



Articles

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"The Treasury, faced with an onslaught of tax-avoidance schemes using transparently phony life insurance valuations, has fired back with this new valuation recipe."

A New Recipe for Life Insurance Valuation

by Peter Katt, CFP, LIC

In August 2005 the Treasury issued final regulations under Internal Revenue Code Section 402(a) that define how to value a life insurance policy when it is distributed from a qualified retirement plan. Correctly applying these regulations provides taxpayers with a safe-harbor value that will be acceptable to the Internal Revenue Service (though I contend later in this column that the regulations often are too harsh). It is reasonable to postulate that these regulations can be used for all life insurance valuations involving tax issues and receive the same safe-harbor treatment. Taxpayers are not *required* to use these regulations in a valuation situation, but alternative valuations could be challenged by the IRS, which could result in tax deficiencies and other possible penalties, especially when associated with a qualified retirement plan.

Permanent life insurance can be very complicated and has often been the asset du jour in various tax-avoidance schemes, including abusive 412(i) qualified retirement plans and so-called welfare benefit plans. Slick tax-avoidance plan developers and enabling tax professionals spread the notion that the 402(a) regs have changed the rules in the middle of their game. Many claim that 412(i)s funded with springing cash value policies and so-called pension rescue life insurance purchases were completely legitimate until these regulations came along and then *wham*, an out-of-control Treasury put an end to their creative use of these loopholes! *Au contraire*: the IRS has never accepted the notion that an asset can be worth X when used for tax measurement purposes and then have its value go up at vast multiples of what that market would otherwise return. For example, a 412(i) plan I reviewed several years ago claimed that \$310,000 was the appropriate value for a life insurance policy when distributed from the 412(i) and five years later would be worth \$1,585,014, which is a 39 percent compound return (see [Life Insurance Perspectives Vol. 5, No. 2, March 2003](#), especially the embedded redacted report).

Regardless of claims made by the sellers of tax-avoidance schemes and the new regulations, the truest measure of a life insurance policy should be its *fair market value*, defined as a price that willing buyers and sellers, having similar information, will agree upon. Certainly no reasonable person would conclude that an asset that will be worth \$1,585,014 in five years has a \$310,000 value today. Only cunning tax-avoidance developers (in cooperation with several life insurance companies)

and tax-professional defenders made such assertions. No doubt it was the perpetrators of such blatant tax cheating that forced the Treasury to craft the strict standards within these regs.

Punitive Valuations

The problem is that valuations performed under the safe harbor of these regulations are quite punitive and in many instances, in my opinion, do not reflect a policy's fair market value. Valuations under these regs are determined with reference to a policy's accumulation or account value, which is generally the premium payment less policy charges plus interest. This account value is reduced by a surrender value factor that has a significant limitation in establishing its safe-harbor value. A recent valuation my firm did for a pension distribution had a safe-harbor value of \$265,208, while we calculated that its market value would be \$172,605. The difference is due to how most life insurance policies camouflage their first-year selling expenses. Many policies use an account value that is determined without regard to the true first-year selling expenses, probably to hide from buyers how large the commissions are. This account value is subject to a large surrender charge with the difference between them being a policy's cash surrender value. The account value dramatically overstates a policy's intrinsic value but these new regs severely limit factoring in the interplay of surrender charges, and this is why they often overstate a policy's market value.

Establishing a Policy's Market Value

To establish a policy's market value, we first calculate its asset share, which tracks monies into and out of the policy to the date of valuation. We determine whether the insured's health is about the same as when the policy was acquired and other factors that could affect a policy's value, such as the financial strength of the insurance company. None of these factors are used in the regs for determining the safe-harbor value. If no adjustments to the asset share are needed, we test how this policy will perform in the future based on appropriate mortality and expenses, and interest crediting that is compared with an in-force illustration for the policy. If no quirks are noted, we can conclude that the asset share is the policy's market value. This is the amount we would advise a seller or buyer to settle on.

If an insured's health has deteriorated more than the passage of time would expect, the insurance company has dismal financial strength, or some other pertinent issue is evident, this will have a direct impact on our determination of the policy's market value. Significantly, the new regulations don't take into account the insured's health or other factors. This can mean that the safe-harbor valuation will be lower, and sometimes much lower than what we would consider the more accurate market value.

We explicitly advise clients that the value determined under the IRS regulations will be accepted by the IRS without question, while our market value could be challenged and may need to be defended. The decision to use one or the other will depend on the amount of the valuation difference, for what purpose it will be used, and how willing the client is to fight if necessary.

The Treasury, faced with an onslaught of tax-avoidance schemes using transparently phony life insurance valuations, has fired back with this new valuation recipe. These valuations often produce a significant penalty because of life insurance companies' fondness for hiding how large their first-year expenses are. A legitimate market value may be sustainable but could be challenged by the IRS with the outcome yet to be determined.

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