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Because you asked

# Valuation of life insurance policies

This guide provides a general overview of policy valuation and addresses some frequently asked questions about this topic. For more information, see [Introduction](#).

INSURANCE PRODUCTS	
MAY LOSE VALUE	NOT A DEPOSIT
NOT BANK GUARANTEED	NOT FDIC INSURED
NOT INSURED BY ANY GOVERNMENT AGENCY	

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When a life insurance policy is transferred, the policy may need to be valued for income tax, gift tax, estate tax, or generation-skipping transfer tax purposes. Even when a policy is not transferred, the policy owner or other interested parties may need to value the policy for tax, accounting, or other nontax reasons. The question “what is the value of a life insurance policy” can result in complex and inconsistent answers for many reasons, including:

- The methodologies for valuing policies presented in the Treasury Regulations and case law have not always been consistent and can differ depending on the transfer itself — e.g., a transfer by gift may be valued differently than a transfer to an employee as compensation under the various regulations.
- Product developments, as well as legal and regulatory developments (e.g., the various approaches to measuring policy reserves), require carriers and financial professionals to apply old valuation methodologies to these newer products to provide clients with information regarding policy valuation. Unfortunately, in the absence of clearer, updated, and more consistent

guidance, life insurance carriers and financial professionals providing information regarding policy valuation often do not agree on how to interpret a particular valuation methodology or how to apply an existing pronouncement to a product that did not exist at the time the pronouncement was published.

- In the absence of applicable regulations or guidance from the IRS, life insurance policies can be difficult to value and there often is no secondary market valuation available, especially for younger and healthier insureds.

In light of these complexities, we’ve compiled frequently asked questions to help you navigate this challenging topic. As is the case with any asset that needs to be valued, the starting point in valuing a life insurance policy is to determine its fair market value.



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## 1. What is fair market value?

The value of any asset for tax purposes is generally its fair market value (FMV) as of the valuation date. Although not specifically defined in the Internal Revenue Code (IRC), the Treasury Regulations generally provide that FMV is the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of relevant facts. The FMV of a particular item of property is not to be determined by a forced sale price. Additionally, these Regulations provide that all relevant facts and elements of value shall be considered in every case.<sup>1</sup>

Using the willing buyer/willing seller standard works well for determining the FMV of assets that are regularly sold in a retail market or in a strong secondary market as of the valuation date. However, secondary market prices are unavailable for many life insurance contracts, particularly where an insured is younger and healthier. Because FMV of a life insurance policy is not easily determinable, tax practitioners often look to other regulations, pronouncements, rulings, etc. issued by the IRS and case law to determine an acceptable value for transfer purposes.

## 2. What does interpolated terminal reserve mean? How is it calculated?

An interpolated terminal reserve (ITR) value is calculated at a particular point in time from the policy's reserve value (the amount of money that the life insurance carrier has set aside by law to guarantee the payment of policy benefits). The regulations provide that this value is derived by computing the difference between the policy's reserve value at the date of the last premium payment and the projected reserve value at the date of the next premium. The difference between these reserve values is then allocated pro rata over the calendar year and added to the previous year's terminal reserve to derive the ITR value.

Under the gift and estate tax regulations, any "unearned premium" as of the date of the policy valuation would be added to the ITR value to determine an appropriate value. Unearned premium is calculated by multiplying the premium paid as of the policy's anniversary date by a fraction representing the number of days remaining until the next anniversary date over the number of days in the year (e.g., if policy valuation date was July 1 and policy anniversary date is January 1 of the following year, the unearned premium would be the premium paid multiplied by  $182/365$ , or  $1/2$ ).

Interestingly, the guidance authorizing the use of ITR was issued by the IRS back in the 1960s when the two most common types of life insurance policies were annual renewable term and whole life. Since then, new insurance products have been created — for example, universal life, variable life, guaranteed no-lapse universal life, and level term insurance — that make valuing these new products using traditional ITR valuation principles difficult.

While the new generation of insurance products carries a reserve value, the terminal reserve value at the end of the policy year is not known ahead of time as it is with whole life policies. Consequently, insurance carriers are not able to follow the exact calculations provided in the regulations to determine an ITR value of these new products.

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To make things even more complicated, there are multiple reserve values tracked by insurance carriers today that were not used back when the regulations on ITR were issued. These reserves include:

- **Tax reserves** – used to determine a carrier’s federal income tax;
- **Statutory reserves** – value required for a carrier’s financial statement filed with state insurance departments; and
- **AG 38 reserves** – reserves required by the National Association of Insurance Commissioners (NAIC) for all universal life policies that employ secondary guarantees, with or without shadow account funds.

Given that the guidance on ITR has never been updated to account for newer life insurance products and there is no longer one method for tracking policy reserves, it is not surprising that insurance companies have interpreted these outdated ITR regulations in different ways with different results. Consequently, radically different policy values for similar life insurance policies could be received from different carriers.

### 3. What reserving system does John Hancock use to calculate a policy’s interpolated terminal reserve value?

John Hancock uses its tax reserves to calculate a policy’s ITR value.

### 4. How does a value obtained from the life settlement market or third-party appraiser factor in?

Valuing a life insurance policy based on its fair market value (FMV) (i.e., the price at which the property would change hands between a willing buyer and willing seller) has traditionally been difficult due to the lack of a secondary market. The emergence of the life settlement market has enabled policy owners to sell their policies for the first time through an organized market and has created an opportunity to apply a market-based, FMV approach in determining the value of a life insurance policy.

The policies eligible for life settlement are generally limited to insureds over the age of 70 who are in poor health and who have experienced significant health changes since the date the policy was originally issued. Settlement companies price these policies using transaction data and an internal rate of return. However, the specific pricing mechanisms used by settlement companies are proprietary, so to determine the value of eligible policies using this approach, a quote must be obtained from the settlement company.

Since the life settlement market is generally limited to the purchase of policies on older, unhealthy insureds, younger, healthier insureds are unlikely to have access to this secondary market. For those policies, a third-party market valuation expert or appraiser may need to be brought in to determine the market value of a contract. These third-party appraisers will study the pricing and financial metrics of market transactions involving similar policies to approximate a specific policy’s value.



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## 5. Does a loan on a policy affect the interpolated terminal reserve value?

Yes. If there is an outstanding loan on the policy when an interpolated terminal reserve (ITR) value has been requested, the amount of the loan is subtracted from the ITR value, thus lowering the value of the policy.

For example, if a policy has a \$100,000 loan against it on the date it is being valued and an ITR value of \$500,000, the reported value would be \$400,000, which reflects the ITR value reduced by the amount of indebtedness.

## 6. How does the insured's health affect policy valuation?

The valuation methodologies used in the gift and estate tax regulations and in other IRS pronouncements are only guidelines to help approximate fair market value (FMV) and **do not** consider the insured's health. These guidelines also state that in determining the value of a life insurance policy, all relevant factors affecting FMV must be considered. Given that the insured's health is a meaningful factor in determining the likelihood or timing of the receipt of death benefit, a change in the insured's health from the time of issue versus the time of valuation must be considered.

In *Estate of Pritchard v. Commissioner* (also discussed in [question 11](#)), the Tax Court determined that a transfer of a policy from a husband to his wife for the policy cash value 30 days prior to his death did not constitute adequate and full consideration. In so finding, the Court stated:

One of the important elements to be considered in determining a value of a life insurance policy is its collectibility. The nearer the insured approaches death, which is the event of collectibility, the nearer its value approaches the face amount for which it was issued. In the instant case, the insured's health was in a desperate and hopeless, or at least a dangerous condition, and death was known to be relatively imminent, i.e., his life expectancy was much less than that shown on the mortality tables as the life expectancy of an insurable man of his age. ... Under these special facts, the cash surrender value was wholly inadequate as a measure of [the policy's] worth at the time of the transfer[], while replacement cost in the instant case, where the insured at the time of the transfer of the polic[y] was obviously uninsurable, would be only helpful as a criterion of the minimum value to be placed on the polic[y] in the absence of "more cogent evidence."

Consequently, where the insured is terminally ill or has significantly diminished life expectancy, valuation of the policy must account for the more imminent collectibility of the death benefit — i.e., the value of the policy is likely equal to the policy's face amount (or very close to the face amount).

If the insured is no longer insurable or has had a change in health that would prevent the insured from obtaining a new policy at the same underwriting class as before, the policy's value is likely higher than the value that would be produced using an internal terminal reserve (ITR) or PERC calculation (see [question 17](#) for more information on PERC). Exactly how much higher is unclear and may need to be addressed using a third-party appraisal or seeking a quote in the life settlement market (where available).



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### 7. Does the guaranteed element of a contract affect its value?

Yes. Internal terminal reserve (ITR) values calculated for a policy are directly impacted by a number of factors, including any underlying guarantees associated with the policy. Therefore, for guaranteed products, as well as current assumption products with limited guarantees, the underlying guarantee does impact the reserves a carrier must have for a specific policy and the resulting ITR for that policy.

Note that whenever a valuation calls for a value other than ITR — e.g., cash value in split dollar transfers — any guarantees associated with the policy may need to be considered so as not to artificially deflate the true value of the contract.

### 8. How do long-term care and chronic illness riders affect policy value?

Long-term care (LTC) and chronic illness riders affect assumptions regarding the timing and manner in which a policy's death benefit is paid. As a result, adding these riders to a policy influences the internal rate of return. These riders, known as "acceleration of death benefit" riders, necessitate additional reserving. However, this is not to the same extent as riders that increase the death benefit amount, such as return of premium (ROP) riders. Because they speed up the payment of an existing death benefit, the impact on reserves is mainly related to the timing of the death benefit payment rather than the total amount.



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## 9. What is the value of a life insurance policy when it is sold for consideration?

As with other forms of transfer, at the heart of a sale of a life insurance policy for consideration is the need to determine the policy's fair market value (FMV).

Where a policy is sold to an unrelated party, the presumption is that the sale price, negotiated at arm's length between two parties under no compulsion to buy or sell, represents the FMV of the policy. Where the sale is to a related party, however, the value of the policy must be supported by other evidence; if the FMV of the policy is either more or less than the consideration received in exchange for the policy, then a taxable gift may result.

To determine FMV, most practitioners will look to other areas of authority to determine this value, including the gift and estate tax regulations, Revenue Procedure 2005-25 and other relevant IRS authority and case law. Depending on the type of contract (term vs. permanent, guaranteed vs. current assumption, etc.) and other factors related to valuation (e.g., insured's health), FMV may be determined using any one or more of these valuation approaches: unearned premium, ITR, PERC value, cash surrender value, or cash value. In some cases, the taxpayer may also seek a value from the secondary market (where applicable) or seek a third-party appraisal. Ultimately, the decision is in the hands

of the taxpayer and their tax counsel to determine what value most closely represents FMV given all the facts and circumstances of a particular transaction.

## 10. How should gain be determined upon surrender or sale of a life insurance policy?

As with any valuable asset, when a life insurance policy is disposed of, whether surrendered to the insurance company or sold to another party, the owner at the time of the disposition may recognize income in the form of gain in the policy.

In the event of a **surrender of a life insurance policy**, the amount of gain is governed by IRC §72(e)(5) and is equal to the amount received by the owner in excess of the owner's "investment in the contract" (commonly referred to as basis and generally consisting of premiums paid).<sup>2</sup> Under most circumstances, any income recognized by a policy owner upon surrender of the policy is characterized as ordinary income.

**Example:** In year 1, Andrew purchases a permanent life insurance policy on his own life. In policy year 8, Andrew surrenders the policy for its cash surrender value of \$78,000. Up until the time of surrender, Andrew paid premiums totaling \$64,000 and has never taken a distribution or a loan from the policy. Under §72(e)(5), gain is determined by subtracting

Andrew's investment in the contract (i.e., \$64,000) from the amount received (the cash surrender value of \$78,000). Andrew must recognize \$14,000 of income on surrender of the contract.<sup>3</sup>

Prior to the enactment of the Tax Cuts and Jobs Act of 2017 (TCJA), the IRS had previously ruled in Revenue Ruling 2009-13 that, in determining the amount of gain incurred in the **sale of a life policy** (as opposed to a surrender), the taxpayer's basis in the policy should be reduced by the "cost of insurance" (COI) charges incurred. With the enactment of the TCJA, Revenue Ruling 2009-13 was reversed and adjustments to basis for COI charges are no longer necessary. Consequently, the amount of gain from the sale of a life policy generally will be equal to the excess of the amount realized (i.e., value received in the sale) over the owner's adjusted basis in the policy, with no adjustment for COIs.

**Example:** Facts are the same as the previous example, except in year 8, Andrew sold the policy for \$80,000 to Betty, a person unrelated to Andrew and who would not suffer economic loss upon Andrew's death. During Andrew's ownership of the policy, he paid total premiums of \$64,000. Andrew must recognize \$16,000 on the sale of the life policy to Betty, which is the excess of the amount realized from the sale (\$80,000) over Andrew's adjusted basis in the contract (\$64,000).

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The gain resulting from a sale of a life insurance policy may have parts that must be treated as ordinary gain and parts that must be treated as capital gain. According to the “substitute for ordinary gain” doctrine, the amount that would have been recognized as ordinary gain in surrender should be recognized as ordinary gain in a sale. Any consideration in excess of this amount should constitute capital gain. In other words, capital gain treatment is recognized on the sale of a life insurance policy where the consideration exceeds the cash surrender value of the policy.

### 11. Can the three-year look back rule be avoided using a sale approach?

The general rule of §2035 is that policies transferred within three years of death are includible in the transferor’s taxable estate (the “three-year look back” rule). However, an exception to this rule exists for any “bona fide sale” for “adequate and full consideration.” Accordingly, a bona fide sale of a life insurance policy for adequate and full consideration will avoid the three-year look back.

The real question then becomes, what constitutes adequate and full consideration? Will the sale of a policy for something less than the face amount avoid the three-year look back? Unfortunately, there is not a definitive answer to this question.

In the 1944 Tax Court case *Estate of Pritchard v. Commissioner* (also discussed in [question 6](#)), the Court determined that a transfer of a policy from a husband to his wife for the policy cash value 30 days prior to his death did not constitute adequate and full consideration, as the transfer was made in contemplation of death. As a result, the policy proceeds were includible in the decedent’s estate.

Similarly, in 1961 the United States Court of Appeals for the Tenth Circuit ruled in *United States v. Allen* that a property interest transferred prior to death, which would otherwise be includible in the decedent’s estate had the property interest been retained by the decedent, was not removed from the gross estate because the consideration received at transfer was not equal to the value at which the property would have been included in the estate. In other words, according to the *Allen* decision, a grantor would have to sell their policy for the face value (i.e., death benefit) for the adequate and full consideration exception of §2035 to apply. It is important to note that the facts of the *Allen* case did not include the transfer of a life insurance policy; however, the IRS has relied on *Allen* and similar cases to cause inclusion of a life insurance policy for estate tax purposes. A Technical Advice Memorandum (TAM) issued by the IRS in 1988 supported the position in *Allen*, stating that the entire value of the proceeds from a life insurance policy, minus the value of the consideration received, was includible in the decedent’s estate under §2035.

More recent private letter rulings (PLRs), however, have ignored the rationale in *Allen* and found that the sale of a policy to a trust in which the decedent retained no incidents of ownership constituted a sale for adequate and full consideration despite the fact that the consideration paid was the internal terminal reserve (ITR) value and not the value of the policy proceeds that would have otherwise been includible in the decedent’s estate.

Although the PLRs discussed indicate that the IRS may be willing to ignore the rationale in *Allen* and would consider a sale of a policy for less than face value as meeting the “fair and adequate” exception of §2035, neither the PLRs nor the TAM are binding authority. *Allen* is only binding in the Tenth Circuit and the case does not consider the sale of a life insurance policy.

If the sale of a policy is contemplated to avoid the three-year look back rule, care should be taken in valuing the policy. Factors such as the insured’s health and age should be considered in any policy valuation. Should the IRS find that a policy was sold for less than “full and adequate” consideration, the proceeds will be includible in the decedent’s gross estate.



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## 12. What is the value of a life insurance policy for gift tax purposes and estate tax purposes?

For estate tax purposes, the value of a policy owned by the decedent insuring their life will be equal to the amount receivable by the beneficiaries from the insurance contract (i.e., the death benefit payable under the contract).<sup>4</sup>

For gift tax purposes and estate tax purposes where a decedent owns a policy on the life of someone else, the regulations generally provide that the value of a life insurance policy issued by a company regularly engaged in selling contracts of that character is determined based on the sale by that company of comparable contracts.<sup>5</sup> For contracts that have been in force for some time and still have premiums due, these regulations also introduce a valuation method using an interpolated terminal reserve (ITR) value.

More specifically, the regulations provide the following guidance on how to ascertain value based on three distinct situations:

- For **newly issued policies** (which practitioners often interpret as up to one year after policy issue), the fair market value (FMV) of a policy is the cost of that policy. In other words, the total premiums paid for the policy at the time of valuation.

- For a life insurance policy on which **no further payments are to be made** (the regulations refer to a single premium policy or a paid-up policy), the FMV of the policy is the amount the life insurance company would charge for a single premium contract of the same specified amount on the life of a person the same age of the insured. This is a “replacement cost” standard.
- For a life insurance policy that **has been in force for some time and requires further premium payments**, the value may be approximated by adding unearned premiums to the ITR at the valuation date. The regulations provide, however, that this ITR valuation method may not be used if, because of the unusual nature of the contract, such an approximation is not reasonably close to the full value of the contract.

It should be noted that these valuation methods do not consider factors outside of the policy that could affect the policy’s value — for example, the insured’s health at the time of valuation. Accordingly, the regulations also provide that “all relevant facts and elements of value must be considered in every case” when

determining a policy’s value. This language, together with relevant case law, supports the proposition that additional factors, such as an insured’s impaired health, may require a different valuation method that results in a much higher value than would result from using the valuation methods discussed.

### For more information

**See question 6** for a further discussion of the insured’s health as a factor in determining a policy’s value.

**See question 13** for a discussion regarding the application of these Regulations to term policy.



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## Gift and estate tax value, *continued*

### 13. How should a term policy be valued?

Valuing a life insurance policy for transfer tax purposes requires using its fair market value (FMV). Based on the gift and estate tax guidelines, albeit outdated, a term policy with premiums still due (except for a “new” policy) should be valued based on the interpolated terminal reserve (ITR) value plus unearned premium. But does a term policy have a reserve value?

An annual renewable term (ART) product generally would not have a reserve value because the death benefit protection is only for one year and the policy matures at the end of the year. With an ART policy, the value of the policy at any given point in time would be the unearned premium as there is no reserve value to interpolate.

With a level term policy, however, some of the premiums paid earlier in the contract must be set aside to cover the increasing cost of insurance expenses as the insured ages, thus building a reserve that is greater than one year’s premium. Minimum reserve calculations are also set by state regulation, and these state regulations require substantial reserves to support the term guarantee. A situation where the reserve is in excess of premiums paid is not unusual.

While many carriers will compute an ITR value for a level term contract, this value may arguably be higher than true FMV (willing buyer/willing seller) due to the large reserves required for guaranteed term contracts. Using unearned premium as the value of a level term policy, however, may provide a value that is lower than FMV as this type of policy provides guaranteed level premiums, guaranteed death benefit for the contractual term of years, and may include the ability to convert the policy to a permanent policy — valuable options compared with an ART product.

Because of these valuation issues, there may be some merit in valuing a level term policy using a “replacement cost” approach. As long as there have been no substantive changes in the insured’s health, it might be appropriate to use the price of a replacement contract. In other words, if an insured could find a similar product on the open market that provides the same benefits, then they might be able to make a case for using that as the basis for calculating a proxy for the transfer value.

For example, if the policy owner were to buy a new guaranteed level term contract at their current age, and assuming no change in health, a present value calculation of the difference in premiums between the new policy and the old policy over the remaining years at an appropriate interest rate might be suitable as a fair appraisal of the value of the existing term policy under the theory of replacement cost.

Although a “replacement” approach to valuation is typically reserved for paid-up policies under the gift and estate tax regulations, these regulations also hint that other valuation approaches may be considered when, under the ITR valuation method, the value “is not reasonably close to the full value of the contract.”

The policy owner should review with their tax professionals the rules regarding the value of the contract and transfers in considering which value might be most appropriate to use in this case.



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## Gift and estate tax value, *continued*

### 14. What policy value is used when making a gift to charity? Other considerations?

Because a transfer of an existing life insurance policy to a qualified charity usually constitutes a gift to the charity, most practitioners will look to the gift and estate tax regulations to determine the fair market value (FMV) of the property being transferred ([see question 12](#) for a discussion of gift and estate tax regulations). Whatever value is determined for gift or estate tax purposes usually will be reported on the appropriate gift or estate tax return and should be completely shielded from any tax liability or depletion of the individual's lifetime exemption via the unlimited charitable deduction.

With respect to taking an income tax deduction associated with a gift of an existing policy to charity, the value of the deduction will be based on the **lesser of the policy's FMV and the owner's cost basis in the policy**. Additionally, a taxpayer may only take an income tax deduction for charitable gifts up a certain percentage of the taxpayer's adjusted gross income (AGI) for the year. The table to the right provides the maximum amount that can be deducted based on the policy owner's AGI, the type of property being transferred and the type of charity that will benefit.

If the entire value of the charitable gift cannot be deducted in the year when the gift is made due to AGI limitations, the taxpayer may be able to carry over the remaining deduction for five additional years, subject to the same limitations.

#### Percentage of AGI that can be deducted\*

Type of gift	Type of charitable recipient	
	Public charity	Private charity/foundation**
Cash	60%***	30%
Ordinary income property	50%	30%
Capital gain property (applies to life estates)	30%	20%
Gift from a C corporation, or entity taxed as a corporation	10% regardless of the type of property transferred	10% regardless of the type of property transferred

\* If a gift is made to a Charitable Lead Trust (CLT) that is classified as a grantor trust, the grantor of the trust may receive an income tax deduction. If so, the deduction is subject to less favorable AGI limitations, including 30% when the lead interest is held by a public charity and 20% when the lead interest is held by a private charity. Also, if a gift is made to a charitable trust in which there are both public and private charities named or the charity is unspecified, the limitation is based on gifts made to a private charity.

\*\* An operating private foundation is equivalent to a public charity with regard to deductibility. Most private foundations, however, are nonoperating and therefore will be subject to the deductions based on a gift made to a private charity.

\*\*\* This was temporarily increased from 50% in the 2017 Tax Cuts and Jobs Act and is scheduled to sunset at the end of 2025.

#### To illustrate these rules, consider the following

**example:** Cecilia owns a life insurance policy that she gifts to her favorite public charity, which is a qualified charity under 501(c)(3). The FMV of the policy at the time of the gift is determined to be \$200,000 and her basis in the policy is \$100,000. Cecilia's AGI that year is \$300,000. While Cecilia is making a \$200,000 gift to charity, the value of the policy is limited to \$100,000 (her cost basis) for the purpose of taking an income tax deduction. Moreover, because she is making a gift of ordinary income property to a public charity, Cecilia may deduct the entire \$100,000 gift in one year as the value of the gift falls within 50% of her AGI (i.e., \$300,000 x 50% = \$150,000).

To receive a charitable deduction for income tax purposes, a qualified appraisal of property (other than publicly traded securities) is required when the FMV of such property being donated exceeds \$5,000. Treasury Regulations provide definitions and rules regarding qualified appraisals and specifically state that a qualified appraisal cannot be prepared by a party to the transaction, which would include the insurance agent or broker selling the policy.<sup>6</sup> Moreover, the insurance carrier will not meet the requirements of a "qualified appraiser" as carriers are not in the business of providing appraisals. Consequently, a taxpayer will need to hire a "qualified appraiser" (as defined in the Regulations) to value a life insurance policy being donated if it is worth more than \$5,000 and an income tax deduction is desired.<sup>7</sup>



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## Gift and estate tax value, *continued*

### 15. What is Form 712? When is it used? What value is reported on this form?

Form 712 (“Life Insurance Statement”) is a supplemental form the IRS requests whenever a life insurance policy must be valued for gift tax purposes on Form 709 (Gift Tax Return) or for estate tax purposes on Form 706 (Estate Tax Return).

The IRS requires the insurance company that issued the policy to complete Form 712 and this form must be signed by an officer of the company.

Part 1 of Form 712 — **applicable when the insured has died** — asks the insurance company to provide specific information about the policy, including (but not limited to) the:

- Face amount of the policy;
- Amount of any indebtedness on the policy;
- Accumulated dividends;
- The amount of proceeds payable at death;
- Whether there was a transfer within three years of death; and
- Whether the decedent held any incidents of ownership on a policy insuring their life that was not owned by the insured at death.

Part 2 of Form 712 — **applicable when a policy has been gifted or where the decedent owned a policy on the life of another** — requires the insurance company to provide a value for the policy as of the date of the gift (or date of death, if applicable) using either the ITR value (for a policy that is not paid up) or the replacement value (for a paid-up or single premium policy). The Form does not distinguish between the type of policy being valued — whether it is a term contract, whole life policy, universal life, etc. — and does not allow the insurance company the discretion to select the valuation method to use in a particular circumstance.

#### Planning note

**Form 712 is only needed when there is a transfer for gift or estate tax purposes.** If a policy value is being requested from the carrier for purposes other than gifting or death, it is generally recommended that the requestor ask for the ITR value (or any other value that the carrier may be able to provide — e.g., cash value, PERC value, etc.) rather than requesting a Form 712 be completed.



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# Other policy valuation scenarios

## 16. What is the value of a policy issued via a 1035 exchange?

A contract issued via a 1035 exchange should be valued similarly to any other life insurance policy — no special rules apply. That being said, a policy that has recently been issued pursuant to a 1035 exchange should qualify as a “newly issued” policy if the taxpayer is valuing the policy in accordance with the gift and estate tax regulations. Under these regulations, a newly issued policy is valued based on its cost — i.e., total premiums paid for the policy at the time of valuation. In the case of a policy that was issued via a 1035 exchange, the cost of the policy should be any money that carried over from the prior contract plus any additional premium that has been paid into the contract at the time the valuation is obtained.

Should valuation be sought after the contract has been in place for some time, the policy may need to be valued based on other valuation principles (e.g., ITR or replacement cost) rather than just premiums paid.

## 17. What is the value of a life insurance policy distributed from a qualified plan or transferred to an employee as compensation? What is PERC value?

Apart from the gift and estate tax regulations and general principles of fair market value (FMV), there have been only a few official IRS pronouncements that deal with the valuation of life insurance. Often, but not always, such pronouncements come as a result of perceived abuses involving transfers of life insurance in a particular type of scenario. One such perceived abuse was a technique commonly referred to as “pension rescue,” which involved the purchase of a life insurance policy inside a qualified plan where policy premiums were funded with the maximum amount of pre-tax plan dollars possible. When the policy's net cash surrender value was at its minimum, usually in the earliest years, the policy was either distributed or sold to the plan participant at the lowest defensible policy valuation — which was commonly believed to be cash surrender value (a value that was much lower than the aggregate plan dollars paid into the policy). Income taxes (or consideration paid, in the case of a sale) were based on this low value; however, a short time after distribution the cash value on that same life policy

would increase significantly, now providing the owner of the policy with substantial cash value that they never had to recognize for income tax purposes.

Due to the perceived abuse of these “springing cash value” policies and valuations based on cash surrender value, the IRS issued Revenue Procedure 2005-25, which provides safe harbor formulas for calculating the FMV of life insurance policies transferred from a qualified plan by distribution or sale. These safe harbor formulas can also be used to determine the FMV of a policy (or policy interests) transferred under a Group Term plan (§79) or transferred to an employee as compensation (§83).

These safe harbor formulas provide that the value of a policy for transfer tax purposes is the greater of: (1) the sum of the interpolated terminal reserve (ITR) 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 (2) the PERC value multiplied by the applicable Average Surrender Factor.

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PERC stands for aggregate premiums, plus earnings, minus reasonable charges. For this calculation, the term aggregate premiums include all premiums paid to date, including premiums that are paid by dividends and dividends that are applied to purchase paid-up additions. Earnings include any amounts credited (or otherwise made available), including interest and similar income items (whether credited or made available under the contract or to some other account). Variable policies may have negative earnings. The term “reasonable charges” is not defined, but explicitly includes mortality charges actually charged on or before the valuation date.

### Planning note

John Hancock policies reflect PERC value in a policy’s Account Value.

As a general rule, surrender charges are not considered for the purposes of these safe harbor rules (except in the case of qualified plans).<sup>8</sup> Consequently, for transfers governed by §79 (group term) and §83 (employees), the safe harbor formula can be restated more simply as the greater of: (1) ITR plus unearned premium or (2) PERC.

In the case of a distribution or sale from a qualified plan, the Average Surrender Factor is said to be:

“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.”

Where there either are no surrender charges or the surrender charges are not contractually specified at issuance or expressed in the form of nonincreasing percentages and amounts, the applicable surrender factor is equal to 1.00.

In applying these safe harbor guidelines, the IRS provides that these valuation rules must be interpreted in a reasonable manner and should be adjusted where contract provisions (e.g., income credits, mortality charges, etc.) would lead to an understated FMV. For example, if mortality charges or other charges under a contract could be returned to the customer (either directly or indirectly), then the charge should not be subtracted in determining the PERC value.

Although the valuation methods articulated in Revenue Procedure 2005-25 represent safe harbor guidelines, they do not prevent the taxpayer from considering (along with competent counsel) other methods for valuing a policy in these scenarios. For example, in *Schwab v. Commissioner*, the Ninth Circuit Court of Appeals upheld a Tax Court ruling allowing for the consideration of surrender charges associated with a life insurance policy transferred from an employee-benefit plan despite the IRS’s position in Rev. Proc. 2005-25, noting that:

“[t]he variety of insurance policies is too great to adopt as a general rule either the Commissioner’s simple proposition that surrender charges should never count, or [taxpayer’s] that such charges should always count, in determining a policy’s value. ... We hold instead that surrender charges may be considered under section 402(b)(2), 'but only as part of a more general inquiry into a policy’s fair market value.'”<sup>9</sup>

Because FMV is based on the facts and circumstances of each case, one cannot look to *Schwab* or Revenue Procedure 2005-25 to find a definitive valuation rule that will apply in every scenario. However, with both of these authorities in mind (as well as others), a taxpayer can determine their willingness to take a valuation position that does not fall within the IRS’s safe harbor guidelines and the likelihood of success.



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### 18. What is the value of a policy transferred subject to a split dollar arrangement governed by the economic benefit regime?

The Final Split Dollar Regulations determine the tax treatment of a policy that is transferred from an owner to a nonowner. Upon the transfer of a life insurance policy from the owner to a nonowner, the nonowner takes into account the excess of the policy's fair market value (FMV) over the sum of (i) the consideration paid by the nonowner to receive the contract and (ii) the amount of certain economic benefits taken into income or paid for by the nonowner during the course of the split dollar arrangement. The economic benefits referred to here do not include economic benefit amounts associated with the life insurance protection provided to the nonowner calculated using PS 58, Table 2001, or the carrier's alternative term rates.<sup>10</sup>

For split dollar arrangements subject to these regulations, FMV is specifically defined as the policy's cash value and the value of all other rights under the contract, other than the value of current life insurance protection. However, for gift tax purposes, these regulations provide that FMV should be determined under the gift tax regulations.

To the extent that the policy transfer is made in connection with the performance of services (e.g., employer/employee scenario), no taxes will apply until the contract is otherwise taxable under IRC §83. The FMV of the contract is determined disregarding any lapse restrictions at the time of the transfer.

1. See, Treas. Reg. §20.2013-1(b) and §25.2512-1.
2. Investment in the contract is defined, as of any date, as the aggregate amount of premiums or other consideration paid for the contract before that date, less the aggregate amount received under the contract before that date to the extent that amount was excludable from gross income. IRC §72(e)(6).
3. Rev. Rul. 2009-13, Situation 1.
4. IRC §2042.
5. Treas. Reg. §2512-6 (for gift tax purposes); Treas. Reg. §20.2031-8 (for estate tax purposes where the policy is on the life of someone other than the decedent).
6. See Treas. Reg. §1.170A-13(c)(5)(iv)(B).
7. Treas. Reg. §1.170A-13(c)(5)(iv).
8. The Average Surrender Factor for transfers governed by §79 or §83 is equal to 1.00.
9. *Schwab v. Commissioner*, 715 F.3d 1169 (2013).
10. Treas. Reg. §1.61-22(g)(1).

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MLINY032625222-1