PURPOSE

(1) This transmits complete reprint for IRM 4.72.8, Employee Plans Technical Guidelines, Valuation of Assets.

NATURE OF MATERIAL

(1) 4.72.8.5.3, Life Insurance Contracts, revised to reflect the issuance of proposed and final regulations regarding the valuation of life insurance contracts upon distribution from a qualified plan as well as other guidance regarding safe harbors which may be used to value these contracts.

(2) 4.72.8.5.3.1, Examination Steps, revised to reflect the new guidance.

EFFECT ON OTHER DOCUMENTS

AUDIENCE

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4.72.8
Valuation of Assets

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4.72.8.1
(09-01-2006)
Overview

(1) Guidance is provided on valuing assets in a qualified retirement plan.

(2) An accurate assessment of fair market value (FMV) is essential to a plan's ability to comply with the Internal Revenue Code requirements and Title I of ERISA. For instance, the FMV of assets must be accurately determined to preclude a(n)—

- Prohibited transaction;
- Exclusive benefit violation under IRC 401(a);
- Violation of the limitation on benefits and contributions under IRC 415;
- Excess deduction under IRC 404;
- Violation of the minimum funding requirements under IRC 412; or
- Discrimination violation under IRC 401(a)(4).

4.72.8.1.1
(09-01-2006)
Valuation in Different Types of Plans

(1) In a defined benefit plan, the valuation of trust assets will determine if the plan is adequately funded and if the plan's funding assumptions are reasonable. This, in turn, will affect the employer's deduction.

(2) In a profit sharing, money purchase, or stock bonus plan, the valuation of assets will determine the value of a participant's account, and ultimately, a participant's distribution.

(3) In an Employee Stock Ownership Plan (ESOP), the valuation will affect both the deduction and distribution. Also, IRC 401(a)(28)(C) requires an ESOP to obtain valuations by an independent appraiser of employer securities which are not readily tradeable on an established securities market, with respect to activities carried on by the plan.

4.72.8.1.2
(09-01-2006)
Formality of Valuation

(1) Whether a formal valuation is required will depend on the transactions that occur with the plan and the form of the plan.

- For example, the valuation in a single participant plan, a self-directed account, or frozen plan can be less formal in a year in which the plan or self-directed account receives no contribution and makes no distribution or change in investment.

(2) The reasonableness of the method for valuing plan assets is based on the surrounding facts and circumstances. Except for certain employer securities held by an ESOP, there is no absolute requirement the annual valuation be based on an independent appraisal. On the other hand, it may be reasonable for an agent to request an appraisal for hard-to-value assets under certain circumstances, such as when distributions are made to plan participants.

4.72.8.2
(09-01-2006)
Form 5500 Information

(1) Form 5500 requires a statement of plan assets valued at FMV as of the beginning and end of the current plan year.

(2) The income statement on Form 5500 asks for unrealized appreciation or depreciation in plan assets.

(3) A question on Form 5500 asks whether any non-cash contributions (real estate, collectibles, and closely held stock, etc.) were made to the plan, the value of which was set without an appraisal by an independent third party.

Note: The Service's position is that contributions of property to pension plans and certain other defined contribution plans are prohibited transactions if they are not covered by a statutory or administrative exemption. The Supreme Court ruled in favor of the Service in Keystone Consolidated Industries v. Commissioner, 508 U.S. 152 (1993).

(4) A question on Form 5500 asks whether the plan holds any nonpublicly traded securities that were not appraised by an independent third-party appraiser.

4.72.8.2.1
(09-01-2006)
Examination Steps

(1) A valuation problem may exist if any of these items are found on Form 5500.

(2) Determine whether the plan reports assets with level values in successive years.

a. If the same value for an asset was reported on Form 5500 for the prior year, it may indicate a yearly valuation was not performed, requiring further examination.
b. The value of some types of investments may not change each year, e.g., certificates of deposit and U.S. government securities.

(3) Determine whether there is a sudden jump in plan asset values in the same year a large distribution is made to highly compensated employees. The plan assets may not have been revalued in prior years, when distributions were being made to only nonhighly compensated employees, indicating there might be discrimination under IRC 401(a)(4).

a. In the case of a plan termination, review Form 6088, Distributable Benefits from Employees Pension Benefit Plan, to determine whether only the accounts of highly compensated employees remain at plan termination. Compare it to Form 5500 for the current year to determine whether any nonhighly compensated employees participate in the plan. If none participate, look at Form 5500 for prior years to determine whether distributions were made to only nonhighly compensated employees in such years.
b. If the plan is not terminating, check Schedule SSA, Annual Registration Statement Identifying Separated Participants With Deferred Vested Benefits, to determine whether mostly the accounts of highly compensated employees who have separated from service remain in the trust.

(4) Refer to the question on Form 5500 on unrealized appreciation/depreciation. A valuation problem may exist if there is no response to this question when the plan reports investments in any corporate stock or security.

(5) Look at the Form 5500 question on non-cash contributions. If there is an exempt contribution of property, determine whether and by whom the property was valued in the year of the contribution.

(6) Look at the Form 5500 question on nonpublicly traded securities. If the plan purchased or received any nonpublicly traded securities not appraised by an independent third-party appraiser, determine whether the securities were valued that year and by whom.

4.72.8.3
(09-01-2006)
Timing of Asset Valuations

(1) In a defined contribution plan, Rev. Rul. 80–155, 1980–1 C.B. 84, provides that since amounts allocated or distributed to a participant must be ascertainable, the plans must value their trust investments—

- at least once a year,
- on a specified date,
- in accordance with a method consistently followed and uniformly applied.

(2) In a defined benefit plan, IRC 412 requires yearly valuations of plan assets for funding purposes. These valuations must be based on reasonable actuarial assumptions. See Reg. 1.401–2(b).

(3) As provided under Rev. Rul. 69–494, 1969–2 C.B. 88, when employer securities are acquired or sold, the securities must be valued at the time of the transaction.

4.72.8.3.1
(09-01-2006)
Interim Valuations

(1) Under Rev. Rul. 80–155, in addition to the required annual valuation, interim valuations are permitted. Thus, a plan provision allowing interim valuations at a trustee's discretion is permitted as long as these valuations are not discriminatory under IRC 401(a)(4).

a. A plan with a valuation date of January 1, the first day of the plan year, which also requires interim valuations at the end of each month in which significant market fluctuations (as defined in the plan) have taken place, would not be discriminatory on its face.
b. However, if a defined contribution plan was amended to provide for interim valuations during a time in which plan asset values were rising and in which highly compensated employees were receiving distributions, the plan could violate IRC 401(a)(4).

(2) A decrease in benefits caused by a change in the date for valuing plan assets is not necessarily a decrease in benefits prohibited by IRC 411(d)(6). See Reg. 1.411(d)–4, Q& A –1(d)(8).

4.72.8.3.2
(09-01-2006)
Examination Steps

(1) Determine whether there has been an annual valuation of plan assets at FMV.

(2) If there are interim valuations, determine that the plan has an annual valuation date and permits interim valuations.

(3) Check whether interim valuations are discriminatory under IRC 401(a)(4). See, for example, Rev. Rul. 80–155.

4.72.8.4
(09-01-2006)
Determining Asset Values

(1) Rev. Rul. 59–60, 1959–1 C.B. 237, provides guidance for determining the value of plan assets. Although Rev. Rul. 59–60 provides methods for valuing shares of stock of closely held corporations for estate and gift tax purposes, the factors may be used to determine values of assets in qualified plans.

a. The factors in Rev. Rul. 59–60 are not an exclusive list of factors for valuing closely-held employer securities. Other factors may be included where appropriate. Also, not all of the listed factors will be relevant to all companies and transactions.

(2) The detail of the plan's valuation should be examined in light of the plan assets involved.

- For example, the valuation should contain substantial detail if it values a limited partnership interest or a closely held corporation.

(3) Where appropriate, stock values should be discounted due to a lack of marketability and, if appropriate, a control premium should be added to the stock value.

4.72.8.4.1
(09-01-2006)
Factors for Determining Value

(1) There are a number of factors to consider when determining the value of an asset, for example:

a. Nature and history of the business issuing the security
b. General economic outlook and the outlook for the specific industry
c. Book value of the securities and the financial condition of the business
d. Company's earning capacity
e. Company's dividend paying capacity
f. Goodwill value
g. Recent stock sales

4.72.8.4.2
(09-01-2006)
ERISA 3(18)

(1) ERISA 3(18) applies for purposes of some prohibited transaction exemptions under both ERISA and the Code.

(2) ERISA 3(18) defines the term adequate consideration for "assets other than a security for which there is a generally recognized market" as the FMV of the asset as determined in good faith by the trustee or named fiduciary pursuant to the terms of the plan and in accordance with regulations promulgated by the Secretary.

(3) Proposed DOL Reg. 2510.3–18(b)(2) defines "fair market value" as the price at which an asset would change hands between a willing buyer and a willing seller when either party is not under any compulsion to enter into the transaction.

4.72.8.4.3
(09-01-2006)
Examination Steps

(1) After careful review of the plan asset valuation, determine if the value assigned to an asset differs from what you expect.

(2) Determine the value of publicly traded securities by checking their price as reported in a newspaper on the valuation date. A local business library has books that publish daily stock prices of all publicly traded companies, and may have a researcher who will provide market values in response to a telephone call as a public service.

(3) In determining the FMV of closely held stock, determine how closely held company shares were valued.

a. Check whether the share prices as reported on Form 5500 rise and fall with its earnings. If the company's earnings have fallen but the report says the price per share has risen or remained constant, it may indicate an incorrect valuation. Request an explanation.
b. Determine whether there have been any recent sales of the company's stock. Check to ensure the sales price is consistent with the valuation.
c. If the current valuation relies on a previous valuation, check the employer's audit report to see if the company's earnings have fallen since the valuation report was written. If they have, it is likely the value of the shares should also have fallen. The plan fiduciary can no longer rely on the price per share from the valuation report because the facts on which it was based have changed. Similar principles apply if the company's earnings have risen since the valuation report was written.
d. Other factors to be used in determining the FMV of closely held stock include their book value, dividend paying capacity, and the goodwill value of the company.

(4) In an investment or holding company, determine whether the valuation gave the greatest weight to the assets underlying the security to be valued. In a company which sells products or services, determine whether the valuation gave the greatest weight to earnings.

(5) If the valuation appears to be inadequate, its accuracy should be verified by asking for another valuation from a fiduciary or qualified appraiser.

4.72.8.5
(09-01-2006)
Types of Plan Assets

(1) Plans may invest a portion of their assets in limited partnerships and invest directly in real property, or in mortgages on real property.

(2) Plans may also invest in life insurance contracts. Described below is a safe harbor that may be used when such contracts are distributed.

4.72.8.5.1
(09-01-2006)
Partnerships

(1) The partnership itself can invest in virtually any type of asset.

(2) Generally, limited partnership interests are not listed on national securities exchanges.

(3) The valuation of a plan's interest in a partnership is especially important in a year in which the plan is making a distribution.

4.72.8.5.1.1
(09-01-2006)
Examination Steps

(1) Ask for information regarding how and when the FMV of the partnership was determined.

a. Ask whether there were sales of or offers for the partnership interests, secondary market trades or quotes, and whether the fiduciary used the general partner's valuation.
b. Determine the basis for the valuation of the partnership, i.e., if the partnership's value was based on the original cost of the investment, or the capital account (reported on the Schedule K–1, which shows the partner's pro rata share of the partnership's income, losses, credits and deductions). Such valuations may not reflect the FMV of the partnership.

(2) The fact a partnership has had no earnings may indicate the partnership is worthless. To determine whether the partnership had earnings, request the plan's K–1's. Depending on the circumstances, the specialist may want to request K–1's for prior years.

4.72.8.5.2
(09-01-2006)
Real Estate

(1) Mortgages valued at cost may be incorrectly valued if based solely on the purchase price of the real estate.

(2) Under special circumstances, the mortgage's valuation should reflect the current value of the real property.

- For example, if the FMV of property held for investment by the plan is lower than the indebtedness secured by the property, the value of the mortgage should be marked down. Also, the value of the mortgage is based on the loan balance.

4.72.8.5.2.1
(09-01-2006)
Examination Steps

(1) To ascertain the value of real estate held by the plan, check the appraisal report, tax assessment document, and the property insurance policy.

(2) Compare the loan or mortgage balance to the appraised value of the property.

(3) The property's best use is one criteria in valuing the asset. Determine what the property is actually used for. If the property's best use is different than the property's actual use, the property may not have been properly valued.

(4) In a defined contribution plan, ascertain if any sudden increases in value coincided with distributions to highly compensated employees.

4.72.8.5.3
(09-01-2006)
Life Insurance Contracts

(1) Section 1.402(a)-1(a)(1)(iii) of the Income Tax Regulations provides, in general, that a distribution of property by a qualified plan is taken into account by the distributee at its "fair market value". Prior to its amendment, section 1.402(a)-1(a)(2) provided, in general, that upon distribution of a retirement income, endowment, or other life insurance contract, the "entire cash value" at the time of distribution must be included in the distributee's income. Amendments to the regulations under §402 were proposed on February 13, 2004, to state that the fair market value standard controls when such a contract is distributed or sold. Final regulations, adopting the fair market value standard, were issued on August 29, 2005. The final regulations provide that the amendments to section 1.402(a)-1(a) are effective for distributions occurring on or after February 13, 2004. The final regulations under section 1.402(a)-1(a)(1)(iii) also include special effective date provisions for bargain sales of these contracts

(2) Q&A-10 of Notice 89-25,1989-1 C.B. 662, described a distribution from a qualified plan of a life insurance policy with a value substantially higher than the cash surrender value stated in the policy. The notice concluded that the practice of using cash surrender value as fair market value 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.

(3) 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, 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.

(4) Rev. Proc. 2004-16, 2004-10 I.R.B. 559, provided a safe harbor for determining fair market value of variable and non-variable contracts for purposes of applying the rules under the proposed regulations issued under §402(a).

(5) Rev. Proc. 2004-16 was modified and superseded by Rev. Proc. 2005-25, 2005-17 I.R.B. 962, which provides two safe harbor formulas that, if used to determine the value of an insurance contract, retirement income contract, endowment contract, or other contract providing life insurance protection that is

distributed or otherwise transferred from a qualified plan, will meet the definition of fair market value for purposes of §402(a). These safe harbor formulas will also meet the definition of fair market value for purposes of §402(b) and, in addition, will meet the definition of vested accrued benefit for purposes of §402(b)(4)(A).

(6) Rev. Proc. 2005-25 applies to distributions, sales, and other transfers made from an exempt employee's trust on or after February 13, 2004, and to non-exempt employees' trusts under §402(b) for periods on or after February 13, 2004. Taxpayers may also rely on the safe harbors of Rev. Proc. 2005-25 for periods before May 1, 2005. Taxpayers may also rely on the safe harbors in Rev. Proc. 2004-16 for periods on or after February 13, 2004, and before May 1, 2005.

4.72.8.5.3.1
(09-01-2006)
Examination Steps

(1) Determine whether a life insurance policy being distributed by a plan is valued properly:

a. In the case of a non-variable life insurance contract, compare the premiums paid with the value of the contract. Generally, the value of a non-variable life insurance contract should be close to the premiums paid under the contract accumulated at a reasonable rate of interest (at least 2 or 3 percent) less reasonable cost of insurance charges (generally, except for very high ages, less than $5,000 per $1 million of death benefit) less reasonable policy expenses (generally, less than $1,000 per $1 million of death benefit).
b. In the case of a variable life insurance contract, the actual investment return should be considered. Generally the value of a variable life insurance contract should be close to the premiums paid under the contract accumulated at the actual investment return rate earned by the contact (which can vary widely because the premiums paid under such contracts are generally invested in mutual fund like instruments) less reasonable cost of insurance charges (generally, except for very high ages, of less than 5,000 per $1 million of death benefit) less reasonable policy expenses (generally, less than $2,000 per $1 million of death benefit).
c. Protect the statute of limitations on the related Form 1040 resulting from any adjustments to the recipient's taxable income. See the Discrepancy Adjustment Procedures in IRM 4.71.4.

4.72.8.6
(09-01-2006)
Effects of Improper Valuation

(1) Rev. Rul. 80–155 requires that a defined contribution plan's assets be revalued at least annually. If the requirements of Rev. Rul. 80–155 are not met, the plan is not qualified.

(2) If assets are valued more frequently than annually in a way that favors distributions to highly compensated employees, prohibited discrimination under IRC 401(a)(4) could occur.

(3) An improper valuation of qualified plan assets can cause a plan to exceed the limitations on benefits and contributions under IRC 415.

- This could occur, for example, if there was an exempt contribution of undervalued property to a plan and the resulting annual additions to participant accounts based on the improper valuation are within the limits of IRC 415, but the annual additions based on FMV of the contributed property would exceed the IRC 415 limits.

- Similarly, there could be excess annual additions if property were sold by the plan for more than FMV.

(4) In extreme cases, an exclusive benefit violation under IRC 401(a)(2) may occur if a qualified plan engages in a prohibited transaction in which it acquires property for more than FMV.

4.72.8.6.1
(09-01-2006)
Funding and Deductions

(1) Although a contribution of property to a plan may be a prohibited transaction if it is not subject to an exemption, a contribution need not be paid in cash to be deductible under IRC 404. If overvalued property is contributed to the plan, the employer may have deducted an amount in excess of that allowed under IRC 404.

(2) Another possible result of contributing overvalued property either to a money purchase pension plan or a defined benefit plan is the plan may not satisfy the minimum funding standards of IRC 412. This may cause the plan to have an accumulated funding deficiency subject to IRC 4971, the two-tier excise tax.

4.72.8.6.2
(09-01-2006)
Prohibited Transactions

(1) Under IRC 4975(d)(13) and ERISA 408(e), a plan may acquire and hold qualifying employer securities and qualifying employer real property.

(2) The acquisition of qualifying employer securities or qualifying employer real property is exempt under IRC 4975(d)(13), only if the securities or real property is sold or acquired for “adequate consideration” as defined under ERISA 3(18). This requires a proper valuation. See IRM 4.72.11, Prohibited Transactions.

4.72.8.6.3
(09-01-2006)
Examination Steps

(1) Evaluate purchases of employer securities and employer real property for compliance with prohibited transaction exemption requirements and the exclusive benefit requirements.

(2) If a contribution of property to a plan is subject to a prohibited transaction exemption, determine whether an employer exceeded contribution or deduction limitations by contributing undervalued property to a qualified defined contribution plan. The IRC 4972 excise tax may apply.

(3) Determine whether an improper valuation has caused the plan to violate IRC 415.

4.72.8.7
(09-01-2006)
ESOP Issues

(1) ESOPs must satisfy the annual valuation requirements of Rev. Rul. 80–155 for defined contribution plans.

(2) ESOPs have special valuation rules in certain circumstances. See IRM 4.72.4.

4.72.8.7.1
(09-01-2006)
Independent Appraiser Rules

(1) IRC 401(a)(28)(C) provides that an ESOP is not a qualified plan unless all valuations of employer securities that are not readily tradeable on an established securities market, with respect to activities carried on by the ESOP, are performed by an independent appraiser.

a. Valuation by an independent appraiser is not required by IRC 401(a)(28)(C) in the case of employer securities that are readily tradeable on an established securities market (as defined at Reg. 54.4975–7(b)(1)(iv)). See IRM 4.72.4, ESOP Examination Guidelines on valuation of employer securities that are readily tradeable.

b. Valuation by an independent appraiser is not required unless the ESOP holds employer securities acquired after 12/31/86.

(2) An appraiser is independent if requirements similar to those found under IRC 170(a)(1) for a “qualified appraiser” are satisfied. Reg. 1.170A–13(c)(5) provides that a “qualified appraiser” must make a declaration on the appraisal summary that the appraiser:

a. Holds himself/herself out to the public as an appraiser or performs appraisals on a regular basis;
b. Is qualified to make appraisals of the type of property being valued; and provides a description of his/her qualifications pursuant to Reg. 1.170A–13(c)(3)(ii)(F).

(3) An appraiser is not independent if:

a. The appraiser is the taxpayer that maintains the ESOP (or a member of the controlled group of corporations that includes such taxpayer);
b. The appraiser is a party to the transaction in which the ESOP acquired the property;
c. The appraiser is employed by the taxpayer maintaining the ESOP (or any entity described in subparagraphs a. or b., above);
d. The appraiser is regularly used by any entity described above and does not perform a majority of his/her appraisals for entities other than those described above.
Example: An employer maintaining an ESOP uses a large, national accounting firm for its auditing and tax requirements. The accounting firm proposes to use its valuation division to perform an appraisal for the ESOP. The valuation division is qualified to perform appraisals of the property and holds itself out to the public as an appraiser. Is the accounting firm’s valuation division an “independent appraiser” for purposes of IRC 401(a)(28)(C)? As long as the accounting firm’s valuation division performs a majority of its appraisals for entities other than the employer maintaining the ESOP or entities related to it, the valuation division is an “independent appraiser”.

(4) A valuation of employer securities by an independent appraiser is required with respect to any activities carried on by the plan. These activities include the contribution of employer securities to an ESOP, the purchase of employer securities by an ESOP and distributions to participants.

a. Employer securities are not necessarily required to be valued by IRC 401(a)(28)(C) as of the date of the plan activity. The plan can generally use the most recent annual valuation done on the plan’s valuation date by an independent appraiser.
b. Plan activities requiring valuations also include the offer of employer securities to the employer by a participant under a right of first refusal, the exercise of a put option by a participant to sell shares to the employer and the allocation of assets to participants’ accounts. See Reg. 54.4975–11(d)(5).
c. A participant’s diversification election under IRC 401(a)(28)(B) is a plan activity requiring a valuation by an independent appraiser.

4.72.8.7.2 (09-01-2006) Examination Steps

(1) Review Form 5500 to see if a current appraisal of employer securities was made immediately before such stock was contributed to or purchased by an ESOP for the plan year.

a. If the answer is "no", a valuation problem may be indicated and the plan may be disqualified.
b. If the answer is "yes", check Form 5500 to see if the appraisal was made by an unrelated third party. If the answer is "no", a valuation problem may be indicated and the plan may be disqualified.

(2) Make sure the appraiser is an "independent appraiser" within the meaning of IRC 401(a)(28)(C).