



Informational ideas important to large and complex cases

# Advanced Sales DIGEST

Vol I, Issue 6 ♦ Sept 2005

## TREASURY ISSUES FINAL REGULATIONS ON LIFE INSURANCE POLICY VALUATION

by Ed Sanchez, CLU, ChFC, MBA, MSFS

Advanced Sales Consultant

AIG Life Brokerage

The Treasury department has issued final regulations under IRC Code Section 402(a), effective August 29, 2005, regarding the value of a life insurance contract when distributed from a qualified plan as well as the value of life insurance with permanent benefits under IRC Code Sections 79 and 83. Below are our first impressions of the regulation.

### Background

The Service (IRS) has been seeking to better regulate so called valuation "gaming" of life insurance for some time. This allegedly occurred when a policy was distributed from a qualified plan or a C (regular) corporation and there was disagreement as to the proper method of valuing the policy for tax purposes. The Service has contended that certain life policies (for example, so-called "springing cash value" policies) are deliberately designed to understate a policy's value upon its sale or transfer. Consequently, in April 2005, they published proposed regulations in Revenue Procedure 2005-25.

The Procedure created a safe harbor for determining

the fair market value of a life insurance policy being distributed from a qualified plan, a C corporation, or from a Section 79 plan of permanent insurance. It essentially required the adding of premiums and earnings and subtracting reasonable charges (including mortality and other reasonable charges); hence the acronym "PERC" which stands for Premiums and Earnings less Reasonable Charges. The procedure also reflected a discount for the possibility that a surrender charge may apply in the event that the policy is transferred from a qualified plan.\*

### Effect of the regulations

Policy valuation is important if and when a policy is distributed from a qualified plan or regular corporation. The regulations will not only determine the value of a policy distributed from a qualified plan but also a policy which has been used as an informal funding device by a regular corporation in a non-qualified deferred compensation arrangement where a distribution of the policy is contemplated upon retirement.

Qualified plan participants who own life insurance within the plan (for example, in a Section 412(i) plan), and do not contemplate a distribution of the policy in the early plan years, are not immediately impacted by the final regulations. This is because the primary objective of any qualified plan is to accumulate and provide retirement benefits to participants, usually at normal retirement age, based upon income tax

continued on next page

For agent use only. Not for public dissemination.

deductible employer contributions.

Further, distributions of plan assets (such as life insurance) *prior* to retirement are not, and, in our opinion, should not be contemplated as the primary objective for creating a qualified plan. Thus, the valuation of the policy is normally deferred until at or close to the participant's retirement.

### The final regulations

The final regulations clarify that where a life insurance contract is distributed from a qualified plan, that the policy's fair market value (that is, the policy's cash value plus the value of all rights under the contract, including any supplemental agreements thereto and whether or not guaranteed) is to be included in the income of the distributee. Also, if the policy is transferred for less than its fair market value, the transfer is nevertheless treated as being made at the full fair market value of the policy. In other words, any bargain element in the sale is treated as a distribution.

One other important aspect of qualified plan policy distributions is this: where there is a bargain element in the distribution, Prohibited Transaction Exemption (PTE) 92-6 not only causes income recognition of the bargain element but will also cause *plan disqualification* (emphasis added) for plans which are prohibited from allowing an in-service distribution. Therefore, for distributions of this type after August 29, 2005, the plan will forfeit qualification. Thus, life professionals need to exercise extreme care to have their clients avoid policy distributions from certain qualified plans in which there is a bargain element.

Fair market value also controls with respect to life insurance contracts distributed under IRC Code Section 79 and 83 as well.

Unfortunately, the final regulations are little more than a summary of the proposed regulations. Fair market value is not defined by the Internal Revenue Code or the regulations. And, what they *do not* tell us, with specificity or precision, is how to put the regulation into practice, nor are examples offered which

might provide guidance in applying the regulations to a specific product. Thus, additional guidance may be needed in order to apply the regulations to the valuation of specific life insurance products. We will provide additional information as it is available.

*For agent and broker use only. Not for use with the public.*

*\* For an additional description of Revenue Procedure 2005-25 and PERC, see Advanced Sales Digest, Issue 3, June 2005, posted on the AIG Life Brokerage Web site.*