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

Comments to the Department of the Treasury Internal Revenue Service

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The American Society of Pension Actuaries (ASPPA) appreciates this opportunity to comment on the IRC Section 412(i) guidance proposed by the IRS and the Treasury on February 13, 2004 (the "Proposed Regulations"). ASPPA applauds the government for tackling this important subject, and in doing so for recognizing and emphasizing the real and important role traditional fully insured §412(i) plans play in private pension planning. ASPPA agrees with and supports the Service's goal of clarifying statutory law by promulgating rules that both preserve traditional fully-insured pension plans and eliminate the use of the fully-insured funding method to circumvent the benefit limitations under the law.

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 Issues

A. The source of the problem with §412(i) plans is the insurance vehicles being used by overly-aggressive promoters.

B. A key element of properly regulating abusive §412(i) plans is policy valuation, including such issues as:

1. Any policy in a §412(i) plan should have a fair market value (FMV) that equals the policy's cash value.

2. Expense charges are an important element of the calculation of FMV. An appropriate FMV calculation should include the impact of expense charges in connection with policy surrender, conversion, and/or exchange.

3. Excess insurance has a value that must be part of the policy's FMV.

4. The FMV of a policy should include the value of prepayment of acquisition costs at the beginning or early in a policy's life, but that are properly allocable to the policy's later years.

5. There are other valuation issues that affect insured plans in general (and not just §412(i) plans) that must be considered in the regulations.

C. Enforcement is needed to restore an appropriate §412(i) marketplace.

D. The final regulations should clarify when a plan is a §412(i) plan and what is required for it to be a qualified plan under Internal Revenue Code (IRC) §401(a).

E. The Service should provide mechanisms for plan sponsors to correct violations of the rules for §412(i) plans, particularly when the violations risk plan qualification.

Discussion

A. The Source of the Problem is the Insurance Vehicles Being Used by Overly-Aggressive Promoters

It is important for ASPPA to note at the outset of this comment that it is not the operation of traditional §412(i) plans that has given rise to the current concern about abuse. Rather, the concern is a reaction to the types of insurance policies that are being promoted for §412(i) purposes by certain service and product providers in the benefits industry. These policies ostensibly permit the payment and tax deduction of greater premiums by the plan sponsor and the receipt of greater benefits by the participants than are available in uninsured or split-funded defined benefit pension plans.

In a properly designed §412(i) program, the plan benefit is provided entirely by a life insurance policy or annuity. The amount to be funded each year to provide that benefit and the amount that is tax deductible is the annual premium for the policy. The benefit that is provided to a participant under the plan is the policy, itself. Because the policy provides all benefits, the actuarial analysis performed by the issuing company in determining the policy premium is considered by Congress and the Service to substitute for the normal actuarial valuation that is needed to develop the defined benefit plan annual contribution. As a result, IRC §412(i) exempts the fully insured plan from the normal minimum funding standards of IRC §412

An overly aggressive §412(i) plan design features an “engineered” life insurance policy. The specially-designed policy manipulates the various elements that go into pricing and valuing insurance (generally, interest, mortality and expenses). The result is what has come to be known as a “sponge policy.” A sponge policy’s features include an artificially high annual premium and a suppressed cash value in the first several years of the policy’s life. In essence, the sponge policy defers the growth of cash value to later years, after the plan design’s anticipated distribution of the policy from the plan to the insured. Tax on the distribution is calculated, not on the policy’s real value, but rather on the suppressed cash value amount.

The troublesome tax result of using these sponge policies is two-fold. First, the artificially inflated annual premiums arguably are fully tax deductible when contributed by the plan sponsor. Second, tax on distribution is minimized by deferring cash value growth until a year after the year of taxable distribution, and then utilizing the suppressed cash value as the taxable amount received by the participant.

Furthermore, this plan design circumvents the pension plan benefit limits set in IRC §415. This results from using the artificially suppressed policy value as the benchmark for comparison to the legal benefit limits, rather than the policy’s real value (which is not reached until after the policy is distributed from the plan). The plan sponsor, therefore, has been permitted to fund an excessively high ultimate benefit and the insured receives a policy that, in fact, provides benefits in the long term that are significantly larger than they appeared at distribution—and larger than the benefit levels that would have been permitted in an uninsured plan.

It is this practice that gives rise to abuse of the §412(i) rules, and it is this abuse that the Proposed Regulations seek to halt. ASPPA supports the Service’s focus on these inappropriate funding vehicles as the way to halt these abuses in the §412(i) marketplace. ASPPA believes that, while the valuation rules contained in the Proposed Regulations are supposed to result in an inability to use these kinds of policies, the regulations would be strengthened if they explicitly stated the Service’s intent to prohibit this type of funding vehicle.

In addition to including a statement of the Service’s intent to prohibit sponge policies in a §412(i) setting, the final regulations should contain a clearer description of the characteristics of policies that are both appropriate and inappropriate for these plans. An effective prohibition of inappropriate insurance vehicles requires specificity of the rules themselves, in addition to a statement of what the rules intend.

B. A Key Element of Properly Regulating Abusive §412(i) Plans is the Valuation of the Policies

ASPPA believes the policy valuation rules the Service suggests in the Proposed Regulations, if properly defined and administered, will address this abuse without harming bona fide §412(i) plans. The attempt in the Proposed Regulations to require a full and appropriate measurement of the value of insurance policies highlights the distortion by the sponge policies and encourages the use of vehicles that properly reflect the value of benefits being delivered. If the policies are correctly valued, and the suppressed or deferred cash value is rejected as a measurement of the proper policy value, the IRC §415 limitations can be applied properly to the fully insured plan. This leads to premiums that are properly and fully deductible and an elimination of the disconnect between the benefit provided by the policy and the benefit required by the plan.

The Proposed Regulations suggest that policies be valued for this purpose based on their true “fair market value” (FMV). Unfortunately, however, the Proposed Regulations provide too little guidance as to how to calculate a policy’s FMV. Because calculation of FMV is so ill-defined, the bullet intended for the heart of the abusive practice could miss its target. This vague definition not only makes it difficult for sponsors of §412(i) plans with bona fide policies to properly determine their FMV, but it also creates sufficient uncertainty to enable the promoters of abusive policies to continue existing practices. The result, unfortunately, is the worst of both worlds: bona fide §412(i) plan sponsors feel at risk for being noncompliant, and sponsors of abusive plans hide behind the imprecision to justify their practices. This concern has been proven true in the weeks since the Proposed Regulations were issued as promoters of abusive §412(i) plans have reassured clients in press releases and letters that the Service’s new guidance has little or no effect on the programs that have been established.

Accordingly, ASPPA urges that the final regulations expand on the Proposed Regulations with carefully-constructed valuation rules that define FMV by taking into account all of a life insurance policy’s valuable elements, including a policyholder’s right under the contract to convert or exchange the policy after its acquisition expenses have been paid.

The following is a sampling of some of the valuation issues that the Service should consider in defining FMV.

1. A Policy in a §412(i) Plan Should Have FMV that Equals the Policy’s Cash Value

A key question the final regulations should answer clearly and explicitly is whether, in order to be a qualified §412(i) plan, the plan must use insurance products whose FMV equals the policy’s guaranteed cash value. IRC §412(i)(3) states in relevant part that the benefits “provided by the [§412(i)] plan are equal to the benefits provided under each contract at normal retirement age under the plan and are guaranteed by the insurance carrier.” Hence, it would be both appropriate and helpful to explicitly state that FMV must equal guaranteed cash value.

In a sponge policy situation, the policy’s cash value is artificially suppressed in the early years. In those years, the benefit under the plan is less than the anticipated plan benefit. This should mean that the sponge policy is inappropriate for use by a fully insured §412(i) plan, as it fails to provide the full benefits that should have been earned during that suppression period. These policies certainly violate the spirit of §412(i), which anticipates accruals under the policy that have some reasonable analogy to an accrued benefit in an uninsured plan.

ASPPA encourages the Service to use its proposed FMV valuation standard as a method for an explicit discussion of the elements of an insurance product—such as a sponge policy—that is inappropriate for §412(i) plan purposes. Included in that discussion should be an analysis of the meaning and application of the §412(i)(3) rule that requires the benefits under the plan to be equal to the benefits under the contract.

2. The Impact of Expense Charges on the FMV Should Consider Whether These

Expense Charges Apply Both on Surrender of the Policy and on Conversion or Exchange

When a participant in a §412(i) plan terminates employment or the plan terminates, the policy is the source of benefits to be paid out. If the participant retains the policy after termination, it can be converted into an annuity that provides the scheduled retirement benefit. On the other hand, if the participant surrenders the policy, the insurer may levy various charges that will reduce the cash payout to something less than the present value of the funded benefit. These charges often apply at surrender only, and not at distribution of the policy, conversion of the policy or exchange of the policy for another policy offered by the insurer.

In a sponge policy, those surrender charges are significant in the early years. Historically, sponge policy promoters have determined the value of the policy at an early distribution to a participant (whether the policy is transferred to the participant or surrendered) to be equal to the cash surrender value—that is, equal to the amount that the participant would receive if the policy were surrendered and any charges applied. In fact, if the participant retains the policy after it is distributed from the plan, the surrender charges will not apply at that time, and may actually dissipate over time.

The ability to retain the policy or to convert it or exchange it to another insurance company product without the application of the surrender charges has economic and actuarial value. ASPPA believes that the rules for calculating FMV should take into account the value of these policy rights and features, and not apply the surrender charges to the policy value as if they were actually being taken from the policy at distribution.

3. Excess Insurance Has a Value That Must Be Part of the FMV

The final regulations should specify that FMV includes in its definition the value and cost of "excess" insurance benefits provided by the policy. These excess benefits arise in one of two ways:

> a) By having a policy in the plan that provides benefits that are within the §415 limits at the time the policy is expected to be distributed from the plan, but are expected to grow to a value in excess of those limits before normal retirement under the plan; or
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> b) By having a policy that provides death benefits that are in excess of the incidental death benefit rules.

The ramifications of this excess insurance are discussed below.

a. The FMV Should Take Into Account Predictable Growth in Policy-Provided Benefits In Excess of the §415 Limits That Occurs after the Policy is Distributed from the Plan, But Before Normal Retirement Age.

The policy's FMV should include all valuable elements of the policy, including those that are suppressed in the early years. The failure of abusive §412(i) plans to include these values stems from a desire to acknowledge for IRC §415 limitation purposes only such benefits as are payable on the day of valuation, subtracting expenses that may be waived in the future and ignoring expected future policy value increases.

In fact, the essence of the use of sponge policies in abusive §412(i) schemes is the anticipated change in the policy after it is distributed from the plan. The structure of the abusive §412(i) plan is to pay large amounts now for benefits that will be hidden within the policy until later years, and then to get the policy out of the plan before those benefits accrue. When only the visible benefits are compared to the Section 415 limits, the policy appears to be in compliance with the law, and the participant receives a policy upon distribution that appears to be worth much less than its actual value.

The projected growth and the elimination of expenses have an economic value that must be considered as part of the FMV of the policy. That value should be included in the FMV of the policy, preventing the artificial undervaluing of the policies. This will, in turn, undercut the abusive structure of the sponge policy

§412(i) scheme, as it will be impossible to bypass IRC §415 with artificially devalued policies.

b. Policies That Provide Nonincidental Death Benefits Must Be Valued Taking Excess Death Benefits into Account

Another crucial issue in valuing a policy's FMV is the impact of a §412(i) plan sponsor's decision to purchase policies that provide a death benefit greater than the incidental limit. It appears from the Proposed Regulations that a §412(i) plan may provide these excess death benefits, so long as the excess death benefits are not payable to the participant's beneficiaries in the event the participant dies while the policy is in force, but the plan sponsor may not deduct the premium attributable to the excess insurance. See Revenue Ruling 2004-20. Many practitioners value the foregone deduction at the Table 2001, PS 58 or group term life insurance rate. This is a very small price for a plan sponsor to pay in exchange for the ability to provide significant excess life insurance to its participants.

The ability to provide excess death benefits undercuts controls on the use of sponge policies and provides a tax advantage to the plan sponsor and the insured participants through the policies' artificially suppressed death benefit values.

ASPPA recommends that the Service clarify that a plan is not a §412(i) plan if it provides nonincidental life insurance coverage or death benefits in excess of the incidental limits, even if those excess death benefits are not payable to the beneficiary of the participant, because the premiums required by the policies which include such excess death benefits are providing benefits which exceed the benefits under the plan. In addition, ASPPA recommends that the distribution of a policy from a plan fails to satisfy the requirements of IRC §401(a) if the life insurance death benefits payable under such contract exceed the incidental life insurance limits. Furthermore, to the extent that one of the effects of having excess insurance is to lose the deduction on the excess amount, the Service should clarify how that foregone deduction is calculated.

4. The FMV of a Policy Should Include the Value of Costs That Are Prepaid At Acquisition of the Policy, but Apply to Later Years

The rules governing the calculation of FMV must also clarify how to adjust that FMV for prepaid costs at acquisition of the policy, and how the costs are to be allocated to a policy's FMV in a given year. These costs constitute a variety of valid insurer expenses, and thus are appropriately excludible from the policy's FMV. However, some of these costs may be attributable to later years (i.e., prepaid within the policy structure). Such cost should be amortized over that extended time and not used to offset the FMV in the years prior to their application.

This can be illustrated by looking at agent commissions, which are built into the policy's price and are visible, easily measured and susceptible to manipulation. Commissions paid are valid expenses that certainly should be excluded from the calculation of a policy's FMV. Nonetheless, there are important timing issues relative to creation of the formula for taking commissions into account. Consider the effect on the FMV if the entire commission attributable to several years of the policy's maintenance is paid to the salesperson in the first year—a common occurrence. Can the entire commission charge be deducted from the policy's FMV in the year it is paid, or is there an economic value to these prepaid commissions that should be included as an addition to the FMV until appropriately worn away?

This is particularly at issue when the policy is distributed prior to completion of the time frame that the commission payment covers, when the recipient of the policy receives the value of the prepayment of these policy expenses by the plan.

It seems appropriate that expenses that apply to future years be spread over the applicable time, rather than being charged in full against the policy value in the year paid. If that is so, how long should the time frame be—the life of the policy? Until the policyholder's normal retirement age? Should the expensing or amortization period be calculated separately and specifically for each policy and each type of expense, based on the individual facts and circumstances of the policy and expense, or should there be a general rule applicable to all policies within one §412(i) plan?

These questions are crucial to the accurate calculation of FMV. Further, they highlight the complicated and highly technical nature of the FMV determination. The IRS and Treasury must address these important questions in the final regulations, but should do so only after careful study of the life insurance policy construction issues involved.

5. There Are Other Valuation Issues that Affect Insured Plans in General (And Not Just §412(i) Plans) That Must Be Considered.

The issues highlighted above are aimed at eliminating abusive §412(i) programs. However, sponsors of legitimate §412(i) plans, as well as sponsors of non-§412 (i) plans that hold life insurance investments, need to be clear on how various plan operations are affected by the final regulations. Non-engineered policies often have a bona fide connection between the cash surrender value of the life insurance policy and the FMV of the policy. In that case, the cash surrender value remains an appropriate measurement of the true policy value, not only upon distribution of the contract or sale of the contract to the participant, but also for ongoing administrative procedures (e.g., valuation of assets for top heavy purposes, Form 5500 reporting).

ASPPA recommends that the Service examine the types of policies for which this is the case and clarify that the cash surrender value may be used by those policies as FMV.

C. Enforcement Is the Key to Restoring an Appropriate §412(i) Marketplace

Vigorous enforcement of all existing qualified plan rules, coupled with the clearer definition of the FMV of insurance products, will go a long way toward resolving the abuses in today's §412(i) marketplace. Enforcement should focus equally on the plan's compliance with the full panoply of qualified plan rules, as well as on its compliance with the funding rules specific to IRC §412(i).

One situation in particular is worth mentioning as an example. Apparently, some promoters of §412(i) plans are encouraging sponsors of owner-only plans to structure their programs so that the value of the insurance products funding the plan never reaches $100,000. Such a structure, it is said, allows these plan sponsors to "hide" from the IRS by avoiding Form 5500-EZ filings. With no Form 5500-EZ, they believe that there is no way for the IRS to know about or audit the plan.

It is essential to maintaining the integrity of the §412(i) marketplace that this type of activity be prevented. It is imperative that there be a mechanism by which all §412(i) plans are subject to effective and adequate reporting and disclosure requirements.

ASPPA recommends that the rules be modified to require that, regardless of asset size, all defined benefit plans file an annual 5500-series form with the Department of Labor. Such a requirement would add only a modicum of administrative burden to plan sponsors and administrators of owner-only defined benefit plans, but the added administrative burden would be minimal and worthwhile to ensure that the IRS has access to information about these plans. Note that such smaller non-§412(i) plans currently are required to complete, but not file, a Schedule B Actuarial Report for all plan years.

D. The Regulations Should Clarify When a Plan is a §412(i) Plan and Whether It Qualifies under §401(a)

The benefits flowing from a sponge policy raise questions about whether a plan containing such a policy constitutes a valid §412(i) qualified plan. In many respects, the use of the sponge policy seems in conflict with the intent of IRC §412(i). ASPPA recommends that the final regulations explicitly state that its valuation rules are intended to prohibit use of sponge policies in §412(i) plans, along with any other policy design that circumvents the funding and accrual assumptions inherent in §412(i) plans. The regulations should further explicitly state that use of a prohibited funding vehicle puts at risk the plan's qualification status if it contravenes any of the requirements of IRC §401(a), such as the §415 limitations on benefits.

To better achieve the objectives discussed above, numerous qualification and tax issues relating to §412(i) plans need to be addressed in the final regulations. ASPPA will discuss these issues in detail in its more technical comments being submitted in a separate letter by the end of May 2004. This separate letter will request guidance on:

1. The definition of accrued benefit under IRC §412(i) plans;

2. 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;

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

4. 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 by §417(e);

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

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

7. The appropriate use of accrual requirements (e.g., a minimum hours of service requirement) under a §412(i) plan;

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

9. 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.

ASPPA recommends that the final regulations also address the extent to which the policies themselves must contain language ensuring compliance with these issues and, where such requirements need be reflected only in the separate plan document, what the effect is under IRC §412(i) if the policies contain features which must be superseded by the rules stated solely in the plan document.

E. The Service Should Provide Mechanisms to Correct Violations of Rules Relating to Section §412(i) Plans, Particularly with Respect to Plan Qualification

The February 13 guidance outlines many situations in which current plans may be in violation of the rules in the Proposed Regulations. The elements of the guidance that are deemed by the Service to be interpretations or clarifications of existing rules are given retroactive effect.

The regulations should include a framework under which the innocent sponsor of a problematic plan who had no previous knowledge of the violations at issue can unwind its plan. Further, the regulations should discuss how a bona fide §412(i) plan converts into a non-§412(i) plan.

ASPPA encourages the IRS and Treasury to provide new EPCRS-type guidance that will provide plan sponsors with a means to voluntarily correct a §412(i) plan's problems and protect its qualification status.

Supplemental Technical Comments

As noted above, ASPPA is submitting under separate cover additional comments focusing on the need for guidance on a variety of technical aspects of §412(i) rules and their interaction with other qualified plan rules. There are many technical issues that must be clarified if plan administrators are to be able to effectively and accurately administer §412(i) plans.

Sincerely,

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