POLICY VALUATION: A GUIDE TO ESTABLISHING FAIR MARKET VALUE

> **When circumstances call for a transfer of ownership, it is critical to establish a precise valuation that can fit the circumstances of the policyowner.**

Life insurance provides valuable death benefit protection to policy owners. However, circumstances may change, prompting a transfer of ownership. When this occurs, a valuation of the life insurance policy is required to assess the tax liability related to income, gift, estate, or generation skipping transfer. It may also be necessary when there is a sale, a distribution of a policy to an employee, for accounting, or other purposes.

Determining the fair market value (FMV) of a life insurance policy on a specific valuation date is crucial for establishing the relevant tax liability.

While Treasury Regulations define FMV as the price at which the property would change hands between a willing buyer and a willing seller[1], establishing a FMV for a life insurance policy can be a challenge. To do so, we refer to a patchwork of authorities to define FMV for life insurance policies used in various transactions or scenarios.

This guide provides an overview of how life insurance policies may be valued for transfer tax, income tax, and sale purposes. It also explores other factors that can affect valuation and should be considered when planning for the transfer of a life insurance policy.

VALUATION FOR GIFT, ESTATE, AND GENERATION SKIPPING TRANSFER TAX PURPOSES

For transfer tax purposes, the Internal Revenue Service (IRS) bases the FMV of the policy on the "comparable contract" theory[2]. The regulations outline three scenarios based on policy age and design:

- Newly issued policies are generally policies transferred within the first policy year. The FMV is considered to be the cost of the policy, i.e., the premiums paid by the valuation date.
- Paid-up policies where no further premiums are due. The regulations define this as a "single premium policy or paid-up policy." FMV is calculated based on a replacement cost standard, where the FMV equals the single premium required to purchase a

[1] 26 CFR § 25.2512-1

[2] 26 CFR § 25.2512-6(a)

comparable contract with the same face amount on the life of an individual of the same age as the insured on the valuation date.

- For policies that have been in force for some time and for which additional premiums are due or being made, the FMV can be approximated using the Interpolated Terminal Reserve (ITR) plus unearned premiums. However, the regulations state that this method of valuation may not be used if the ITR-based FMV is not reasonably close to the full value of the policy due to the unusual nature of the contract.

For gifts of a life insurance policy, the FMV must be reported on Form 709 (gift tax return). For policies held at death (unmatured policies), the FMV will be reported on Form 706 (estate tax return). A Form 712, the Life Insurance Statement, must be attached to these forms. Form 712 which is provided by the issuing life insurance carrier and complies with IRS valuation guidance, includes values such as premiums paid and ITR.

Since the IRS generally accepts the value reported by the insurance carrier, most legal and tax advisors rely on the Form 712 value. Frequently however, the Form 712 value is surprisingly high, for example, in the case of level term or guaranteed universal life policies. Likewise, the declining health of the insured may indicate a higher value than that reported on the Form 712. In such instances, it is critical to work with a licensed tax advisor to settle any disagreement over the provided value and to explore alternative valuation options such as obtaining a qualified appraisal from a licensed valuation professional.

INTERPOLATED TERMINAL RESERVE (ITR)

ITR is often central to the available valuation guidance. However, it is not broadly applicable to modern life insurance policies. The original IRS guidance was provided when only two types of insurance were widely available: whole life insurance and annual renewable term insurance. Simply put, a life insurance carrier must maintain reserves to support future financial obligations created by its life insurance products. ITR is a value of the whole life policy's reserve value, which can be estimated ahead of time.

Since the original ITR valuation guidance, numerous life insurance products have been developed, such as universal life (UL), no-lapse guaranteed universal life (NLGUL), variable universal life (VUL), indexed universal life (IUL), and various level term policies. These products have different reserve values, which may not be known ahead of time and make the ITR calculation largely inapplicable. Insurance carriers track multiple reserve values that were not contemplated at the time of the regulations, including tax reserves, statutory reserves, and AG 38 reserves. Due to the lack of IRS guidance, practitioners should communicate with the issuing life insurance carrier to determine the reserve values they use for valuation guidance.

OTHER FACTORS AFFECTING POLICY VALUE

Several factors can affect the value of a life insurance policy:

- **Policy loans:** Outstanding policy loans reduce the ITR value.
- **1035 Exchanges:** A policy issued via a recent 1035 exchange should be considered a "new" policy for valuation purposes. Therefore, if the policy is newly issued (within the first policy year), it should be valued at its "cost," which includes premiums paid (cash value from the relinquished policy plus any additional premiums paid to date).
- **Insured's health:** In cases where the ITR is not a reasonable approximation of the FMV, the value of the policy may be significantly higher. For instance, if the insured is uninsurable, severely ill, or terminally ill, the policy's value may approach the death benefit amount. In such cases, a third-party valuation is advisable.

INCOME TAX VALUATION OF A POLICY

Apart from transfers by gift or bequest, life insurance policies may be transferred for business reasons, requiring a FMV calculation for income tax liability. Examples may include a distribution of a policy by a business to the employee or owner, or distribution from a qualified plan to the participant. Revenue Procedure 2005-25 provides a safe harbor definition of FMV for income tax valuation purposes. The policy is valued at the greater of ITR plus unearned premiums or PERC (premiums plus earnings minus reasonable charges). PERC often represents the cash value of the policy, excluding surrender charges. However, for distributions from qualified plans, PERC may be reduced by an average surrender factor (ASF). It is essential to work directly with the issuing carrier to obtain the PERC, ASF and ITR values for the product and transaction involved.

If the insured is chronically ill, the FMV of the policy may be substantially higher than the safe harbor valuation.

VALUATION FOR SALE OF A LIFE POLICY[3]

While not covered by regulations, determining the FMV for sale purposes can be reasoned as follows:

- **Sale to an unrelated third party:** The FMV should be the sale price agreed upon by a willing buyer and a willing seller, both having reasonable knowledge of all the facts and not under compulsion to buy or sell.
- **Intra-family sales:** These sales should generally follow the gift tax FMV processes, often using the ITR value reported by the insurance carrier on the Form 712. If the insured's health suggests a higher value, a third-party valuation may be advisable.
- **Purchase from a business or qualified plan:** Following the related Rev. Proc. 2005-25, FMV safe harbor makes sense for setting the sales price unless it is clear that the safe harbor does not represent the value of the policy.

OTHER VALUATION METHODS

If ITR does not accurately reflect the value of the policy, other traditional means may be considered to establish FMV based on the willing buyer, willing seller standard. For insureds 70 and older, and with health issues, this can include referencing the secondary market, such as the life settlement market, where life settlement companies connect policy owners with purchasers to establish market prices. For younger and healthier insureds, accurately assessing the market-based valuation through life settlements can be challenging. Alternatively, a qualified appraisal of the policy or using the current cost of a comparable contract may be attempted to establish FMV. While these methods should logically meet the general willing buyer, willing seller standard, it is critical to note that these alternative valuation methods are not expressly contemplated by the IRS guidance on valuing life insurance policies.

CONSIDER ALL OPTIONS TO PROPERLY VALUE POLICIES

The IRS guidance for valuing life insurance policies is outdated, confusing, and frequently does not accurately reflect the value of current policy designs. As a result, practitioners may struggle to provide accurate valuations while adhering to the letter of the law. Even life insurance carriers do not agree on a uniform application of available IRS guidance. Therefore, practitioners should be aware of these challenges and consider partnering with third parties, such as life settlement companies or professional appraisers, to provide alternative valuations when ITR values do not align with policy values. In such cases, alternative methods that reflect the willing buyer, willing seller standard may be more appropriate for determining the FMV of a life insurance policy.

[3] Note that the sale of a life insurance policy will result in a transfer for value under IRC Sec. 101(a)(2), and an exception should be sought in order to avoid adverse tax consequences.

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