

IRS Releases Regulations and Guidance on Valuing Life Insurance Policies

The IRS has released [final regulations](#) (T.D. 9223) that, it suggests, will keep employers from playing games with the value of life insurance policies in employee compensation arrangements. Combined with [Rev. Proc. 2005-25](#) released last May, the IRS has provided an outline of when transferring or selling a life insurance policy is taxable and how you calculate the taxable amount.

Before February 14, 2004, the effective date listed in Rev. Proc. 2005-25, an employee paid tax on the “cash value” (typically the cash *surrender* value) of a life insurance policy she received from an employer or a qualified plan. Now, in nearly every case, she pays tax on the “fair market value” (FMV) of the policy—the policy cash value *and* “all other rights... (including any supplemental agreements ... whether or not guaranteed).”

The new rules apply to sales, distributions and transfers such as:

- Distributing a policy from a qualified retirement plan.
- The sale of a policy from such a plan for less than fair market value.
- Permanent benefits under group term life insurance.
- Transfer of policies in connection with the performance of services (including split dollar).
- A participant in a nonqualified deferred compensation plan who no longer has a substantial risk of forfeiture.

The regulations also say the distribution of an annuity contract must be treated as a lump sum distribution for purposes of determining the tax under the Section 402(e) 10-year averaging rule. This is so even if that distribution itself is not currently taxable.

You *may* rely on the rules in Rev. Proc. 2005-25 when you value life insurance, no matter *when* the transfer happened. You *must* rely on Rev. Proc. 2005-25 for distributions, sales and other transfers occurring after May 1, 2005. Finally, you *may* rely on earlier IRS guidance ([Rev. Proc. 2004-16](#)) for transfers occurring on or after February 13, 2004 and before May 1, 2005.



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The usual ways to value life insurance may no longer be accurate:

- Cash surrender value. Total policy reserves, including life insurance reserves, and reserves for advance premiums, dividend accumulations, etc. may more accurately represent real value.
- However, total policy reserves may not be suitable sometimes because of the “unusual nature” of a policy.
- Interpolated terminal reserve plus the proportionate part of any premium paid before the sale or transfer, may not lead to a true value, especially if the reserve does not “reflect the value of all of the relevant features of the policy.”
- Net surrender value (cash value after taking off surrender charges).
- “Entire cash value”.

You may still use these methods—at your own risk—and they *may* still produce a fair market value (FMV) acceptable to the IRS. However, Rev. Proc. 2005-25 includes “safe harbors” for calculating a policy’s FMV. We’ll talk about them later. **If you use these safe harbors, the IRS says it *will* accept the value you come up with.** If you want to use a *different* way to value a policy—and you think you can convince the IRS that you’re right—you may do so. The IRS, however, will not automatically accept your value.

Like all safe harbors, good nautical charts help you avoid steering your ship into the shoals as you enter those harbors. Unfortunately, the chart the IRS offers in these regulations and the revenue procedure does not always give you all the answers you may need to reach those safe harbors. Until it provides more guidance, one guess may be as good as another. But *any* guess may lead you to the uncharted waters outside the safety of Rev. Proc. 2005-25. Here are some discussions of various settings that Rev. Proc. 2005-25 covers, followed by a discussion of the safe harbor rules.

GROUP-TERM LIFE INSURANCE

Some group-term life insurance plans include “permanent benefits” such as paid-up or cash surrender value life insurance. Employees pay tax on the cost of those permanent benefits (reduced by anything the employee pays). You may calculate this cost using a formula based in part on the increase in the employee’s deemed death benefit during the year.

One of the factors that makes up this deemed death benefit is “the net level premium reserve at the end of that policy year for all benefits provided to the employee by the policy or, if greater, the cash value of the policy at the end of that policy year.” The new regulations merely replace the term “cash value” with “fair market value”.

TRANSFERS IN CONNECTION WITH THE PERFORMANCE OF SERVICES

When a service recipient (an employer, for example) transfers property to a service provider (an employee, subcontractor, director, etc.), the employee pays tax on the value of the property (reduced by anything he paid).

These transfers, taxed under Section 83, include, for example:¹

- Roll out of a split dollar plan
- Transfer of a business owned policy to a key person (or anyone else)
- Transfer of a policy a business owned as part of a deferred compensation plan

In the past, when they transferred a policy to an employee, most employers reported the “cash surrender value” as the taxable amount.

When the IRS issued final [split dollar regulations](#) a couple of years ago, it began to change how policies were to be valued in a compensatory setting. Now in TD 9223 and Rev. Proc. 2005-25, the IRS expands that requirement to all transfers of a life insurance policy, retirement income contract, endowment policy, or other contract providing life insurance protection in a compensatory setting.

Under the new regulations, the employee pays tax on the policy’s FMV. You calculate that value as soon as the employee may transfer *any* rights in the policy or when there is no longer a substantial risk of forfeiture. And, as we’ll note in a moment, for transfers subject to Section 83 you may not reduce that value by surrender charges (or any other “lapse restrictions”).

In summary, unless there’s a specific exception, you must include in an employee’s income the value of all features of a life insurance policy providing an economic benefit to them (including, for example, the value of a springing cash value feature).

One of those exceptions is if the policy is part of a split dollar arrangement entered into before September 17, 2003, that hasn’t been materially modified after then. You may continue to value the policy based on just the cash value—but you still can’t subtract surrender charges.

DISTRIBUTIONS FROM QUALIFIED PLANS

ERISA generally does not allow a qualified plan to sell a life insurance policy (or anything else) to a “disqualified person”. A disqualified person includes the plan participant, his family and a trust for the benefit of his family.

There is an exception that lets a plan sell a policy for its cash surrender value *even if* the policy’s FMV is higher.² It may sell the policy to (1) a plan participant who is the insured, (2) his employer, (3) a relative who is a beneficiary, or (4) another qualified plan.

Under the old rules, if the buyer didn’t pay at least the cash surrender value, the participant paid tax on the difference. It was easy to avoid the tax because it was easy to find out what the cash surrender value was and have the participant pay that amount.

Under the new regulations, you must use “fair market value” as the measure of the policy’s value—the cash surrender value is no longer the best measure of what the policy is worth.

That, however, is only one part of the problem with the sale of life insurance policies from qualified plans. The second part—*the more serious concern*—is whether the income created when you pay less than the policy’s fair market value is a *plan distribution*. If it is, that distribution must adhere to all the rules that apply to qualified plan distributions.

For example, unless the plan participant is over 59½ or satisfies another exception, the distribution will be subject to the 10% federal penalty tax.

That is, however, not the real problem. The real problem is even more serious and is one we’ve never had to deal with. The plan document must *allow* in-service distributions. If it does not, the plan may not legally make the distribution the IRS says it has made. If the plan makes an illegal distribution, it could lose its status as a qualified plan.

Under the earlier guidance, although the participant may have had taxable income, that income was *not* treated as a *distribution* from the plan. These new regulations, however, change that. If the participant has taxable income because he did not pay what the IRS says is the policy's FMV, not only does he have taxable income, but that income is also automatically treated as a plan distribution.

Coming up with that value, as we'll see in a moment, is not always easy. Both the plan and the buyer may *intend* to peg the sales price at the policy's FMV. If, however, they misinterpret the formulas in the IRS safe harbors and the buyer pays something less than the IRS later decides is the policy's FMV, *the qualified plan may lose its status as a qualified plan*. Its earnings are no longer tax exempt. Contributions to the plan are no longer tax deductible. The plan is subject to taxes and penalties.

We can't stress too much this difference. Under the old rules the difference between the FMV and the cash surrender value was *not* treated as a *plan* distribution even though it *was* a *taxable* distribution. For sales and transfers after August 28, 2005, a sale for less than FMV—whether intentional or not—creates *both* taxable income *and* a plan distribution.

THE SAFE HARBORS—THE DETAILS

Next, let's look at the nitty-gritty of how the IRS wants you to calculate a policy's FMV.

<i>The Fair Market Value of a Life Insurance Policy</i> (Whichever value is greater)	
Adjusted ITR	Adjusted PERC Amount
The interpolated terminal reserve value (ITR) <i>plus</i> any unearned premiums <i>plus</i> a pro rata portion of a reasonable estimate of dividends expected to be paid for that policy year based on company experience	The PERC Amount times the Average Surrender Factor.

This introduces two new terms—the PERC Amount and the Average Surrender Factor. What do those terms mean?

The "PERC Amount" is the IRS's way of deciding what a life insurance policy is worth—the safe harbor formula for calculating FMV. As long as you use this formula, the IRS says it will accept the result as the value of the policy.

<i>PERC Amount</i>	
(Premiums, Earnings and Reasonable Charges)	
Non-Variable Policies	Variable Policies
Premiums paid from the date of issue through the valuation date (but you can't subtract dividends used to pay premiums).	
<i>Plus</i> dividends used to buy paid-up insurance before the valuation date.	<i>Plus</i> dividends applied to increase the value of the policy (including dividends used to buy paid-up insurance) taken before the valuation date.
<i>Plus</i> any amounts credited (or otherwise made available) to the policyholder for premiums. This includes interest and similar income (whether credited or made available under the policy or to some other account). It does not include dividends used to pay premiums and dividends used to buy paid up insurance.	<i>Plus or minus</i> all adjustments (whether credited or made available under the policy or to some other account) that reflect the investment return and the market value of segregated assets.
<i>Minus</i> explicit or implicit mortality charges and other reasonable charges, <i>actually</i> made by the valuation date 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	
<i>Minus</i> any distributions (including dividends and dividends held on account), withdrawals, or partial surrenders taken before the valuation date.	

The IRS has not required these kinds of calculations in the past. The regulations and other guidance from the IRS are not detailed enough to answer many questions that taxpayers (and insurance companies) will ask. There are no answers, for example, to questions like these:

- How do you factor in expected earnings?
- If a policy is converted from a term policy, do you also count the premiums paid while it was term insurance?
- Does the “do not expect” rule mean you just don’t expect the company will later refund, rebate or otherwise reverse charges? Or does it mean the company cannot contractually do that? If there is a change of policy ownership, who is the person who “can’t expect”?

The next step is to calculate the “Adjusted PERC Amount”. You do this by multiplying the PERC Amount times the “Average Surrender Factor”, (ASF). This factor adjusts the value of the policy to reflect the impact of surrender charges.

There are different rules for calculating the ASF for policies owned by qualified plans and for policies not owned by qualified plans.

Average Surrender Factor (ASF)	
<i>Multiply this by the PERC Amount to get the Adjusted PERC Amount</i>	
Qualified Plans	Non-Qualified Plans
<p>The ASF is the unweighted average of the ASFs for ten years beginning with the policy year of the distribution or sale. In other words, this will be a projected value.</p> <p>The ASF for a policy year is the <i>greater of</i></p> <p style="text-align: center;"> seventy or $\frac{\text{Projected Cash Surrender Value}}{\text{Projected (or Actual) PERC Amount}}$ percent (0.70) </p>	<p>The ASF is always 1.00.</p> <p>Thus, for non-qualified plans, the Adjusted PERC Amount is always the same as the PERC amount.</p>
<p>In years when there is no surrender charge, the ASF is 1.00.</p>	

Although this may suggest having to do the calculations every year, notice that the ASF is always the *greater of* 0.70 or the fraction. If, because of policy design, you know it’s *always* going to be less than 0.70, it wouldn’t seem the calculation must be done every year.

You may consider surrender charges only if they meet *all* the following requirements:

- The policy specifies the charge when it is issued.
- It is expressed in the form of nonincreasing percentages or amounts.
- It cannot be waived or otherwise avoided.
- The insurance company did not create the charge for purposes of the transfer or distribution. There is no guidance suggesting what this means or how you decide if a surrender charge was or was not imposed “for purposes of” a transfer.

If an *existing* policy is not eligible to take surrender charges into account, there will be no reduction for potential surrender charges in future years. The ASF will be 1.0. Nothing the IRS has said allows an insurance company to change an existing policy so surrender charges could be “taken into account”.

GENERAL RULES FOR APPLYING THE SAFE HARBORS

Rev. Proc. 2005-25 offers general rules you may rely on in applying the safe harbors for both variable and non-variable policies:

Reasonable Interpretations: You must interpret the safe harbors reasonably and consistent with the purpose of calculating a policy's FMV. For example, if you calculate income with respect to premiums paid under the policy, you must also include that amount in the PERC Amount. This is true even if there would only be taxable income because of a right of exchange that results in a springing cash value under another policy.

Understated FMV: You may not interpret the safe harbors in a manner that understates a policy's FMV and associated distributions or transfers. It is unclear what factors the IRS thinks you should consider in deciding this. Even the example it provides raises significant issues. The IRS suggests that if a policy "has not been in force for some time", the value will generally be the premiums paid. But what does "for some time" mean? Is it a set number of years? Or is it a range of years—maybe one to three years, for example? Or are there other factors?

Dividends Held on Deposit: The general rule is you do not include dividends held on deposit in the policy's FMV. Rather, those dividends are taxable income to the employee when he receives them.

Treatment of Loans: If a loan (including a loan secured by the cash value of a policy) is made in connection with the performance of services, to the extent the debt ends when the policy is transferred, the loan is another distribution to the employee. This applies even if the loan is merely forgiven, canceled, etc. The critical factor is if the loan no longer exists after the transfer.

CONCLUSION

The IRS, in its [press release](#) announcing the regulations, said:

Issuing these regulations completes a 2-year project to shut down abusive transactions involving "section 412(i) plans" and other similar arrangements. The final regulations are aimed at arrangements that attempt to avoid taxes by using artificial devices to understate the value of insurance contracts.

It then went on to talk about springing cash values (a "specially designed" policy that has a surrender value that is "depressed to a level significantly below the premiums paid", but where "the cash surrender value increases significantly after it is transferred to the employee..."). The IRS went on to say:

The employer takes a deduction for the entire value of the premiums paid into the insurance plan and the employee pays taxes only on the artificially depressed value of the contract allowing the employee to avoid taxes on the true value of the contract while the employer takes the full deduction for the premiums paid.

It's clear the IRS has created rules that affect far more than 412(i) plans and springing cash values. As Larry Brody commented in one of [Stephen Leimberg's newsletters](#)³

...the final regulations do make it very clear that the Treasury and IRS are determined to put an end to valuation gaming with life insurance. Expect to see these principles extended beyond Sections 402, 79, and 83, perhaps to the value of policies for gift tax purposes under the Section 2512 regulations.

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¹ In addition to tax under IRC §83, these transfers may also be a “transfer for value” under §101.

² Prohibited Transaction Exemption (PTE) 77-8 (1977-2 C.B. 425), later replaced by PTE 92-6.

³ Steve Leimberg's Employee Benefits and Retirement Planning Newsletter # 326 (September, 2005)