained age (Treas. Reg. § 25.2512-6(a), Example (3))
Existing Term	**No definitive rule** May want to consider using unearned premium (See, Schwab v. Commissioner 136 TC 6 (2011))
Existing Return of Premium Term	**No definitive rule** (Treas. Reg. § 25.2512-6(a) indicates that the ITR is the proper measure so long as this represents the policy's "full value." Depending on circumstances, may wish to consider using either: a. Cash surrender value, or b. ITR plus unearned premium)
Existing Whole Life with Future Premiums Due	ITR plus unearned premium (Treas. Reg. § 25.2512-6(a), Example (4))
Existing UL, VUL and Other Policies	**No definitive rule** (Treas. Reg. § 25.2512-6(a) indicates that the ITR is the proper measure so long as this represents the policy's "full value." May want to consider the greater of: a. ITR plus unearned premium, or b. PERC)
Shortened Life Expectancy or Insured No Longer Insurable	Seek professional policy appraisal based on reduced life expectancy. (Estate of Pritchard v. Commissioner, 4 TC 204 (1944))

Other Considerations

Transfer of Ownership to an Irrevocable Trust

The potential tax consequences of transferring a policy to an irrevocable trust will depend on whether the transfer is characterized as a sale or a gift. If the policyowner makes a gratuitous transfer of a policy to a trust, the transfer could be subject to gift tax.[25] Only gifts of present interest are eligible for the annual exclusion. Assuming the trust language allows beneficiary access to trust principal via Crummey powers, only the FMV of the policy in excess of available annual exclusion(s) would be subject to gift tax. The donor(s) may use all or a portion of their available lifetime gift tax exemption in order to minimize or eliminate the out-of-pocket gift tax liability associated with the gift to the trust. Additionally, should the donor/insured(s) die within the three-year period following the date of the gift, the death benefit will be included in the donor's taxable estate and may be subject to estate tax.[26]

Where the policyowner receives valuable consideration in exchange for the policy, the transfer will be characterized as a sale. The sale of a policy is subject to the transfer-for-value rule, which subjects the death benefit to ordinary income tax to the extent that the death benefit exceeds the consideration paid and any subsequent premiums paid by the new owner.[27]

Transfer-for-Value

Where a transfer for valuable consideration falls under one of the following safe harbor exceptions to the transfer-for-value rule, the death benefit will continue to be federally income tax-free. The transfer for valuation consideration exceptions include a transfer to

- The insured;
- A trust that is a defective grantor trust as to the insured;[28]
- A partner of the insured, including members of a limited liability company taxed as a partnership;[29]
- A partnership of which the insured is a partner;
- A corporation of which the insured is a shareholder or officer; or
- A transfer in which the basis in the hands of the transferee is determined in whole or in part by the basis in the hands of the transferor.

Other Transfer-for-Value Considerations

A sale of a policy owned by a trust to another trust will not be treated as a transfer-for-value if the purchasing trust is treated as owned for income tax purposes by the insured.[30] Additionally, a sale of a survivorship policy from a trust to a trust that is deemed owned for income tax purposes by one of the insured spouses should not be treated as a transfer-for-value.[31]

A company-owned life insurance policy transferred to a corporation in a tax-free reorganization would fall under an exception if the insured is a shareholder or officer in the corporation. Even if the insured were not a shareholder or officer in the corporation, the transfer would not be subject to the transfer-for-value rule if it was transferred as part of a general tax-free transfer, for example, statutory merger, consolidation or transfer of nearly all of the property of one corporation solely in exchange for the voting stock of another corporation.

Gift to a Not-for-Profit Organization

The gift of an existing life insurance policy can benefit the charitable organization as well as provide the donor with a charitable income tax deduction. Both the charitable gift tax and charitable income tax regulations define the FMV of property in the same manner: “the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of the relevant facts.”[32] For the gift of a new policy (in the first year), the deduction is generally the initial premium paid. For a policy that has been in force for a longer period, the deduction is generally determined as the lesser of the donor’s cost basis or the fair market value.[33] Keep in mind that Revenue Ruling 2009-13 required the taxpayer to reduce his or her basis in a life insurance contract for the “pure insurance” portion of the life insurance policy. This pure insurance portion is generally known as the “cost of insurance,” and reducing the basis in the contract for the cost of insurance could ultimately result in a lower charitable income tax deduction. Any future cash gifts made to the charity to pay premiums are eligible for the charitable income tax deduction in the year made.[34]

Substantiation

Where a gift to a charity has a value of $250 or more, whether of cash or property, the IRS requires the donor to have a contemporaneous written acknowledgment from the charity showing:

a. The amount of cash given and a description (but not the value) of any property donated, and

b. Whether the organization provided any goods or services in return for the donor’s contribution. If goods or services were received, a description and estimate of the value must be included.

An acknowledgment is considered to be contemporaneous if the taxpayer obtains the acknowledgment on or before the earlier of the dates he files a return or the date the return is due (including extensions).[35]

Where the value of the life insurance policy, either by itself or when added to other non-cash gifts during the taxable year, exceeds $500, the taxpayer must attach Form 8283 “Non-Cash Charitable Contributions” to the income tax return with Section A completed. Section A provides the charity’s name and address, a description of the policy, the name of the donor, the date of the contribution, the donor’s cost basis, the FMV of the policy and the method used to value the policy.

Where the value of the life insurance policy or policies exceeds $5,000, the donor must obtain a “qualified appraisal,” as provided by Treas. Reg. Section 1.170A-13(c), no earlier than 60 days before the date of contribution. An appraiser-prepared summary of the appraisal should be attached to the donor’s tax return in addition to Form 8283 with Section B completed. Section B contains information relating to the donated property and the appraiser’s binding declaration with regard to the Pension Protection Act of 2006 (PPA) changes. Form 8283 is signed by the taxpayer, the appraiser and the charity.

A qualified appraiser as defined in Treas. Reg. Section 1.170A-13(c)(5)(i) is one who:

- Either holds himself or herself out to the public as an appraiser or performs appraisals on a regular basis
- Is qualified to make appraisals of the type of property being valued
- Is independent
- Understands that an intentionally false or fraudulent overstatement of the value of the property described in the qualified appraisal or appraisal summary may subject the appraiser to civil penalties

The PPA expanded these requirements to include that the appraisal must be conducted in accordance with generally accepted appraisal standards. Additionally, under IRC Section 170(f)(11), a "qualified appraiser" must have earned an appraisal designation from a recognized professional appraiser organization or have otherwise met minimum education and experience requirements.

Practical Considerations

Rev. Proc. 2005-25 provides a safe harbor policy valuation equal to the greater of [1] the policy's interpolated reserve or [2] the product of the PERC value multiplied by the "Average Surrender Factor." Under Rev. Proc. 2005-25, for purposes of IRC Sections 402, 79 and 83(a), with the exception of qualified plan policies, the safe harbor does not allow for surrender charges. Complying with a safe harbor provision assures the taxpayer that the IRS will accept the valuation. However, the existence of a safe harbor does not mean that another approach will necessarily violate applicable law. Where the "willing buyer/willing seller" doctrine would normally take into account any potential surrender charges, some taxpayers may wish to consider the benefit of valuing the policy based on its net surrender value versus the risks of not availing themselves of the Rev. Proc. 2005-25 safe harbor.

With the uncertainty surrounding policy valuations for income, gift and estate tax purposes, advisors would be well-advised to undertake some preliminary discovery with the issuing carrier in order to avoid unwanted valuations. Those steps should include:

- Having a clear understanding of the underlying transaction for the purpose of the valuation, e.g., whether the transfer is compensatory, a gift (charitable or non-charitable) or a sale
- Clarifying the carrier's valuation methodology and what other reserve values the carrier uses and whether they are higher or lower than the standard valuation that the carrier reports on Form 712
- Obtaining a preliminary valuation from the carrier prior to the issuance of any formal valuation or Form 712, in order to avoid being locked into an undesirable final number
- Working with the carrier's advanced sales or legal department to adjust any preliminary valuations that appear inaccurate for the purpose of the transaction or that do not comply with the applicable tax standard

As the life insurance industry evolves, life insurance policies are becoming more complicated financial instruments that are used for a variety of purposes, not just as a source of death benefit. Given this complex world, the question of policy valuation is one that comes up often and, as this paper demonstrates, is without a satisfying answer. Due to conflicting, and occasionally outdated, rulings from the IRS, practitioners often find themselves in situations wherein the policy in question has many different fair market values depending on the applicable tax regime. This is inconsistent with tax principles and requires practitioners to use their best judgment to resolve to the best of their ability and in their client's best interest. Hopefully, this paper will serve as a roadmap to give guidance to practitioners seeking to negotiate the complex world of life insurance policy valuation.

Footnotes

1 See IRC § 83(a), Treas. Reg. § 20.2031-1(b), and Treas. Reg. § 25.2512-1. See also *Guggenheim v. Rasquin*, 312 U.S. 254 (1941).

2 Treas. Reg. §1.170A-1(c)(2) and Treas. Reg. § 25.2512-1.

3 IRC § 83(a).

4 Treas. Reg. § 1.402(a)-1(a)(2).

5 Treas. Reg. § 1.83-3(e), pre-2004.

6 See Treasury Regs §§ 1.402(a)- 1(a)(1)(iii); 1.402(a)-1(a)(2); 1.83-3(a); and 1.79-1(d)(3).

7 Rev. Proc. 2005-25, § 3.03.

8 Treas. Reg. § 25.2512-6(a); see also Treas. Reg. § 20.2031-8(a)(2).

9 Treas. Reg. § 25.2512-6(a); see also *Guggenheim v. Rasquin* 312 U.S. 254, 255 (1941); *Phipps v. Commissioner*, 43 B.T.A. 790 (1941) (value of policy of life insurance, on which only the first premium had been paid, is the cost of the policy at the date of gift).

10 Treas. Reg. § 25.2512-6(a) Ex. (1).

11 Treas. Reg. § 25.2512-6(a) Ex. (1).

12 Treas. Reg. § 25.2512-6(a); see also *Guggenheim v. Rasquin* 312 U.S. 254, 256 (1941).

13 *U.S. v. Ryerson*, 312 U.S. 260 (1941); Treas. Reg. § 25.2512-6(a).

14 Treas. Reg. § 25.2512-6(a) Ex. (3).

15 Treas. Reg. § 20.2031-8(a)(2) and Treas. Reg. § 25.2512-6(a).

16 Treas. Reg. § 25.2512-6(a) Ex. (4).

17 Treas. Reg. § 20.2031-8 and Treas. Reg. § 25.2512-6.

18 Treas. Reg. § 20.2031-8(a)(2) and Treas. Reg. § 25.2512-6(a).

19 Policy loans and partial withdrawals may reduce available surrender value and death benefit or cause the policy to lapse. Generally, policy loans and partial withdrawals will not be income taxable if there is a withdrawal to the policy's cost basis (usually premiums paid), followed by policy loans (but only if the policy qualifies as life insurance, is not a modified endowment contract and is not lapsed or surrendered).

20 See IRS Notice 89-25, Q&A-10; Rev. Proc. 2004-16; and Rev. Proc. 2005-25.

21 See Rev. Rul. 59-195 (1959-1 C.B. 18).

22 Treas. Reg. § 20.2031-8(a)(2), Treas. Reg. § 25.2512-(6)(a).

23 *Estate of Pritchard v. Commissioner*, 4 TC 204 (1944).

24 *Estate of Pritchard v. Commissioner*, 4 TC 204, 208 (1944). See also PLR 9127007 (holding that an insured's terminal illness made the policy's value significantly more than its reserve value).

25 See Treas. Reg. § 25.2511-2(c).

26 IRC § 2035.

27 IRC § 101(a)(2).

28 *Swanson v. Commissioner*., 75-2 USTC ¶9528 (8th Cir. 1975).

29 PLR 9625013.

30 Rev. Rul. 2007-13, 2007-11 IRB 684.

31 PLR 201423009.

32 Treas. Reg. § 1.170A-1(c)(2) and Treas. Reg. § 25.2512-1.

33 The fair market value of a charitable contribution of property is reduced by the amount of gain which would have been recognized as ordinary income had the property been sold at the date of contribution. IRC § 170(e)(1)(A).

34 The maximum charitable income tax deduction for gifts of life insurance allowed in one year is either 30% of adjusted gross income (AGI) to public charities or 20% of AGI to private charities. IRC § 170(b)(1)(A); IRC § 170(b)(1)(B).

35 IRC § 170(f)(8).

About PartnersFinancial

PartnersFinancial is a national community of industry-leading, independent life insurance and financial professionals. For more than 25 years, the organization has supported its members as they build insurance industry knowledge and expertise. In the process, PartnersFinancial members created a powerful culture of idea-sharing and collaboration — all for the benefit of their clients.

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