WHAT THE HECK IS THIS POLICY WORTH?

Fair Market Value of a Universal Life Insurance Policy

CASSIDY & COMPANY

What the Heck is This Policy Worth?

Fair Market Value of a Universal Life Insurance Policy

This paper summarizes the determination of the fair market value of certain permanent life insurance policies for purposes of transferring, gifting or selling the policy from one individual or trust to another. Historically, life insurance companies offered two types of life insurance: Annual Renewable Term Insurance and Whole Life Insurance. Over time, new types of policies have evolved, such as Universal Life and Variable Life, which have been difficult to reconcile with the outdated Internal Revenue Service ("IRS") guidelines for valuation. As a result, insurance companies are uncertain how to properly value certain policies, which has led to inconsistent valuations across life insurance companies. Accordingly, this paper focuses on alternative valuation methods of certain difficult to value life insurance policies, even after an IRS Form 712 has been issued.

Fair Market Value

The two Treasury Regulations ("Treas. Regs.") applicable to valuing life insurance policies, Treas. Regs. §§ 20.2031-8 and 25.2512-6, were last amended in 1974. These Treas. Regs. are tailored to historically common policies, namely, Annual Renewable Term and Whole Life. An Annual Renewable Term policy has no reserves, thus the valuation is determined by looking to the "unearned premium[1]." In order to determine the fair market value of a Whole Life policy (that has been in effect for several years with premiums remaining), insurance companies frequently use the interpolated terminal reserve value (hereinafter "ITR value")[2]. Typically, the cash surrender value and the ITR value are very similar because the insurance company is aware of how much reserve is necessary each year based on the amount of future premiums to be received and the expected death benefit[3].

In the 44 years since the IRS amended the Treas. Regs. regarding valuation of life insurance, new life insurance products have entered the market. For example, a Universal Life policy is a flexible premium policy, thus the terminal reserve value is not known until the end of the policy year. As a result, it is difficult to apply the Treas. Regs. currently used to determine the fair market value of these new types of policies[4].

Furthermore, today there are several types of reserve values, including: tax reserve, statutory reserve, AG 38 reserve, and deficiency reserve. It is unclear which reserve an insurance company should use to calculate the fair market value of a policy. In addition, a few insurance companies use the cash surrender value, or the cash accumulation value, or the California Method (the average of the cash surrender value and the cash accumulation value), as the ITR value. The different options available for the reserve value has led to different methodologies for calculating the ITR value, which has resulted in different insurance companies arriving at vastly different fair market values for similarly situated policies.

IRS Form 712

Generally, in order to determine the fair market value of a life insurance policy, an owner will request an IRS Form 712 from the insurance company. The insurance company will then complete the form and certify that the information is "true and correct." However, once an insurance company has developed a particular methodology (based on the type of reserve value calculation) for determining fair market value, the company is unlikely to change their methodology because they have an interest in ensuring equal treatment among policy holders who request an IRS Form 712[5].

A dilemma occurs when the IRS Form 712 is returned with a value different than expected. If the owner chooses to use another value as the fair market value, it is recommended that the owner provides a full explanation regarding how the value was determined. This explanation is important in order to clarify that the transaction was actually a sale and not a gift, for example, in the event of a sale from an individual to his or her irrevocable grantor trust or from one grantor trust to another.

Consider the following example, which is based on a study by a life insurance company and cited from a Leimberg Services LISI Newsletter, for an insured who bought a combination of six policies each with a $5,000,000 face amount from three different companies[6]:

[1] The unearned premium is calculated by multiplying the premium already paid that year by a fraction. The numerator of which is the number of months from the current date until the next premium is due; the denominator of which is the total number of months the policy covers.
[2] The ITR value is calculated by subtracting the policy's prior year reserve from the reserve at the end of the current policy year. Then, multiply the difference by a fraction. The numerator is the number of months of the current year the policy was in existence; the denominator is 12. Then, the product is added to the reserve of the previous year. Last, add this result to the unearned premium (unearned premium is calculated in footnote 1).
[3] Richard Harris, *Transferring Life Insurance by Gift or Sale*, Trust & Estates, (April 2011), trustsandestates.com.
[4] Brody, Lawrence, et al., § 8.02 Current Issues Regarding the Valuation of Life Insurance Policies, NYU Review of Employee Benefits, (2012).
[5] Id.
[6] Source: LISI Estate Planning Newsletter 1638 (May 10, 2010), www.leimbergservices.com

Carrier	Policy Type	Face Amount	Cumulative Premium	Cash Surrender Value	Value Reported by Carrier	Carrier Valuation Method
A	GUL	$5,000,000	$866,950	$0	$941,803	AG 38 Statutory Reserve with Deficiency
	UL	$5,000,000	$866,950	$285,011	$432,620	Statutory Reserve
B	GUL	$5,000,000	$982,500	$237,930	$237,930	Cash Surrender Value
	UL	$5,000,000	$982,500	$374,550	$374,550	Cash Surrender Value
C	GUL	$5,000,000	$912,500	$170,413	$512,389	AG 38 Statutory Reserve without Deficiency
	UL	$5,000,000	$912,500	$390,053	$474,053	California Method

Qualified Appraisal

Due to the lack of guidance from the IRS regarding the determination of fair market value of a certain policies, and the vast inconsistencies in methodologies amongst life insurance companies, an owner of a policy may argue that the fair market value is more accurately represented by a qualified appraisal that uses the "willing buyer, willing seller" standard. The "willing buyer, willing seller" approach is found in Treas. Regs. §§ 20.2031-1 and 25.2512. The Treas. Regs. provide that "[t]he value of the property is the price at which such property would change hands between a willing buyer and willing seller." Therefore, **a qualified appraisal using the "willing buyer, willing seller" approach is an alternative valuation method, which may be used to justify a lower sale price than the IRS Form 712 calculated.**

Secondary Market Valuation (SMV)

Determining fair market value of a life insurance policy may no longer need to be a guessing game. The policy can be valued similarly to other pieces of property in the secondary market for life insurance. The secondary market for life insurance can produce an alternative value than the insurance carrier will provide. All types of policies can qualify, including term, if the policy fits the current purchase parameters.

A regulated and institutional framework has developed over the past decade to formalize the "willing buyer and willing seller" in a transparent platform. Policy owners and their advisors are no longer forced to rely on outdated rules for calculating fair market value. There is a proven methodology and process to determine a life insurance policy's value based upon the current health of the insured and by analyzing the details of the life insurance contract and premium streams.

Revenue Ruling 59-60: A determination of fair market value, being a question of fact, will depend upon the circumstances in each case. No formula can be devised that will be generally applicable to the multitude of different valuation issues arising in estate and gift tax cases.

- In resolving such differences, he should maintain a reasonable attitude in recognition of the fact that valuation is not an exact science.
- A sound valuation will be based upon all the relevant facts, but the elements of common sense, informed judgment and reasonableness must enter into the process of weighing those facts and determining their aggregate significance.

The methodology to estimate the fair market value of a client's life insurance policy is outlined in a process known as the Secondary Market Valuation (SMV). This process employs standardized industry practices and analytics, which consist of a combination of analyzing the insurance contract, policy values, required capital outlay (premiums), database comparatives, and the life expectancy of the insured. The process is simple to follow and easy to integrate into an existing planning process. The insured and policy owner complete the appropriate forms and disclosures, and current information is obtained and reviewed to determine the potential value of the policy and the options that might exist.

Some of the common fact patterns for advisors and their clients participating in the Secondary Market are in situations such as:

- Determining the fair market value of the contract
- Transferring a policy from one entity to another
- Completing a business valuation - including insurance or annuities
- Valuing a Convertible Term Contract for a buy/sell or key-executive
- Split Dollar rollouts
- M&A or bankruptcy transactions
- Exit-Planning recommendations

The process to evaluate a policy begins with contacting the insured and policy owner to sign the state regulated forms that provide the proper authorization to begin the valuation process. The following items and steps are required to build and facilitate the bidding process. The critical steps include a collection of the last five years of medical records, acquisition of independent life expectancy reports from licensed providers, review of database comparisons for reference, and engage the licensed buyers/capital markets to facilitate the bidding process.

The most attractive policies to institutional buyers are those that were issued standard or preferred and there has been a change health since issue. Ideal policies were issued by highly rated insurance carriers, with very low credit risk or volatility, and have a manageable carrying cost or future premium streams. This is important due to the illiquid nature of the asset itself. Buyers in the current market require returns similar to other alternative investments, as they are committed to a longer duration and have to maintain considerable capital commitments and reserves.

This life insurance asset and Secondary Market for Life Insurance is known globally as "Longevity Risk." Top-rated insurance carriers performed better than banks during the Credit Crisis of 2008-2009 and both domestic and global funds became attracted to the non-correlated aspect of this asset class. It is not tied to the equity markets or other traditional markets. Sophisticated institutional buyers such as pension plans, reinsurers, private equity, municipalities, and others have realized that they could deploy large amounts of capital, while benefiting from an aging population, in short, an aged population has more predictable mortality. Many experts feel this investment strategy continue to attract global investors as it qualifies for a higher standard known as "socially responsible investing," which is grounded by an approach that focuses on maximizing both financial return and social good.

Conclusion

Life insurance policy valuation remains a complicated topic fraught with antiquated Treas. Regs. and vast inconsistencies amongst life insurance companies. The result is no ascertainable standard for consistency in valuation methods. Therefore, a policy owner may, instead, wish to rely on a qualified appraisal that uses the "willing buyer, willing seller" standard to determine fair market value. The secondary market, for which there is no better example of "willing buyer, willing seller," may provide a viable option for clients engaging in financial and/or estate planning transactions where determining the fair market value of a policy for tax reporting purposes is required. However, the secondary market is typically only available to policies that meet specific criteria, such as insureds who are over age 65. For younger insureds, or others for which the secondary market is not available, a qualified appraisal by an independent appraiser who specializes in life insurance valuation may be the better means for reporting purposes if the value reported by the carrier on Form 712 is not an appropriate representation of the policy's fair market value.

IRS Required Statement: *Pursuant to recently-promulgated U.S. Treasury Department Regulations, we are now required to advise you that, unless otherwise expressly stated, any federal tax advice contained in this communication, including attachments and enclosures, is not intended or written to be used, and cannot be used, for the purpose of (i) avoiding tax-related penalties under the Internal Revenue Code or (ii) promoting, marketing or recommending to another party any tax-related matters addressed herein.*

614 West Bay Street, Tampa, FL 33606 | O 813.877.7766 | F 813.877.8844 | cassidy-co.com