

Part III. Administrative, Procedural, and Miscellaneous

26 CFR 601.201: Rulings and determination letters.
(Also, Part I, §402; §1.402(a)-1.)

Rev. Proc. 2004-16

SECTION 1. PURPOSE

This revenue procedure is issued in connection with the issuance of proposed regulations under § 402(a) of the Internal Revenue Code regarding the valuation of life insurance contracts upon distribution from a qualified retirement plan and proposed regulations under §§79 and 83 regarding the valuation of life insurance contracts under those sections (REG-126967-03). The preamble to the proposed regulations states that it is not appropriate in some cases to use either the net surrender value of a distributed life insurance contract (i.e., the contract's cash value after reduction for any surrender charges) or the contract's reserves as the contract's fair market value upon distribution of an insurance contract from a qualified plan but the preamble provides limited guidance as to what value may be used instead. Similarly, the proposed regulations under §§79 and 83 clarify that the amount includible in income under those sections is based upon the fair market value of the insurance contract rather than its cash value but these proposed regulations do not provide any guidance as to what constitutes fair market value. The regulations are generally proposed to apply beginning on the date the proposed regulations are filed in the Federal Register. The preamble to the proposed regulations also requests public comments regarding appropriate methods for valuing life insurance contracts when distributed from qualified retirement plans and for purposes of §§79 and 83. Until further guidance is issued, this revenue procedure provides interim rules under which the cash value (without reduction for surrender charges) of a life insurance contract may be treated as the contract's fair market value when the contract is distributed from a qualified plan under §402 and for purposes of §§79 and 83.

SECTION 2. BACKGROUND

.01 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) shall be taxable to the distributee, in the taxable year of the distributee in which distributed, under § 72.

.02 Section 1.402(a)-1(a)(1)(iii) of the current regulations provides, in general, that a distribution of property by a §401(a) plan shall be taken into account by the distributee at its "fair market value." Section 1.402(a)-1(a)(2) of the current regulations provides, in general, that upon distribution of an annuity or life insurance contract, the "entire cash value" must be included in the distributee's income. The current regulations do not define "fair market value" or "entire cash value" and questions have arisen regarding the interaction between these two provisions.

.03 The proposed regulations would clarify that the requirement that a distribution of property must be included in the distributee's income at fair market value is controlling in those situations where the existing regulations provide for the inclusion of the entire cash value. Thus, the proposed regulations provide that, in those cases where a qualified plan distributes a life insurance contract, retirement income contract, endowment contract, or other contract providing life insurance protection, the fair market value of such a contract is generally included in the distributee's income rather than the entire cash value of the contract. For this purpose, the policy cash value and all other rights under the contract (including any supplemental agreements thereto and whether or not guaranteed) are included in determining the fair market value of such a contract. The proposed regulations provide a similar rule for purposes of the valuation of such contracts under §§ 79 and 83.

.04 In Rev. Rul. 59-195, 1959-1 C.B. 18, the Service ruled that in situations similar to those where an employer purchases and pays the premiums on an insurance policy on the life of one of its employees and subsequently sells such policy, on which further premiums must be paid, the value of such policy, for computing taxable gain in the year of purchase, should be determined under the method of valuation prescribed in §25.2512-6 of the Gift Tax Regulations. Under this method, the value of such a policy is not its cash surrender value but the interpolated terminal reserve at the date of sale plus the proportionate part of any premium paid by the employer prior to the date of the sale which is applicable to a period subsequent to the date of the sale. 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 may not be used to determine the fair market value of an insurance policy where the reserve does not reflect the value of all of the relevant features of the policy.

.05 In Q&A-10 of Notice 89-25, 1989-1 C.B. 662, the IRS addressed the question of what amount is includible in income under § 402(a) when a participant receives a distribution from a qualified plan that includes a life insurance policy with a value substantially higher than the cash surrender value stated in the policy. The notice noted the practice of using cash surrender value as fair market value for these purposes and concluded that this practice 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.

.06 Since Notice 89-25 was issued, life insurance contracts have been marketed that are structured in a manner which results in a temporary period during which neither a contract’s reserves nor its cash surrender value represent the fair market value of the contract. For example, some life insurance contracts may provide for large surrender charges and other charges that are not expected to be paid because they are expected to be eliminated or reversed in the future (under the contract or under another contract for which the first contract is exchanged), but this future elimination or reversal is not always reflected in the calculation of the contract’s reserve. If such a contract is distributed prior to the elimination or reversal of those charges, both the cash surrender value and the reserve under the contract could significantly understate the fair market value of the contract. Thus, the preamble to the proposed regulations states that, in some cases, it would not be appropriate to use either the net surrender value (i.e. the contract’s cash value after reduction for any surrender charges) or, because of the unusual nature of the contract, the contract’s reserves to determine the fair market value of the contract. Accordingly, Q&A-10 of Notice 89-25 should not be interpreted to provide that a contract’s reserves (including life insurance reserves (if any) computed under § 807(d), together with any reserves for advance premiums, dividend accumulations, etc.) are always an accurate representation of the contract’s fair market value.

.07 As stated in the preamble to the proposed regulations, the amount of any distribution determined under §402 also applies for purposes of determining the qualified status of any plan. For example, the fair market value of a distributed life insurance contract, determined in accordance with the proposed regulations and this revenue procedure, must be considered in determining whether the insured participant has received benefits in excess of the limits imposed by §415.

.08 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 Income Tax Regulations, under specified circumstances group-term life insurance may be combined with other benefits, referred to as permanent benefits.

.09 Permanent benefits provided to an employee are subject to taxation under rules described in §1.79-1(d). Under those rules, the cost of the permanent benefits, reduced by the amount paid for those benefits by the employee, is included in the employee’s income. The cost

of the benefits can be no less than an amount determined under a formula provided in the regulations. The formula 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."

.10 The proposed regulations would amend §1.79-1(d) to delete the term cash value from the formula for determining the cost of permanent benefits and substitute the term fair market value. The purpose of the change is to clarify that, unless specifically excepted from the definition of permanent benefits, the value of all features of a life insurance policy providing an economic benefit to an employee (including, for example, the value of a springing cash value feature) must be included in the employee's income.

.11 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) 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. The proposed regulations generally would amend §1.83-3(e) to 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 this section. However, in the case of the transfer of a life insurance contract, retirement income contract, endowment contract, or other contract providing life insurance protection, which was part of a split-dollar arrangement (as defined in §1.61-22(j)) entered into on or before September 17, 2003, and which is not materially modified (as defined in §1.61-22(j)(2)) after September 17, 2003, only the cash surrender value of the contract is considered to be property.

SECTION 3. INTERIM GUIDANCE FOR DETERMINING FAIR MARKET VALUE

.01 The Service and the Treasury recognize that many taxpayers could have difficulty determining the fair market value of an insurance contract after the issuance of the proposed regulations under §§79 and 83 and the clarification in the preamble to the proposed regulations under §402 that Notice 89-25 should not be interpreted to provide that a contract's reserves (including life insurance reserves (if any) computed under §807(d), together with any reserves for advance premiums, dividend accumulations, etc.) are always an accurate representation of the contract's fair market value. Accordingly, in connection with the proposed regulations, this revenue procedure provides interim rules under which the cash value (without reduction for surrender charges) of a life insurance contract distributed from a qualified plan may be treated as the fair market value of that contract. These interim rules also apply for purposes of determining the value of insurance contracts under §§79 and 83.

.02 Cash value (without reduction for surrender charges) may be treated as the fair market value of a contract as of a determination date provided such cash value is at least as large as the aggregate of: (1) the premiums paid from the date of issue through the date of determination, plus (2) any amounts credited (or otherwise made available) to the policyholder with respect to those premiums, including interest, dividends, and similar income items (whether under the contract or otherwise), minus (3) reasonable mortality charges and reasonable charges (other than mortality charges), but only if those charges are actually charged on or before the date of determination and are expected to be paid.

.03 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 as large as the aggregate of: (1) the premiums paid from the date of issue through the date of determination, 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 charges and reasonable charges (other than mortality charges), but only if those charges are actually charged on or before the date of determination and are expected to be paid.

.04 The date of determination in the case of a distribution of a contract from a qualified plan is the date of that distribution. 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.

SECTION 4. EFFECTIVE DATE

This revenue procedure is effective on February 13, 2004.

DRAFTING INFORMATION

The principal authors of this revenue procedure are Robert Walsh 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, please contact the Employee Plans' taxpayer assistance telephone service at 1-877-829-5500 (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, 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). Mr. Walsh and Mr. Isaacs may be reached at (202) 283-9888 (not a toll-free number).