So, you think you know to value a life insurance policy? Think Again!

Heart of America Fellows Institute
American College of Trust and Estate Counsel

Class II Program 2

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What is the “fair market value” of a life insurance policy for Federal tax purposes?

Is it determined, as it is for other hard-to-value assets, based on the usual willing buyer/willing seller formula of the Section 2512 and 2031 Regulations-Treas. Reg. Secs. 25-2512-1 and 20-2031-1?

Since, other than the life settlement market for a subset of policies, as described below, there is no willing buyer for policies, the courts and the IRS Regulations, described below, have long provided other, arguably artificial but easily determinable, so-called conventions for valuing policies for tax purposes.

In any event, under those valuation conventions, the answer may depend on why the question is being asked.

The interesting and unanswered question under all of these valuation conventions is what effect, if any, the insured's health and life expectancy have on the outcome.

Income tax transactions involving policy valuation

What is the value of a policy for general Federal income tax purposes?

What is the fair market value of a policy for transfers out of qualified plans or as compensation?

What about for other income tax purposes not covered by the safe harbors provided in the 2005 Regulations, described below?

Rev. Proc. 2005-25, 2005-17 IRB 962, superseding Rev. Proc. 2004-16, 2004-10 IRD 559, provided a safe harbor rule under Sections 83, 402, and 79 for determining the fair market value of a policy for these limited income tax purposes.

Gift tax transactions involving policy valuation.

These transactions involve transfers of policies from an insured/owner or another owner to a third party owner, such as an insurance trust.

The usual Federal gift tax valuation of a policy is set out in Reg. Sec. 25. 2512-6(a), relying on the cost of what it calls a “comparable” policy, since there traditionally was no market for life insurance policies (and still isn’t for most policies, other than those that qualify for the life settlement market, as discussed below).

For a single premium or a truly paid-up policy on which no further premiums are due, either of which would be an unusual policy, its gift tax value is its replacement cost. Example (3) of Reg. Sec. 25.2512-6(a).

For a new policy, its gift tax value would be the premium paid. Example (1) of Reg. Sec. 25.2512-6(a).

For a more usual policy on which further premiums are due (even if they are to be paid out of policy values) and which has been in force for some time (an undefined term), since the Regulations conclude that the cost of a "comparable policy" would be hard to determine, the Regulations provide that its gift tax value may be approximated by the policy's interpolated terminal reserve (its "ITR" value), plus any prepaid premiums.

(Emphasis added, for the reasons discussed below).

For annually renewable term, which is rarely purchased, the gift value should only be the unearned premium for the year of the gift.

For assignments of group term policies, Rev. Rul. 76-490, 1976-2 C.C. B. 300, provides another convention – the remainder of the economic benefit for the year of the gift provided to the employee/insured, measured as provided in Rev. Rul. 84-147, 1984-2 C.B. 201, under group term Table 1.

Reg. Sec. 25.2512-6(a) also provides that if, “due to the unusual nature of the contract” (an undefined phrase) the regulation formula doesn’t reasonably approximate its full value (also an undefined phrase), it may not be used (with no indication of what may be used instead).

As noted above, these valuation rules were developed before the life settlement market provided any measure of a policy's real fair market value, based on the usual willing seller/willing buyer test (since there was no willing buyer for qualifying policies before this market developed).

The instructions to Form 712 indicate that for single premium or paid-up policies, the amount shown on the Form may not be relied on where the surrender value of the policy exceeds its replacement cost; instead, they indicate that the policy's full economic value – an undefined term – must be used.

The practice of carriers in reporting values on Form 712 is apparently not consistent, with some only reporting the ITR value and some others also reporting the policy cash value, the surrender value, the PERC value (and Lord knows what else)

What is the value of a policy sold to avoid the three year look-back provision of Section 2035 (under its adequate and full consideration exception)?

What is the value of a gift of an undivided interest in a policy, recognizing that, under the terms of every policy, all owners must act together to deal with the policy – no one owner can surrender it, cancel it, borrow against it, etc.

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