Tax Court May Give Valuable Guidance on Valuing Some Life Insurance Policies, Estate Planning Journal, Jan 2023

Estate Planning Journal (WG&L)

From Howard M. Zaritsky

Tax Court May Give Valuable Guidance on Valuing Some Life Insurance Policies

Author: HOWARD M. ZARITSKY

HOWARD M. ZARITSKY is a retired attorney in Rapidan, Virginia. He is the co-author of several treatises published by Thomson Reuters, including Tax Planning for Family Wealth Transfers During Life, Tax Planning for Family Wealth Transfers at Death, and Tax Planning With Life Insurance. Mr. Zaritsky is a Fellow of the American College of Trust and Estate Counsel and a member of the Virginia Bar.

[pg. 42]

Estate planners often recommend that life insurance policies be given away or sold. New policies are easy to value - the premium that has just been paid, prorated for the period it covers. Relatively new policies are most often valued by the interpolated terminal reserve plus the unexpired premium. **1**

Policies that have been in existence for several years, however, are often difficult to value under even the interpolated terminal reserve method.

The gift tax regulations state:

> The value of a life insurance contract or of a contract for the payment of an annuity issued by a company regularly engaged in the selling of contracts of that character is established through the sale of the particular contract by the company, or through the sale by the company of comparable contracts. As valuation of an insurance policy through sale of comparable contracts is not readily ascertainable when the gift is of a contract which has been in force for some time and on which further premium payments are to be made, the value may be approximated by adding to the interpolated terminal reserve at the date of the gift the proportionate part of the gross premium last paid before the date of the gift which covers the period extending beyond that date. *If, however, because of the unusual nature of the contract such approximation is not reasonably close to the full value, this method may not be used.* (emphasis supplied) **2**

Dematteo - A Case of First Impression on a Very Old Issue

The scope of these regulations with respect to the valuation of a life insurance policy with a few years of history is currently in litigation in the U.S. Tax Court. In *Dematteo v. Commissioner*, Joseph Dematteo made taxable gifts of one-half interests in two policies insuring his life. **3** He hired an independent professional appraiser, The Ashar Group, who was familiar with valuing life insurance policies for Federal gift tax purposes. The written appraisals value one policy at $7,500,000 and the other at $5,522,308, for a total of $13,022,308.

Joseph filed gift tax returns reporting the gifts as one-half of these values, $3.75 million and $2.76 million. The IRS disagreed, arguing that the policies must be valued at their interpolated terminal reserves plus unexpired premiums, under **Reg. 25.2512-6(a)** , which produced values of $8.83 million and $7.56 million for the one-half interests. Joseph filed with the Tax Court to dispute the assessment and moved for partial summary judgment regarding which valuation method should be applied.

The Tax Court (Judge Cohen) denied the motion for partial summary judgment, holding that the question of which valuation method was more reasonable and accurate would have to be decided at trial.

Analysis and Comments

The terminal reserve guidance was originally issued by the IRS back in the early 1960s, when the two most prominent types of life insurance products were annual renewable term and whole life insurance. Annual renewable term insurance provides death benefit protection for one year only and has no reserve value. A whole life policy provides permanent insurance protection and the insurer is legally required to maintain reserves on its balance sheet reflecting the future death benefit claims. With whole life insurance, calculated at a specific percentage increase per year, and the terminal reserve value at the end of each policy year is known in advance. It is possible to interpolate the terminal reserve value of the policy to reflect a valuation on any specific date.

Since the 1960's, however, the insurance industry has developed many new types of insurance, such as universal life insurance, variable

[pg. 44]

life insurance, variable universal life insurance, indexed universal life insurance, guaranteed no-lapse universal life insurance, and level term policies for a various fixed terms. It is very difficult to apply the original interpolated terminal reserve guidance to these newer policies.

All of these newer products have a reserve value, but the terminal reserve value is not known or published before the end of the policy year. It is, therefore, impossible actually to interpolate the terminal reserve value before the end of the year, as the regulations require. Also, in the 1960's, there was only

one type of reserve value. Today, there are several reserve values, including tax reserve values (used to determine the insurer's federal income tax liability), statutory reserve values (reported in the insurer's annual financial statement filed with the state insurance departments, and differing from the tax reserve by the interest rate applied), the AG 38 reserves (used for a universal life policy with a no-lapse secondary guarantee), and deficiency reserve values (used for policies with secondary guarantees, such as a guaranteed universal life policy, where the calculation of minimum reserves is required).

It is difficult to determine which of these reserves should be used to calculate the interpolated terminal reserve. Today, when one asks the insurer for the interpolated terminal reserve on many types of policies, several different reserve values can be given. Typically, the insurer will give all of them on a Form 712 and suggest that the policy owner's tax adviser select the appropriate one. Neither the regulations nor any other IRS or Treasury guidance provides any help in making this selection.

The new existence of a strong secondary market for life insurance policies raises a question as to whether practitioners should rely on the interpolated terminal reserve plus unexpired portion of the present premium in valuing an existing life insurance policy. The secondary market is, indeed, strong, and many life insurance policies on the lives of older individuals could be resold to life settlement companies, often for much more than the interpolated terminal reserve plus unexpired portion of the present premium. Unfortunately, there are few sources of quotations for such sales, as there is with respect to publicly traded stock.

Also, the secondary market involves many variables. Different buyers will apply different tests to determine the actuarial value of a particular policy, so that obtaining four quotes from prospective buyers in the secondary market will likely result in at least three widely disparate figures.

Furthermore, the secondary market is almost exclusively based on purchases of policies insuring the lives of elderly insureds (generally in their mid-60s to mid-80s), and it may be difficult to obtain several quotes for policies insuring the lives of younger, healthier individuals.

Yet, there are many instances in which the value of a life insurance policy must be accurately determined. Certainly, when making a gift of a policy the value must be determined for gift tax purposes. When a policy on the life of another is included in a decedent's estate, the value must be determined for estate tax purposes. The estate or trust's fiduciary will want to value the policy accurately, but not overvalue it.

The interpolated terminal reserve plus unexpired term may provide an accurate value, but in most cases it will not. If it provides a value above the actual fair market value, as in *Dematteo*, a fiduciary's reliance upon it could result in surcharge.

Similarly, a fiduciary who sells a policy for a purchase price that is less than the interpolated terminal reserve will need to justify the lower sales price. Again, failure to do provide a cogent explanation for the difference between the two values could result in surcharge.

Also, when an insured sells a policy within three years of his or her death, the proceeds will be included in the insured's gross estate under **Section 2035(a)** , as modified by **Section 2035(d)** , unless the policy was transferred in a "bona fide sale for an adequate and full consideration in money or money's worth." If one undervalues the policy in such a sale, the entire proceeds (less the amount actually paid) will be includible in the gross estate.

The decision in *Dematteo,* if one is ultimately issued, may, therefore, be very significant.

1 For more on this topic, see also Leimberg & Zaritsky, *Tax Planning with Life Insurance: Analysis With Forms* ¶ 3.02[2][a] *(Thomson Reuters/WG&L, 2d Ed. 1998 & Supp. 2022-3).*

2 **Reg. 25.2512-6(a)** ; see similar language in **Reg. 20.2031-8(a)(1)** , **-8(a)(2)** .

3 Tax Ct. Dkt. No. 3634-21 (July 21, 2022).

© 2023 Thomson Reuters/Tax & Accounting. All Rights Reserved.