

Part III. Administrative, Procedural, and Miscellaneous

26 CFR 601.201: Rulings and determination letters.

(Also, Part I, §§79, 83, 402; §§1.79-1, 1.83-3, 1.402(a)-1.)

Rev. Proc. 2005-25

SECTION 1. PURPOSE

This revenue procedure provides guidance on how to determine the fair market value of a life insurance contract, retirement income contract, endowment contract, or other contract providing life insurance protection for purposes of applying the rules of §§ 79, 83 and 402 of the Internal Revenue Code. Rev. Proc. 2004-16, 2004-10 I.R.B. 559, is modified and superseded.

SECTION 2. BACKGROUND

.01 Relevance of Fair Market Value

(1) Distributions from Qualified Plans Under § 402(a). Section 402(a) provides generally that any amount actually distributed to any distributee by any employees' trust described in § 401(a) (which is exempt from tax under § 501(a)) is taxable to the distributee, in the taxable year of the distributee in which distributed. Section 1.402(a)-1(a)(1)(iii) of the Income Tax Regulations provides, in general, that a distribution of property by a qualified plan is taken into account by the distributee at its "fair market value." Section 1.402(a)-1(a)(2) provides, in general, that upon distribution of a retirement income, endowment, or other life insurance contract, the "entire cash value"

at the time of distribution must be included in the distributee's income. Amendments to the regulations under § 402 were proposed on February 13, 2004 (69 FR 7384) to clarify that the fair market value standard controls when such a contract is distributed. The same valuation standard applies when such a contract is sold by the plan to a participant. This fair market value standard under the proposed regulations would apply to distributions or sales that occur on or after February 13, 2004.

(2) Permanent Benefits Provided Under § 79. Section 79 generally requires that the cost of group-term life insurance coverage on the life of an employee that is in excess of \$50,000 of coverage be included in the income of the employee. Pursuant to § 1.79-1(b) of the regulations, under specified circumstances, group-term life insurance may be combined with other benefits, referred to as permanent benefits. Under § 1.79-1(d), the employee's income includes the cost of those permanent benefits, reduced by the amount the employee paid for the benefits. The cost of the permanent benefits is determined under a formula provided in the regulations that is based in part on the increase in the employee's deemed death benefit during the year. One of the factors used for determining the deemed death benefit is "the net level premium reserve at the end of that policy year for all benefits provided to the employee by the policy or, if greater, the cash value of the policy at the end of that policy year." Amendments to the regulations under § 79 were proposed on February 13, 2004 (69 FR 7384) that would delete the term "cash value" from the formula for determining the cost of permanent benefits in § 1.79-1(d) and substitute the term "fair market value." The proposed regulations would apply to permanent benefits provided on or after February 13, 2004.

(3) Transfers Under § 83(a). Section 83(a) provides that, when property is transferred to any person in connection with the performance of services, the service provider must include in gross income (as compensation income) the excess of the fair market value of the property, determined without regard to lapse restrictions (such as life insurance contract surrender charges), and determined at the first time that the transferee's rights in the property are either transferable or not subject to a substantial risk of forfeiture (i.e., when those rights become "substantially vested"), over the amount (if any) paid for the property. Section 1.83-3(e) of the regulations provides 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. Amendments to the regulations under § 83 were proposed on February 13, 2004 (69 FR 7384) that would provide that, in the case of a transfer of an insurance contract, retirement income contract, endowment contract, or other contract providing life insurance protection, the policy cash value and all other rights under the contract (including any supplemental agreements, whether or not guaranteed), other than current insurance protection, are treated as property for purposes of § 83. The proposed regulations would apply to transfers that occur on or after February 13, 2004 (with an exception for any contract that was part of a split-dollar arrangement entered into on or before September 17, 2003, and which is not materially modified after that date).

(4) Contributions To and Distributions From Nonexempt Employees' Trusts. Section 402(b)(1) provides that contributions to an employees' trust made by an employer during a taxable year of the employer which ends with or within a taxable year

of the trust for which the trust is not exempt from tax under § 501(a) are included in the gross income of the employee in accordance with § 83 (relating to property transferred in connection with the performance of services), except that the value of the employee's interest in the trust is substituted for the fair market value of the property for purposes of applying § 83. Section 1.402(b)-1(a) of the regulations provides that any contributions to a nonexempt trust by an employer during a taxable year of the employer which ends within or with a taxable year of the trust shall be included as compensation in the gross income of the employee for the employee's taxable year during which the contribution is made, but only to the extent that the employee's interest in such contribution is substantially vested (within the meaning of § 1.83-3(b)) at the time the contribution is made.

Section 1.402(b)-1(b)(1) of the regulations provides that if rights of an employee under a trust become substantially vested during a taxable year of the employee and a taxable year for which the trust is not exempt under § 501(a) ends with or within such year, the value of the employee's interest in the trust on the date of such change (substantially nonvested to substantially vested) is included in the employee's gross income for that taxable year. Section 1.402(b)-1(b)(2)(i) provides that the term "the value of the employee's interest in a trust" means the amount of the employee's beneficial interest in the net fair market value of all the assets in the trust as of any date on which some or all of the employee's interest in the trust becomes substantially vested. The net fair market value of all the assets in the trust is the total amount of the fair market values (determined without regard to any lapse restriction, as defined in § 1.83-3(h)) of all the assets in the trust, less the amount of all the liabilities to which such

assets are subject or which the trust has assumed (other than the rights of any employee in such assets), as of the date on which some or all of the employee's interest in the trust becomes substantially vested.

Section 402(b)(2) and § 1.402(b)-1(c) provide that any amount actually distributed or made available to any distributee by an employee's trust in a taxable year in which it is not exempt under § 501(a) is taxable under § 72 (relating to annuities) to the distributee in the taxable year in which it is so distributed or made available. If, for example, the distribution consists of an annuity contract, the amount of the distribution is considered to be the entire value of the contract at the time of the distribution. Such value is includible in the gross income of the distributee to the extent that such value exceeds the investment in the contract, determined by applying § 72. The distributions are included in income under the rules of § 72 whether or not the employee's rights in the contributions become substantially vested beforehand.

Section 402(b)(4)(A) provides that, if one of the reasons a trust is not exempt from tax under § 501(a) is the failure of the plan of which it is a part to meet the requirements of § 401(a)(26) or 410(b), then a highly compensated employee shall, in lieu of the amount determined under § 402(b)(1) or under § 402(b)(2), include in gross income for the taxable year with or within which the taxable year of the trust ends an amount equal to the vested accrued benefit of such employee (other than the employee's investment in the contract) as of the close of such taxable year of the trust.

.02 Prior Guidance Regarding Fair Market Value

(1) Rev. Rul. 59-195 - Interpolated Terminal Reserve. Rev. Rul. 59-195, 1959-1 C.B. 18, addressed the determination of the fair market value of a policy in a situation

in which an employer sold to an employee a life insurance contract on which premiums were still due. The revenue ruling held that, for purposes of computing the employee's taxable gain in the year of the purchase, the value of the contract should be determined using the approach of § 25.2512-6 of the Gift Tax Regulations. Under that regulation, the value of a life insurance contract that has been in force for some time and on which further premium payments are to be made is not its cash surrender value, but, rather, the interpolated terminal reserve as of the date of sale plus the proportionate part of any employer-paid unearned premiums. Section 25.2512-6 also provides that if "because of the unusual nature of the contract such approximation is not reasonably close to the full value, this method may not be used." Thus, this method is appropriate only where the reserve reflects the value of all of the relevant features of the policy.

(2) Notice 89-25 – Tax Reserves. Q&A-10 of Notice 89-25, 1989-1 C.B. 662, described a distribution from a qualified plan of a life insurance policy with a value substantially higher than the cash surrender value stated in the policy. The notice concluded that the practice of using cash surrender value as fair market value is not appropriate where the total policy reserves, including life insurance reserves (if any) computed under § 807(d), together with any reserves for advance premiums, dividend accumulations, etc., represent a much more accurate approximation of the policy's fair market value.

(3) Rev. Proc. 2004-16 – Safe Harbor for Determining Fair Market Value. Rev. Proc. 2004-16, 2004-10 I.R.B. 559, provided a safe harbor for determining fair market value of variable and non-variable contracts for purposes of applying the rules under the proposed regulations issued under §§ 79, 83, and 402(a). The safe harbor for non-

variable contracts set forth in Rev. Proc. 2004-16 permitted the use of the contract's cash value without reduction for surrender charges as the fair market value so long as this cash value is at least equal to the sum of: (1) the premiums paid, plus (2) interest, dividends or other credits, minus (3) reasonable mortality and other reasonable charges actually charged by the date of determination (e.g., date of the transfer or distribution) that are expected to be paid. In those cases where the contract is a variable contract (as defined in § 817(d)), cash value without reduction for surrender charges may be treated as the fair market value of the contract provided such cash value is at least equal to the sum of: (1) the premiums paid, plus (2) all adjustments made with respect to those premiums during that period (whether under the contract or otherwise) that reflect investment return and the current market value of segregated asset accounts, minus (3) reasonable mortality and other reasonable charges actually charged by the date of determination (e.g., date of the transfer or distribution) that are expected to be paid.

.03 Need For Further Guidance. After the issuance of Rev. Proc. 2004-16, the Service received comments concerning the safe harbors set forth in that revenue procedure. Commentators asserted that the formulas did not function well for certain types of traditional policies. In addition, commentators were concerned about the possible double-counting of dividends under the formulas, and the fact that the formulas did not make an explicit adjustment for surrender charges, withdrawals, or distributions. The Service has determined that adjustments to the safe harbors are appropriate.

SECTION 3. GUIDANCE FOR DETERMINING FAIR MARKET VALUE

.01 Safe Harbor Formulas for Fair Market Value. This revenue procedure provides two safe harbor formulas that, if used to determine the value of an insurance contract, retirement income contract, endowment contract, or other contract providing life insurance protection that is distributed or otherwise transferred from a qualified plan, will meet the definition of fair market value for purposes of § 402(a). These safe harbor formulas will also meet the definition of fair market value for purposes of §§ 79, 83, and 402(b) and, in addition, will meet the definition of vested accrued benefit for purposes of § 402(b)(4)(A).

.02 Safe Harbor for Non-Variable Contracts. Except as provided in section 3.03 of this revenue procedure (which applies only to variable contracts), the fair market value of an insurance contract, retirement income contract, endowment contract, or other contract providing life insurance protection may be measured as the greater of: A) the sum of the interpolated terminal reserve and any unearned premiums plus a pro rata portion of a reasonable estimate of dividends expected to be paid for that policy year based on company experience, and B) the product of the PERC amount (the amount described in the following sentence based on premiums, earnings, and reasonable charges) and the applicable Average Surrender Factor described in section 3.04 of this revenue procedure. The PERC amount is the aggregate of: (1) the premiums paid from the date of issue through the valuation date without reduction for dividends that offset those premiums, plus (2) dividends applied to purchase paid-up insurance prior to the valuation date, plus (3) any amounts credited (or otherwise made available) to the policyholder with respect to premiums, including interest and similar income items

(whether credited or made available under the contract or to some other account), but not including dividends used to offset premiums and dividends used to purchase paid up insurance, minus (4) explicit or implicit reasonable mortality charges and reasonable charges (other than mortality charges), but only if those charges are actually charged on or before the valuation date and those charges are not expected to be refunded, rebated, or otherwise reversed at a later date, minus (5) any distributions (including distributions of dividends and dividends held on account), withdrawals, or partial surrenders taken prior to the valuation date.

.03 Safe Harbor for Variable Contracts. If the insurance contract, retirement income contract, endowment contract, or other contract providing life insurance protection being valued is a variable contract (as defined in § 817(d)), the fair market value may be measured as the greater of: A) the sum of the interpolated terminal reserve and any unearned premiums plus a pro rata portion of a reasonable estimate of dividends expected to be paid for that policy year based on company experience, and B) the product of the variable PERC amount (the amount described in the following sentence based on premiums, earnings, and reasonable charges) and the applicable Average Surrender Factor described in section 3.04 of this revenue procedure. The variable PERC amount is the aggregate of: (1) the premiums paid from the date of issue through the valuation date without reduction for dividends that offset those premiums, plus (2) dividends applied to increase the value of the contract (including dividends used to purchase paid-up insurance) prior to the valuation date, plus or minus (3) all adjustments (whether credited or made available under the contract or to some other account) that reflect the investment return and the market value of segregated asset

accounts, minus (4) explicit or implicit reasonable mortality charges and reasonable charges (other than mortality charges), but only if those charges are actually charged on or before the valuation date and those charges are not expected to be refunded, rebated, or otherwise reversed at a later date, minus (5) any distributions (including distributions of dividends and dividends held on account), withdrawals, or partial surrenders taken prior to the valuation date.

.04 Average Surrender Factor.

(1) Sections 79, 83, and 402(b). The Average Surrender Factor for purposes of §§ 79, 83, and 402(b) (for which no adjustment for potential surrender charges is permitted) is 1.00.

(2) Qualified plans. In the case of a distribution or sale from a qualified plan, if the contract provides for explicit surrender charges, the Average Surrender Factor is the unweighted average of the applicable surrender factors over the 10 years beginning with the policy year of the distribution or sale. For this purpose, the applicable surrender factor for a policy year is equal to the greater of 0.70 and a fraction, the numerator of which is the projected amount of cash that would be available if the policy were surrendered on the first day of the policy year (or, in the case of the policy year of the distribution or sale, the amount of cash that was actually available on the first day of that policy year) and the denominator of which is the projected (or actual) PERC amount as of that same date. The applicable surrender factor for a year in which there is no surrender charge is 1.00. A surrender charge is permitted to be taken into account under section 3.04 of this revenue procedure only if it is contractually specified at issuance and expressed in the form of nonincreasing percentages or amounts.

.05 Application of Safe Harbor Formulas. The formulas set forth in sections 3.02 and 3.03 of this revenue procedure must be interpreted in a reasonable manner, consistent with the purpose of identifying the fair market value of a contract. Thus, for example, if income is calculated with respect to premiums paid under the contract, that amount must be included in item (3) of the formulas, even if the income can only be realized through an exchange right that gives rise to a springing cash value under another policy. Similarly, if a mortality charge or other amount charged under a contract can be expected to be directly or indirectly returned to the contractholder (whether through the contract, a supplemental agreement, or under a verbal understanding and regardless of whether there is a guarantee), the charge is not permitted to be subtracted under item (4) in the formulas. In addition, a surrender charge cannot be taken into account in determining an average surrender factor if it may be waived or otherwise avoided or was created for purposes of the transfer or distribution. Furthermore, at no time are these rules to be interpreted in a manner that allows the use of these formulas to understate the fair market value of the life insurance contracts and associated distributions or transfers. For example, if the insurance contract has not been in force for some time, the value of the contract is best established through the sale of the particular insurance contract by the insurance company (i.e., as the premiums paid for that contract).

.06 Date as of Which Fair Market Value is Determined. In the case of a distribution or sale of a contract from a qualified plan, the date as of which the fair market value is to be determined is the date of that distribution or sale. The date of determination in the case of the provision of permanent benefits subject to § 79 is the

date those benefits are provided. The date of determination in the case of a transfer of an insurance contract subject to § 83 is the date on which fair market value must be determined under the rules of § 83. The date of determination in the case of a non-exempt employees' trust under § 402(b) is the date on which fair market value must be determined under the rules of § 402(b).

SECTION 4. ADDITIONAL AMOUNTS THAT MUST BE INCLUDED IN INCOME

.01 Treatment of Dividends Held on Deposit. Dividends held on deposit with respect to an insurance contract are not included in the fair market value of the contract. However, such dividends are taxable income to the employee or service provider at the time the rights to those dividends are transferred to that individual. For example, if a qualified plan distributes a contract to an employee along with the rights to dividends held on deposit with respect to that contract, the employee must take into income both the fair market value of the contract and the value of the dividends held on the deposit. This is the case regardless of whether the dividends on deposit are paid directly to the employee at the time the contract is distributed or merely made available for payment at a later time.

.02 Treatment of Loans. If a loan (including a loan secured by the cash value of a life insurance contract) is made to an employee or other service provider in connection with the performance of services, to the extent the debt owed by the employee or other service provider is terminated upon distribution or transfer of the collateral, the terminated loan or debt amount constitutes an additional distribution to the employee or service provider at that time. For this purpose, it is irrelevant whether

the loan is described as having been forgiven, canceled, satisfied, extinguished, or otherwise offset, provided that the loan no longer exists after the distribution or transfer. For example, if a life insurance contract with a fair market value of \$100,000 (without regard to any debt) is collateral for a policy loan of \$30,000 (borrowed by the employer, who then lends the \$30,000 to the employee) prior to the distribution or transfer of the contract, and the loan to the employee no longer exists after the distribution or transfer so that the amount distributed is \$70,000 ($\$100,000 - \$30,000$), the entire \$100,000 must be taken into account by the employee. If a participant receives a loan from a life insurance contract held by a qualified plan (or other plan subject to the rules of § 72(p)) and the contract is subsequently distributed to the participant in satisfaction of the participant's benefit under the plan, the reduction in the value of the distribution in order to repay the participant's loan from the plan constitutes a plan loan offset amount, which is treated as a distribution from the plan. See § 1.72(p)-1, Q&A-13(b).

SECTION 5. EFFECTIVE DATE

This revenue procedure applies to distributions, sales, and other transfers made on or after February 13, 2004, to permanent benefits within the meaning of § 1.79-0 provided on or after February 13, 2004, and to non-exempt employees' trusts under § 402(b) for periods on or after February 13, 2004. However, for periods before May 1, 2005, taxpayers may rely on the safe harbors of this revenue procedure and for periods on or after February 13, 2004, and before May 1, 2005, taxpayers may also rely on the safe harbors in Rev. Proc. 2004-16.

SECTION 6. EFFECT ON OTHER DOCUMENTS

Rev. Proc. 2004-16 is modified and superseded.

DRAFTING INFORMATION

The principal authors of this revenue procedure are Bruce Perlin and Linda Marshall, Office of Division Counsel/Associate Chief Counsel (Tax Exempt and Government Entities) and Larry Isaacs of the Employee Plans, Tax Exempt and Government Entities Division. For further information regarding this revenue procedure as it pertains to § 402(a), please contact Bruce Perlin or Linda Marshall at (202) 622-6090 (not a toll-free number) or Larry Isaacs at (202) 283-9888 (not a toll-free number) or contact the Employee Plans' taxpayer assistance telephone service at (877) 829-5500 (a toll-free number) between the hours of 8:00 a.m. and 6:30 p.m. Eastern Time, Monday through Friday. For further information regarding this revenue procedure as it pertains to § 79, please contact Betty Clary of the Office of Division Counsel/Associate Chief Counsel (Tax Exempt and Government Entities) at (202) 622-6080 (not a toll-free number). For further information regarding this revenue procedure as it pertains to §§ 83 and 402(b), please contact Robert Misner of the Office of Division Counsel/Associate Chief Counsel (Tax Exempt and Government Entities) at (202) 622-6030 (not a toll-free number).