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IRS Continues Efforts to Control
Insurance Planning in Retirement Plans

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Reacting to the growth of tax planning techniques that use retirement plan assets and insurance protection to bring about dramatic reductions in tax liability, the IRS has issued guidance in several forms on the valuation of life insurance contracts. This guidance is designed to separate legitimate from abusive planning.

Life insurance is frequently used in tax, estate and retirement planning, as a means of enhancing the benefits of other tax-saving techniques. For example, life insurance may be used in providing funds to pay federal estate taxes through an irrevocable life insurance trust or as an investment of qualified retirement plans. Life insurance has two very important tax attributes that help to make it useful in many planning situations: the internal buildup of value inside a life insurance policy is not subject to current income tax, and the proceeds of a life insurance policy that is owned by an irrevocable trust can escape federal estate taxation. As often happens, when something works well, an effort is made to have it work better. There is nothing wrong with creative tax planning, unless the process of "pushing the envelope" results in tax consequences clearly not contemplated by the statute and that misuse the planning process. Aggressive tax planning has occurred very frequently in the past few years, and particularly in the use of life insurance in retirement plans and in other compensatory situations. As a result, the IRS has now proposed new rules to use in valuing life insurance contracts. These rules deal with the question of the value of a life insurance policy that is transferred as part of a tax-planning technique in the context of qualified retirement plans within the meaning of Section 401(a) of the Internal Revenue Code of 1986 (hereafter, all Section references are to the Code, except as otherwise indicated), as well as life insurance planning under IRC Section 79 and the transfer of life insurance policies in an employer-employee context pursuant to IRC Section 83.
BACKGROUND

The use of qualified retirement plans as a means of reducing current income tax liability and of providing a source of retirement income extends back many years. While the enactment of the Employee Retirement Income Security Act of 1974 (ERISA)\(^1\) began the process of very detailed regulation of retirement plans, as well as welfare benefit plans, regulations under the Code prior to that law's enactment governed the design and operation of retirement plans. A very brief mention in those pre-ERISA regulations\(^2\) authorized the purchase of life insurance in retirement plans, without specifying the limits on the amount of insurance that could be purchased. This was left to a series of revenue rulings, beginning in the 1950s and extending to the 1980s.\(^3\) The result of permissive purchase of life insurance in qualified retirement plans is that contributions to such plans, for which an income tax deduction is available, are used to purchase insurance on a pre-tax basis. When the insured person dies, the insurance proceeds are paid to the retirement plan and then to the beneficiary of the deceased. The amount of the proceeds up to the cash value of the policy will be subject to income tax, and the balance will be received free of income tax.\(^4\) The full amount of the distribution will be subject to federal estate tax,\(^5\) unless a limited grandfather provision applies. Purchasing life insurance through a retirement plan could be based on the view that the insurance purchase is a worthwhile investment when compared to other investment vehicles. Alternatively, a plan participant might feel the need for insurance coverage for family reasons, but not have adequate funds outside the retirement plan to purchase the insurance.

Suppose that, instead of holding the insurance in the plan until the plan participant died, there was instead either a distribution of the insurance policy itself or a sale of the policy prior to death or retirement. The distribution of the policy would be a taxable event, giving rise to some amount of income tax liability. The sale of the insurance policy\(^6\) would be for a price determined by reference to a value of the policy. In either situation, a value must be determined for the policy. (And the same problem arises with the transfer or sale of insurance policies in other compensatory contexts, such as might arise with a group insurance plan under IRC Section 79 or the transfer of property to an employee under IRC Section 83.)

The taxation of distributions from retirement plans is governed by IRC Section 402. With respect to life insurance, a specific rule is set forth in Treasury Regulations Section 1.402(a)-1(a)(2): if a retirement plan purchases a life insurance policy and later distributes it to a participant, an amount equal to the "entire cash value" of the policy is treated as taxable income. That term is not defined elsewhere, and it is not clear what concept is being suggested by the phrase. It could be a reference to the cash value of an insurance policy, a familiar term that has a well-recognized IRS Continues Efforts to Control Insurance Planning meaning. If so, what does the word "entire" add? Perhaps it means the entire value of the policy, taking into account all aspects of the policy's utility (holding it until death, borrowing against it, surrendering it for cash, selling to a third party) and expressing them in a cash amount. The latter seems to be the more sensible interpretation, and the Treasury deserves criticism for issuing a regulation that left its meaning so uncertain.

Many planners used the uncertainty in the regulations to take the position that the value of a policy was its cash surrender value, the amount that could be obtained by surrendering the policy to the insurance company. That calculation would take into account surrender charges, often very substantial in the early years of a policy. This could mean that, by purchasing a policy and distributing
or selling it only a few years later, the value or price would be very low compared to the premiums paid. Consequently, amounts in a retirement plan, which would be taxable income if distributed in cash, would instead be used to purchase life insurance and, when distribution or sale took place, the dollar value (cost or taxable income) of the transaction would be much lower. A large amount of potential income would be stripped out of the plan at a much lower cost in tax liability or the cash needed to purchase the policy. After the transfer, the cash value would continue to grow and the surrender charges would eventually disappear. To make this type of transaction even more advantageous, insurance policies could be, and were, designed to have a suppressed cash value in early years, which would "spring up" after distribution or sale.

The regulations governing transactions covered by IRC Section 83 were more explicit, stating that:

In the case of a transfer of a life insurance contract, retirement income contract, endowment contract, or other contract providing life insurance protection, only the cash surrender value of the contract is considered to be property.\(^7\)

There was no doubt, then, that in Section 83 situations, cash surrender value was the approved measure of value.

The possible abuses that the regulations might permit were noted in Announcement 88-51.\(^8\) In that Announcement, the IRS referred to issues relating to insurance contracts that had what it called springing cash values. It used the example of a policy used to fund a defined benefit pension plan that was purchased a short time before the participant's retirement, after which the cash value increased substantially. Where the cash surrender value did not accurately reflect the true value of the insurance policy, the IRS indicated that it might be necessary to use a different measure, such as replacement cost or the net present value of future benefits. The Announcement further noted that distributing an asset with a value in excess of that used by the plan in its calculations could result in disqualification of the plan.

In the following year, Notice 89-25,\(^9\) in providing guidance on a number of plan distribution issues, discussed the issue of what amount a plan participant should include in income upon receipt of a life insurance policy with a value in excess of its cash surrender value. The Notice suggested as an alternative measure the total policy reserves, including Section 807(d) reserves, advance premium reserves and dividend accumulations. The Notice repeated the Announcement's warning that a distribution in excess of the amount to which a participant was entitled under the plan might result in disqualification.

A third pronouncement by the IRS, Announcement 92-182,\(^10\) described various problems that might arise if an accurate measure of value were not used when a life insurance policy was distributed: a prohibited transaction under IRC Section 4975; violation of the Section 415 limits on benefits and contributions; violation of the funding requirements of IRC Section 412; violation of the rule of IRC Section 401(a)(4) requiring that a plan be operated for the exclusive benefit of participants and beneficiaries; and prohibited discrimination, also under IRC Section 401(a)(4). Problems with springing cash value policies were again noted, and IRS agents were advised to accept cash surrender value as the appropriate measure for the value of a life insurance policy only
when it was approximately equal to the premiums paid for the policy.

The sum of these pronouncements was an increasing concern on the part of the IRS that the rules set forth in its regulations were being used to cause transfers of value without the appropriate tax liability. However, without more official action, marketers of insurance planning techniques were able to continue to point to the uncertain nature of the law as a way of justifying aggressive valuation positions.

It should be noted, as the explanatory section of the proposed regulations and of the revenue procedure do, that a different measure of value was established in the gift tax regulations, Treasury Regulations Section 25.2512-6. Where premiums on a policy must continue to be paid, the value of the policy would not be its cash surrender value, but rather the interpolated terminal reserve plus any unearned premiums. Those regulations also state the unusual nature of a policy may render even that method inappropriate. Where a policy did not have an interpolated terminal reserve, such as a variable life insurance policy, other reserves would be calculated to determine value. Revenue Ruling 59-125, 1959-1 CB 18, followed these rules. Where an employer paid the premiums of a policy insuring the life of one of its employees and subsequently sold the policy, the value of the policy was to be measured under the Gift Tax Regulations. The reasoning of that ruling was adopted in Prohibited Transaction Exemption 77-8,11 which was later redesignated as Prohibited Transaction Exemption 92-6.12 However, the overall rule of the latter document was to permit cash surrender value to be the measure of value. Specifically, the sale had to arise in the situation in which the policy would otherwise be surrendered by the plan. That is an important condition, but some planners either ignored the condition or deliberately placed plan participants in circumstances where the policy would otherwise be surrendered, such as by purchasing a policy shortly before the participant's retirement. While the IRS was attempting to establish the principle that cash surrender value was not necessarily the correct measure of value in every situation, its pronouncements seemed tentative and invited disregard because of the lack of a single, clear valuation rule.

**THE RECENT IRS ACTION**

On February 13, 2004, the IRS issued proposed regulations, a revenue procedure and two revenue rulings. The press release that accompanied the issuance of the regulations, rulings and procedure, indicated that the guidance had been issued in response to abusive situations arising under retirement plans under IRC Section 412(i). Nevertheless, the guidance covers the range of qualified retirement plans and other compensatory situations.

*Proposed Regulations*

The proposed regulations amend the existing regulations under IRC Section 402(a), as well as those rules in IRC Section 79 and IRC Section 83 that correspond to the Section 402(a) rules. The Summary of the proposed regulations refers to the rule of Treasury Regulations Section 1.402(a)-1(a)(2) mentioned above that, upon the distribution of an annuity or life insurance policy, the "entire cash value" is to be included in income, adding that the regulations do not define that term, nor the term "fair market value." The Summary also notes the preamble to Prohibited Transaction Exemption 77-8,13 which was redesignated as Prohibited Transaction 92-6, and which
stated that the value of a life insurance policy was not the same as and could be more than its cash surrender value. The preamble added that an incorrect determination of value could result in additional income to the distributee, but that the additional income amount would not be considered a distribution from the plan.

The connection of the Section 402(a) distribution rules to group term life insurance coverage pursuant to IRC Section 79 lies in the ability to combine such group term coverage with other benefits, extending beyond one policy year and referred to as permanent benefits. The permanent benefits provided to an employee are taxed pursuant to Treasury Regulations Section 1.79-1(d), and it is here that there is a reference, in the existing regulations, to the cash value of the policy. Likewise, the Section 83 regulations, specifically Treasury Regulations Section 1.83-3(e), provide, as noted above, that the amount includible in income is the cash surrender value of the policy.

THE CHANGES MADE IN THE PROPOSED REGULATIONS

The proposed regulations under IRC Section 402(a) tie the determination of value when an insurance policy is distributed to the familiar concept of fair market value. Specifically, the proposal states that, in the case of a distribution of a life insurance policy, "the policy cash value and all other rights under such contract (including any supplemental agreements thereto and whether or not guaranteed) are included in determining the fair market value of the contract." This does not give a definite explanation of how fair market value is determined, however. The explanation of the regulations refers back to Rev. Rul. 59-195, with its reference over to the gift tax regulations, and its measure of the interpolated terminal reserve of the policy, plus any unused premium. This value may be departed from when some aspect or aspects of the policy make another measure more appropriate. Noting the rule of Notice 89-25 to use policy reserves, the overview rejects that as a firm standard, having found situations in which both reserves and cash value are suppressed in the early years of a policy. Reserves or cash value as a measure would not be appropriate, for example, if those measures are significantly less than the sum of premiums paid and dividends or other investment returns, less some reasonable mortality charges.

The proposed regulations under IRC Section 402(a) add that where a distribution of a larger amount is found to have been made because of an error in the valuation method when a policy is transferred, the excess of the fair market value of the property over the amount received is treated as a distribution from the retirement plan, reversing the prior rule described in Prohibited Transaction Exemption 77-8.

CHANGES IN THE SECTION 79 AND SECTION 83 REGULATIONS

The brief change in the regulations under IRC Section 79 is a change in the formula for determining the value of permanent benefits, replacing "or, if greater, the cash value of the policy at the end of that policy year" with "or, if greater, the fair market value of the policy at the end of that policy year."

The change in the regulations under IRC Section 83 is likewise brief, but significant. The
measure of the value distributed by the cash surrender value is gone, replaced by a reference to the cash value "and all other rights under such contract (including any supplement agreements there-to and whether or not guaranteed," echoing the Section 402(a) proposal. A grandfather provision is included for certain split dollar arrangements, permitting the continued use of the cash surrender value.

The regulation changes under IRC Section 79 and IRC Section 83 are to be applicable to benefits provided and transfers occurring on or after February 13, 2004. Likewise, the change in the Section 402(a) regulations from entire cash value to fair market value is applicable to any distribution occurring on or after that date. However, the amendment to the Section 402(a) regulations regarding the expansion of the fair market value concept to cash value and all other rights in the contract is to be effective when final regulations are published in the Federal Register. Comments are solicited on appropriate methods for valuing insurance policies in the Sections 79, 83 and 402 contexts, including an appropriate discount to apply to account for the possibility that some insurance policies will be surrendered while surrender changes are in effect. That would appear to be a difficult calculation to make.

Revenue Procedure 2004-16

Revenue Procedure 2004-16, 2004-10 IRB 559, provides interim rules on valuation of life insurance transfers pursuant to IRC Sections 402(a), 79 and 83. Interim guidance is needed because of the uncertainty of the correct measure of fair market value, even under the proposed regulations. Merely to say that fair market value is the correct measure is inadequate guidance, especially in view of the wide range of types of policies and their terms and features. As in the case of the proposed regulations, the explanatory materials in the Revenue Procedure indicate that there are situations in which neither the cash surrender nor the policy reserves would be an accurate measure of the fair market value of the policy. Similar problems may arise in transactions governed by IRC Sections 79 and 83. Because of the difficulty of f ording a measure of value that will comply with the proposed regulations with a fair degree of certainty, interim guidance is offered.

The interim rule is that cash value (without reduction for surrender charges) may be used as the fair market value of a contract, for purposes of IRC Sections 79, 83 and 402 provided that cash value is at least equal to:

1. Premiums paid on the policy, plus
2. Amounts to the policy, such as interest or dividends, minus
3. Reasonable mortality charges and reasonable charges, other than mortality charges.

In the case of a variable life insurance policy, the second item is investment return and the value of segregated asset accounts. This calculation has already acquired its own acronym, the grail tax practitioners try to find in every tax concept and technique: PERM (premiums, earnings, reasonable mortality14). This interim rule will help in many situations, specifically where the cash value is not less than PERM. But what is the result when cash value is less? Why doesn't the interim guidance state that PERM can be used as the fair market value of the policy? If the purpose of the
proposed regulations is to cast off from cash value as the measure of a policy's fair market value, why does the interim guidance return to that concept, in certain circumstances? It is helpful to have the interim guidance, but is the IRS telling planners that if cash value is less than PERM, they are consigned to an uncertain tax situation that they should avoid? If the goal of the interim guidance is to offer a degree of certainty in some situations, it has only partially achieved that goal.

**Revenue Ruling 2004-20**

Another element of the guidance issued was Revenue Ruling 2004-20, 2004-10 IRB 546. This ruling dealt specifically with abuses that had been observed in the use of Section 412(i) plans. In one situation, a defined benefit pension plan funded with life insurance contracts and annuities resulted in benefits available at retirement, pursuant to those contracts and annuities, in excess of the benefits provided for by the terms of the plan. In the second situation described in the ruling, a plan provided a death benefit meeting the requirements of the incidental death benefit rules, as set forth in the rulings cited above. Funding of the plan included the purchase of life insurance policies with a face amount exceeding the promised death benefit. The excess amount paid at the plan participant's death was to be used by the plan to pay the premiums for coverage for other participants.

The ruling provides a useful summary of the operation of Section 412(i) plans. A Section 412(i) plan must be funded with group or individual insurance contracts. An employee's plan benefit must be equal to the benefits provided under the individual insurance contracts at retirement. Applying these rules to the first situation, the ruling concluded that the plan could not be a Section 412(i) plan. Consequently, it was subject to the general funding requirements of IRC Section 412. In the second situation, the plan was not disqualified because the death benefits under the insurance contracts exceeded the death benefit under the plan. Rather, the cost allocable to the excess death benefit was not currently deductible but would, instead, be carried over to some future years when employer contributions were less than the deductible limit. The nondeductible contributions would be subject to the ten percent excise tax of IRC Section 4972.

Revenue Ruling 2004-20 is of interest primarily because of its clarification of how funding requirements and deductibility are affected when a Section 412(i) plan is "overstuffed" with contracts that provide retirement benefits or death benefits. These are clearly abuses that use the qualified plan rules to finance benefits that cannot be given to participants. In that sense, these types of purchases are not designed to fund retirement plans but to sell insurance.

**Revenue Ruling 2004-21**

Revenue Ruling 2004-21, 2004-10 IRB 544, views the funding of retirement plans with life insurance as a problem of discrimination in favor of the highly compensated. Under the facts of that ruling, life insurance contracts were purchased to provide an incidental death benefit satisfying the Section 401 regulations and the rulings.

Prior to the date distributions were to commence, each participant in the plan had the right to purchase the policy insuring his life for an amount equal to its cash surrender value. The ruling stated, without further explanation, that the policies covering the lives of non-highly compensated
participants had different "features" than the policies covering the lives of highly compensated participants. Further, because of these differences, the rights of the non-highly compensated participants to purchase their insurance policies were not of "inherently equal or greater value" than the rights of the highly compensated. The ruling did not state what these different features are, but later gave as examples of such features a different rate or growth in cash value or different rights to exchange the policy for another vehicle.

For example, the plan might have provided for a death benefit equal to 100 times the monthly retirement benefit to which each participant was eventually entitled. If this calculation resulted in the purchase of a policy with proceeds in excess of $1 million, the type of policy might be one in which cash value growth was very low for many years of the policy’s existence, increasing dramatically in later years. By contrast, the policies with a face value of less than $1 million might provide for cash value that, after a few years, increased gradually every year. The differences in the policies would result in very different financial consequences. The highly compensated participants would purchase the policies, at cash surrender value, for an amount that, when compared to the face value of the policy, was far less, relatively, than the cost to the non-highly compensated participants.

The ruling cited the Treasury Regulations Section 1.401(a)(4)-1(b)(3) requirement that benefits, rights and features under the plan must be available in a nondiscriminatory manner; the rule of Treasury Regulations Section 1.401(a)(4)-4(e)(3)(i) that a distinct right or feature exists if it is not substantially the same as another right or feature; and the rule of Treasury Regulations Section 1.401(a)(4)-4(d)(4) that features can be aggregated if one of them is of inherently equal or greater value than the other and is available to a nondiscriminatory group of participants. Since the better features of the policies covering the highly compensated participants were not available on a nondiscriminatory basis, the plan was held to violate the nondiscriminatory requirements of IRC Section 401(a)(4).

CONCLUSION: NOW WHAT?

The movement demonstrated by the proposed regulations toward greater uniformity, greater certainty and a firmer embrace of the fair market value concept in the valuation of life insurance policies is a welcome one. There is no sensible reason for different measures of value in retirement plans, compensatory and gift tax contexts. Nor is there a reason to have special rules for life insurance valuation that depart from the fair market value concept in the name of ease of administration; at least, not until more effort has been put into measures to value the various types of policies and their features. There is no doubt that an accurate valuation of life insurance will usually be more difficult than valuing stocks and bonds in a retirement plan, due to the many features that can be included in policies. There is also no doubt that the form and structure of policies will continue to evolve, to meet new demands of purchases and the various circumstances that call for life insurance coverage. New planning techniques using life insurance will be developed, most of them valid and consistent with the fair market value standard to which all of the regulations should move and adhere. There are still many opportunities available involving the transfer of policies and the investment of retirement funds in life insurance, including those that are not dependent upon the valuation of life insurance.15 Where techniques attempt to rely on valuation methods that depart from reasonable methods of calculating
fair market value, they will be subject to challenge by the IRS and should be avoided by careful practitioners. Because of the continuing growth in retirement plan assets and the inventiveness of insurance planners, the Treasury should remain aware of the chances of abuse of its regulations and be vigilant in responding to planning that violates basic tax principles that require taxation of the full value of assets transferred in the retirement and compensatory contexts.

As stated at the outset of this article, life insurance offers some valuable tax and financial attributes, and its use should be considered in many planning situations. Effective, creative insurance planning that complies with the letter and the principles of the federal tax system remains an important means of helping individuals and families achieve their long-term financial goals at the lowest possible tax cost.

NOTES

1. PL. 93-406.


5. IRC § 2039.


8. 1988-13 IRB 34.


14. "O, for an acronym of fire, that would ascend the highest heaven of invention!" Shakespeare, almost.