

**Excerpt from Notice 89-25 addresses “springing” cash values in life insurance contracts:**

Q-10: What amount is included in a plan participant's gross income when the participant receives a distribution from a qualified plan that includes a policy issued by an insurance company with a value substantially higher than the cash surrender value stated in the policy?

A-10: Subject to certain exceptions not here applicable, section 402(a) of the Code provides that the amount actually distributed by a qualified employees' trust shall be taxable to a plan participant in the year in which so distributed under section 72 (relating to annuities). Section 1.402(a)-1(a)(1)(iii) of the regulations provides that the amount includible in a plan participant's gross income by reason of the distribution of property by the plan shall be the fair market value of such property. Life insurance contracts constitute property within the meaning of this section. Section 1.402(a)-1(a)(2) of the regulations provides that a distributee must include in gross income the cash value of any retirement income, endowment, or other life insurance contract at the time of the distribution. Section 1.72-16(c)(2)(ii) of the regulations indicates that the reserve accumulation in a life insurance contract constitutes the source of and approximates the amount of such cash value.

Individuals who receive an insurance policy as a distribution from a qualified plan use the stated cash surrender value of the policy as its fair market value for purposes of determining the amount includible in their gross income under section 402(a) of the Code. However, this practice is not appropriate where the total policy reserves, including life insurance reserves (if any) computed under section 807(d), together with any reserves for advance premiums, dividend accumulations, etc., represent a much more accurate approximation of the fair market value of the policy than does the policy's stated cash surrender value. These circumstances are illustrated by the following example.

A is a participant in a qualified noncontributory defined benefit plan. On January 1, 1986, \$400,000 of plan assets were used to purchase an insurance policy. The policy was distributed to A on January 1, 1988, two years after the date of purchase.

The policy provides a stated cash surrender value for each of the first five policy years, as set forth in the table below. The total end of year reserves held by the insurance company for the policy also are set forth in the table. These reserves may include life insurance reserves and any reserves for advance premiums, dividend accumulations, etc. Life insurance reserves, if any, are calculated using the rules in section 807(d) of the Code, which provides rules for determining the amount of those reserves for purposes of calculating the tax liability of the insurance company issuing the policy.

<u>Year</u>	<u>Surrender Value</u>	<u>Reserves</u>
1	\$106,000	\$406,949
2	\$112,360	\$426,596
3	\$119,102	\$447,052
4	\$126,248	\$468,178
5	\$489,908	\$489,908

As the total reserves for the policy at the end of year two, \$426,597, substantially exceed the policy's cash surrender value, \$112,360, the reserves represent a much more accurate approximation of the fair market value of the policy when distributed than does the policy's cash surrender value. Accordingly, the amount includible in A's gross income by reason of the distribution of the policy at the end of year two is an amount equal to the \$426,597 reserve, not the \$112,360 stated cash surrender value at that date.

In the case of a distribution in excess of A's accrued benefit, as defined in section 1.411(a)-7(a)(1) of the regulations, resulting from valuing the policy at \$112,360 rather than \$426,547, the distribution would not be treated as a distribution to A from a qualified plan and, depending upon the facts and circumstances of the case, could be treated as a reversion to the employer. Of course, depending on the facts and circumstances, such distributions could disqualify the plan because they raise a number of qualification issues under, for example, section 415 of the Code, limitations on benefits and contributions, section 401(a) requirements that benefits be definitely determinable, and section 401(a)(4), discrimination in contributions and benefits, particularly if A was a member of the group of employees in whose favor discrimination is prohibited and other employees were not provided with similar distributions.