Value of Life Insurance Contracts When Distributed From a Qualified Retirement Plan

Follow-Up Letter

January 20, 2005

Comments to the
Department of the Treasury
Internal Revenue Service

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The American Society of Pension Professionals & Actuaries (ASPPA) appreciates the opportunity to provide further comment on the Internal Revenue Code (IRC) Section 412(i) guidance proposed by the IRS and the Treasury on February 13, 2004 (Proposed Regulations). ASPPA provided initial comments to the IRS and the Treasury on May 17, 2004. This letter is intended to augment some of the previously provided comments in regard to certain technical issues. ASPPA thanks the IRS and the Treasury for permitting the augmentation of the original comment letter.

ASPPA is a national society of retirement plan professionals. ASPPA's mission is to educate pension professionals and to preserve and enhance the private pension system. Its membership consists of more than 5,000 actuaries, plan administrators, attorneys, CPAs and other retirement plan experts who design, implement and maintain qualified retirement plans, especially for small to mid-size employers.

Summary of Additional Issues

Below is a summary of the additional issues discussed in this letter:

- The definition of accrued benefit under IRC §412(i) plans.
- The application of the anti-cutback rules under IRC §411(d)(6) with respect to the benefits accrued under a §412(i) plan and the effect of the conversion of a §412(i) plan to a non-§412(i) defined benefit plan.
- The manner in which Revenue Ruling 74-307 and other guidance relating to incidental life insurance limits are applicable to §412(i) plans.
- The interrelationship between the minimum lump sum distribution requirements of IRC §417(e) and the funding rules under IRC §412(i), with specific guidance requested on the manner in which a §412(i) plan satisfies any additional lump sum required to be provided by IRC §417 (e).
- The calculation of minimum distributions under IRC §401(a)(9) with respect to §412(i) plans.
- The application of the nondiscrimination testing rules under IRC §401(a) (4) to §412(i) plans that are not safe harbor plans (*e.g.,* plans that perform general nondiscrimination testing) and clarification of the "same series" requirement under the safe harbor test.
- The appropriate use of accrual requirements (*e.g.,* a minimum hours of service requirement) and vesting rules under a §412(i) plan.
- The proper tax treatment of a life insurance policy held by a qualified plan under which the death benefit may exceed the incidental life insurance limits but such excess death benefits are not payable to the participant's beneficiary.
- Clarification of separate rights or features under policies held by a §412 (i) plan or other qualified plan for which the nondiscriminatory availability requirements under Treas. Reg. §1.401(a)(4)-4 must be satisfied.

Discussion of Issues

A. The definition of accrued benefit under §412(i) plans.

There is a concern over the determination of an accrued benefit in a fully insured defined benefit plan [§412(i) plan]. In general, the accrued benefit is defined in terms of the cash surrender value of the policies being used to provide the benefits. However, certain features of the policies themselves can cause the cash surrender value to change based on a participant's elections or the lapse of certain surrender charges over time. Furthermore, the impact of certain Code provisions may cause a compliance with one requirement to lead to a failure of another requirement. Guidance is needed to reconcile the accrued benefit rules with the fully insured requirements.

IRC §411(b)(1)(F) requires that a participant's accrued benefit under a fully insured defined benefit plan as of any applicable date not be less than the cash surrender value of the insurance contracts on his or her life as of such applicable date if the requirements of paragraphs (4), (5) and (6) of IRC § 412(i) are satisfied.

Paragraphs (4), (5) and (6) of IRC § 412(i) require that:

- Premiums payable for the plan year, and all prior plan years, under such contracts have been paid before lapse or there is reinstatement of the policy [IRC §412(i)(4)];
- No rights under such contracts have been subject to a security interest at any time during the plan year [IRC §412(i)(5)], and
- No policy loans are outstanding at any time during the plan year [IRC §412(i)(6)].

Thus, IRC §411(b)(1)(F) provides that a participant's accrued benefit cannot be less than the cash surrender value of the timely-paid, unencumbered policies purchased with respect to the participant's benefits. The cash surrender value of the participant's policies is normally stated as a single sum amount.

This requirement creates confusion as to the determination of the participant's accrued benefit, in general, for purposes of IRC §411. In particular, IRC §§411(a)(7)(A)(i) and 411(c)(3) require that:

- the accrued benefit be, "in the case of a defined benefit plan, the employee's accrued benefit determined under the plan and, except as provided in subsection (c)(3), expressed in the form of an annual benefit commencing at normal retirement age" [IRC §411(a)(7)(A)(i)]; or
- "For purposes of this section, in the case of any defined benefit plan, if an employee's accrued benefit is to be determined as an amount other than an annual benefit commencing at normal retirement age … the employee's accrued benefit …shall be the actuarial equivalent of such benefit…" [IRC §411(c)(3)]

To satisfy these requirements, as well as the requirement under IRC §412(i) that all benefits be funded exclusively with the insurance contracts, regulations should require that actuarial equivalence be determined using the insurer's guaranteed actuarial basis. If that is done, the accrued benefit payable as an annual benefit commencing at normal retirement age will be determined by converting the cash surrender value of the contract to this annual benefit, using the policy's guaranteed actuarial basis. If any other basis for conversion is used, the participant's accrued benefit if the participant terminates employment and defers benefit commencement until normal retirement age, will not equal the benefit payable by the insurance contracts.

Furthermore, it is possible under a non-safe harbor § 412(i) plan or under a plan that has switched contract series for there to be insurance contracts with different underlying assumptions, each providing a portion of the benefit for a given participant. In order to ensure that the plan accrued benefit and the benefit under the policies will be the same if the participant defers commencement to normal retirement age, regulations should specify that actuarial equivalence is to be determined separately for each contract, taking into account the guaranteed actuarial basis for each contract.

B. The application of the anti-cutback rules under IRC §411(d)(6) with

respect to the benefits accrued under a §412(i) plan and the effect of the conversion of a §412(i) plan to a non-§412(i) defined benefit plan.

Defining the accrued benefit as the cash surrender value of the policy may be inconsistent with the definition of accrued benefit for other types of plans. This is especially true when one considers the benefit payable as of annuity starting dates between the determination date and normal retirement age. This inconsistency raises questions as to the extent of IRC §411(d)(6) protections of these intervening benefits. Again, ASPPA recommends that the Treasury reconcile these inconsistencies for §412(i) plans.

Are IRC §411(d)(6) protections extended to the accrued benefit at normal retirement, the accrued benefit and the cash surrender value as of the determination date, or the various options related to the cash surrender value (*i.e.,* conversion options, guaranteed increases in cash surrender value, etc.)?

Consider a §412(i) plan that is switching contract series and replacing all contracts. Assume that immediately after conversion, a participant terminates employment and no further premiums are paid on the contract. If the new series has different underlying actuarial assumptions, it would be impossible to match the benefit payable at every age under the new replacement contract to those payable under the prior contracts. While the cash surrender value could be matched at conversion age, if the underlying interest assumption in the new contract exceeds that of the old contract, the benefit at normal retirement age could exceed the benefit payable under the written plan [in violation of IRC §412 (i)], as well as that which would have been payable under the prior contracts.

Alternatively, if the conversion is designed so that the annual benefit at normal retirement age under the new policy matches that of the old policy, but the new policy uses a higher interest rate, then the resulting cash value at the determination date and every intervening age would be less than the guaranteed cash value of the original policy just prior to the conversion. Would this constitute an impermissible cutback of the accrued benefit under IRC §411(d)(6)?

Similar guidance is needed with respect to previously accrued benefits when §412(i) plans are converted to non-412(i) plans. Which benefits provided under the insurance contracts must be protected after the conversion to a non-412(i) plan and the surrender of the contracts? Must the plan guarantee all the benefit levels between conversion date and normal retirement age? Or, alternatively, is the plan required only to guarantee the same accrued benefit payable at normal retirement age?

C. The manner in which Revenue Ruling 74-307 and other guidance relating to incidental life insurance limits are applicable to §412(i) plans.

ASPPA requests that the IRS provide guidance to clarify the application of the incidental death benefit rules to §412(i) plans. Specifically, the application of the “50% to insurance” rule of Revenue Ruling 74-307 must be elucidated. ASPPA recommends that this guidance make it clear that the incidental death benefit rules apply to §412(i) plans and that the limitations are calculated in the same manner as they are for non-§412(i) plans.

Practitioners have used a variety of methods to satisfy the “50% to insurance” rule. Many have limited the total premium paid under a §412(i) plan so that 50% of the total deposit is for life insurance premiums and 50% is for annuity premiums. This approach is rumored to be widely used, although it has little regulatory basis. It also seems to limit the premiums unnecessarily.

Revenue Ruling 74-307, as clarified by the November 8, 1979, letter from Winfield C. Burley of the IRS to Robert G. Chipkin at Phoenix Mutual Life Insurance Company (Chipkin Letter), provides that the maximum amount that may be used to pay premiums for whole life insurance products in a defined benefit pension plan is 66 2/3% of the theoretical reserve under the Individual Level Premium (ILP) funding method. If greater, the insured death benefit may be as high as 100 times the projected monthly benefit.

We are aware of no guidance that would indicate that different limitations apply to §412(i) plans. Practitioners commonly determine the ILP theoretical reserve using the interest and mortality implicit in the guaranteed basis of the contract. ASPPA requests that the IRS issue guidance to address how the assumptions

should be determined if the §412(i) plans use more than one series of contracts or if the insurer changes the underlying rates in the contract series. ASPPA recommends that the maximum insurance amount be based on the lowest interest rate guaranteed in a contract actually issued to the plan.

Alternatively, guidance may examine whether the guaranteed rate is proper for determining the maximum insurance amount. For example, guidance may provide a safe harbor interest rate for determining the maximum premium amount in a §412(i) plan. Given that the guaranteed interest rates in §412(i) products are considerably below the funding rates for traditional defined benefit plans, the establishment of a standard rate for §412(i) plan life insurance premiums will eliminate the inequity in death benefit amounts between traditional and fully insured defined benefit plans. On the other hand, such a requirement would mandate a determination by an actuary as to the maximum amount of insurance that may be in the §412(i) plan, which is contrary to the goal of eliminating the need for actuaries (other than those that determine the rates of the policy for the insurer) in fully insured plans.

D. The interrelationship between the minimum lump sum distribution requirements of IRC §417(e) and the funding rules under IRC §412(i), with specific guidance requested on the manner in which a §412(i) plan satisfies any additional lump sum required to be provided by §417(e).

The application of the rules under IRC §417(e) to nonannuity benefit payments is yet another situation that hinges on the definition of “accrued benefit,” as referenced earlier. As has been seen with cash balance plans, in situations where the accrued benefit is defined in terms of a single sum benefit payable immediately, the calculation of the lump sum benefit payable can be complex and yield surprising results.

Consider the situation in which the interest rate in the guaranteed actuarial basis exceeds the applicable interest rate. If the rules of IRC §417(e) are applied to the annual benefit commencing at normal retirement age, the minimum required lump sum benefit will exceed the single sum benefit payable from the contract. From what funds will this additional benefit be provided?

Standard industry practice looks only to the actual interest component of the policy’s guaranteed actuarial basis to determine the normal retirement age benefit. The guaranteed actuarial bases for these policies invariably has been less than the applicable (GATT) interest rate; thus, the application of IRC §417 (e) has not impacted the benefit payable.

ASPPA recommends that, because the application of IRC §417(e) rates could cause a fully insured plan to run afoul of the IRC §412(i) requirements, a safe harbor be granted to §412(i) plans. For example, in a situation in which a policy’s cash surrender value adequately reflects its fair market value, the plan should be allowed to assume that the guaranteed interest rate in the policy does not exceed the IRC §417(e) applicable interest rate.

E. The calculation of minimum distributions under IRC §401(a)(9) with respect to §412(i) plans.

It is unclear how the minimum required distribution rule applies to a §412(i) plan. If a participant takes a lump sum distribution from a plan and rolls that amount over to an eligible retirement plan, the defined contribution distribution rules clearly apply. However, it is unclear how the rules apply when the participant receives a distribution at retirement of the insurance policy from the §412(i) plan.

ASPPA recommends that, if the participant takes the policy from the plan, it be tantamount to receiving annuity payments from the plan and, as such, the benefits paid from the plan would be subject to the minimum required distribution rules of the plan. As a result, the policy used for §412(i) plans must contain a provision properly meeting the requirements of IRC §401(a)(9), and such provision would continue to apply after the policy was distributed to the participant.

F. The application of the nondiscrimination testing rules under IRC §401(a)(4) to §412(i) plans that are not safe harbor plans (e.g., plans that perform general nondiscrimination testing) and clarification of the “same series” requirement under the safe harbor test.

1. The Same Series Requirement.

The vast majority of §412(i) plans purportedly meet the nondiscrimination requirements of IRC §401(a)(4) by satisfying the safe harbor requirements of Treas. Reg. §1.401(a)(4) –3(b)(5). The safe harbor places restrictions, not only on the plan's normal retirement benefit formula, but also on the types of policies that may be used as funding vehicles. Specifically, there is a requirement that all the contracts used be of the "same series."

Treas. Reg. §1.401(a)(4)–3(b)(5)(vii) requires that, in order to be a safe harbor §412(i) plan:

All benefits must be funded through contracts of the same series. Among other requirements, contracts of the same series must have cash values based on the same terms (including interest and mortality assumptions) and the same conversion rights. A plan does not fail to satisfy this requirement, however, if any change in the contract series or insurer applies on the same terms to all employees.

Clarification is needed as to the application of this "same series" requirement. Common thinking among practitioners is that this "same series" requirement means that all life insurance contracts issued on the lives of the §412(i) plan participants have to be of the same series and all annuity contracts have to be of the same series. However, current informal guidance from the IRS suggests that this is not the case because of the inherent difference between life insurance and annuities. If this informal guidance is adopted officially, the only §412(i) plan design that would meet the safe harbor requirement of Treas. Reg. §1.401(a)(4)–3(b)(5)(vii) would be a plan funded exclusively with annuity contracts of the same series. A plan funded with a combination of life insurance and annuities would not qualify as safe harbor design. This would be a quantum change from what has been perceived as appropriate in the §412(i) plan marketplace, and could cause a significant number of plans to be reevaluated to confirm compliance with the nondiscrimination requirements of the Treasury regulation. Furthermore, it would reduce significantly the number of §412(i) plans that could exist without requiring administrative processes and outside consultants. Remembering that one reason sponsors may decide to have a §412(i) plan is the ease of administration (*i.e.,* the plan's administrative issues are "self-contained" in the policy), this may make §412(i) plans much less attractive to employers.

Certain insurers working in the §412(i) plan marketplace have "paired" insurance and annuity products using the same underlying assumptions to ensure they are of the same series. ASPPA recommends that guidance clarify that the use of these paired products inside a plan will not cause a failure of the same series requirements even though both insurance and annuities are being used.

Furthermore, practitioners are concerned that a change in insurance product in later years for increased benefits will create a situation in which a different series will be perceived as existing. In such a situation, any change in insurance products would require the replacement of all existing policies by the new product, which would be to the detriment of both participants and plan sponsors. Participants whose insurability has changed significantly might not be able to be covered by the new product. In addition, all life insurance premiums for permanent policies likely will be higher than those that are replaced, as the insureds will be older than they were at initial issuance. ASPPA recommends that guidance confirm that the insurer or contract series may be changed prospectively for future purchases without needing to replace the existing policies.

2. The Application of General Testing to §412(i) Plans

Failure to meet the nondiscrimination safe harbor subjects the plan to the general test for nondiscrimination under IRC §401(a)(4). Currently, there is no guidance on the application of the general test to fully insured plans.

The general nondiscrimination test of IRC §401(a)(4) requires that the plan demonstrate that each rate group under the "plan" being tested satisfy a modified version of the coverage requirements of IRC §410(b). A rate group exists for each highly compensated employee (HCE) and consists of the HCE and each other participant with normal and most-valuable benefit accrual rates at least equal to that of the HCE being tested. Since the general test measures benefit

accrual rates, the issues in performing the tests are similar to the issues discussed above in determining the accrued benefit.

A common practice in determining normal accrual rates under the annual method for §412(i) plans involves projecting the increase in cash surrender value for the plan year to testing age using the guaranteed rates under the contract. In determining the most valuable accrual rate, the increase in cash surrender value is projected to the earliest permissible annuity starting date using the contract rates (without consideration to adjustments due to potential changes in surrender charges) and then normalized to testing age using standard assumptions. Similar methodology is used for the accrued-to-date method or for testing involving fresh-starts.

In situations in which more than one series of contracts are used, the normal accrual rates are determined separately with respect to the benefits provided under each contract and the separate results aggregated to determine the total rates for the participant.

G. The appropriate use of accrual requirements (*e.g.,* a minimum hours of service requirement) and vesting rules under a §412(i) plan.

One of the considerations for a §412(i) plan has to do with the timing of accrual of benefits under the plan, as compared to the timing of benefit increases within the insurance policy. Generally, insurance premiums are paid at the beginning of the policy period, often at the beginning of the year. Benefit accruals, on the other hand, usually require the passage of time or the working of a certain number of hours of service. If the premium for the insurance is paid at the beginning of a period (for example, at the beginning of the plan year), but accrual of benefits takes place later in the year (such as, after the participant has completed 1,000 hours of service), what is the effect of the accrued benefit under the policy being greater than the participant's accrued benefit under the plan? This issue is particularly problematic for a situation in which the participant terminates mid-year, prior to working the necessary hours of service.

The reverse problem occurs if accruals occur faster than premium payments. Suppose a plan provides for accrual of benefits after completion of 1,000 hours of service, and the insurance policies that are fully funding the plan are designed to have monthly premium payments. If a participant terminates mid-year, after completion of 1,000 hours of service, the plan must continue to pay the remaining monthly premiums (in fact, may need to accelerate their payment) so that the benefit provided under the contract aligns with the benefit under the plan terms.

If a plan is to be in simultaneous compliance with IRC §§412(i) and 411, is it required that the insurance policies be structured so that premium payments (and accrual of benefits under the policies) align with plan provisions relating to the accrual of benefits?

A similar issue arises in the first year of a participant's entry into the plan. Commonly, the participant will enter the plan during the year, but the determination of such entry and the purchase of the life insurance policies for such participant occur at year-end or after, when the plan data is collected and analyzed. If the participant terminates employment or dies before the insurance is issued, how can the plan comply with the fully insured requirements and still provide the participant with the benefit he or she has accrued?

If a participant terminates employment prior to fully vesting in the plan, the cash value of the policy will commonly exceed the benefit payable to the participant. In such a situation, the policy cannot be simply distributed to the participant. If the policy is divided, so that the participant is provided with the portion equal to the vested benefit and the balance is surrendered, what happens to the surrender proceeds if they exceed any premium due at the time of the surrender? If the cash value is significant, the surrender proceeds could even exceed the total premium due for all participants for the coming year.

ASPPA recommends that the IRS consider these issues and provide guidance as to how a §412(i) policy can comply with the requirement that the plan be funded exclusively with insurance contracts, the IRC §411 accrual and vesting rules, and the terms of the plan.

H. The proper tax treatment of a life insurance policy held by a qualified plan under which the death benefit may exceed the incidental life insurance limits but such excess death benefits are not payable to the participant's beneficiary.

It is not uncommon for the face amount of insurance for a given participant in a §412(i) plan or a split-funded plan to exceed the incidental death benefit. Revenue Ruling 2004-20 notes that the premium for the excess insurance is not deductible as a proper plan contribution.

Nonetheless, the maintenance of excess insurance raises other issues about the benefits to be provided to participants upon termination of employment. In particular, at termination of employment prior to retirement or plan termination, it is possible that the Plan would distribute a policy with excess insurance to the participant.

ASPPA recommends that the IRS clarify that the face amount of life insurance to be distributed to a participant may not exceed the amount permitted under the incidental death benefit rules.

I. Clarification of separate rights or features under policies held by a §412(i) plan or other qualified plan for which the nondiscriminatory availability requirements under Treas. Reg. §1.401(a)(4)-4 must be satisfied.

There may be situations in which a plan sponsor purchases different types of policies for different participants. This situation may occur in plans that are split-funded, as well as §412(i) plans, and may be caused by such considerations as:

- The passage of time (*i.e.,* a different type of policy or different insurer is more economical now than the original contract or insurer when the plan was put into place);
- The insurability of participants (*i.e.,* an older or sicker participant may be uninsurable under one contract, but not under another offered by either the same or a different insurer); or
- Investment decisions by the trustees (*e.g.,* a decision by the trustees of a split funded plan to self-insure death benefits of less than $100,000, purchasing insurance only for those participants with death benefits greater than that).

If the plan owns a life insurance contract on a participant, the participant will likely be provided with the right to receive such contract as part of the benefit distribution or to buy the contract from the plan pursuant to available class prohibited transaction exemptions. Is the ability to buy this contract out of the plan a benefit, right, or feature that must be available to a nondiscriminatory group under IRC §401(a)(4) and Treas. Reg. §1.401(a)(4)-4?

ASPPA recommends that this question be clarified in final regulations. In addition, ASPPA recommends that the availability of an insurance product to be distributed or purchased from the plan not be considered to be a benefit, right, or feature when comparable death benefits are provided by the plan. Creating such a consideration would wreak administrative havoc in the plan as benefits and insurance contracts change.

This letter was primarily authored by Ilene H. Ferenczy, Esq., CPC, Co-chair of the Government Affairs Committee, and Thomas J. Finnegan, MSPA, CPC, QPA, of the Defined Benefits subcommittee. Please contact us if you have any comments or questions regarding the matters discussed above.

Sincerely,

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