Session 3: The Good, the Bad and the Benefits of Insurance and Annuities in Plans

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Agenda

- Pros & Cons: Insurance & Annuities
- Limitations: DC plans and DB Plans
- Compliance: Plan Provisions, Coverage, Discrimination
- Deductions, Funding, Administration
- FMV - Report product values accurately
- Distribution and Taxation
- 412(e)3 Parameters

Pros of Life Insurance

- Provides access to life insurance that might not otherwise be affordable
- May give access to guaranteed issue policies
- Pre-tax contributions can be used to purchase permanent insurance
- Premiums may be paid by employer contributions or from employee accounts
- Protects family in event of premature death
- Buy/Sell policy may be funded with deductible dollars
Cons of Life Insurance

- PS 58 Costs - the term insurance cost is taxable each year (Table 2001)
- Purchasing life insurance can reduce retirement fund balances as retirement
- Proceeds of insurance are included in participant's estate if they die with policy
  in the plan
- Plan administration may be more costly
- Basis must be tracked (PS 58 Costs)
- Plan freezes &/or benefit reductions would be problematic
- Is this a tax shelter within a tax shelter?

Pros of Annuities

- Provides guaranteed returns
- Ensures assets will be available for benefits at retirement
- Allows greater tax-deductible contributions
- Can stabilize contributions
- Provides guaranteed lifetime income if annuitized at retirement

Cons of Annuities

- Plan asset returns are limited to the policy rate of return
- Investment in stocks & bonds likely to provide greater long-term returns
- Significant surrender charges can apply in early years
- Distribution options may be limited
Limitations Defined Contribution Plans

- Insurance Premiums are charged to the Participant’s account
- Earmarked investment of the Participant
- Premiums are limited to % of employer contributions (includes EE deferrals):
  - 50% towards whole life
  - 25% towards term or universal life

IRS Revenue Rulings 54-51 & 74-307

Limitations Defined Contribution Plans

- No limitation on premium for employee after tax contributions or rollover accounts
- Seasoned Money – 2 Year Rule
- ESOPs – May not use proceeds from an exempt loan
  - Would require assets from exempt loan to be tracked separately

PLR 201043048 (provides rulings on certain policy riders)

Limitations Defined Benefit Plans

- Insurance premiums are paid with plan assets or directly by employer contributions
- Death Benefit must be incidental to retirement benefits
- Death benefit payable may not exceed either:
  - $100 x anticipated normal retirement monthly annuity, or
  - the face amount of the insurance policies plus the theoretical ILP reserve less the cash value of the insurance policies
Incidental Benefit Rules under Rev. Rul. 74-307

- **Face Amount:** Pre-retirement death benefits under a qualified plan are considered incidental if they don’t exceed 100 times the anticipated monthly normal retirement benefit.

- **Reserve Method:** the maximum amount of premium used to purchase life insurance may be no more than 2/3 of the theoretical individual level premium cost of the normal retirement benefit for whole life policies, or 1/3 for universal or term policies.

Plan Provisions

- The application of the seasoned money rules is only available if the plan document allows “in-service” distributions.
- The qualified plan document must have suitable language authorizing the use of contributions and fund balances (self-directed) for the payment of premiums.
- The qualified plan is both the owner and beneficiary of these life insurance policies.
- The policy cash value is an asset of the plan and is used to fund retirement benefits while the “pure” death benefit (face amount less the policy cash value) is typically designated for the EE’s (participant’s) beneficiaries.

Availability of Benefits, Rights and Features

Treas. Reg. §1.401(a)(4)-4 provides that BRFs include:
- Optional forms of benefits
- Ancillary benefits
- Other rights and features- including Right to a particular form of investment
Deduction & Funding

- DC Plans
  - No additional deduction

- DB Plans
  - Under PPA, insurance premium is an expense of the trust
  - No additional contribution in first year
  - Indirect increase in contributions in subsequent years

Administration

- Current value to be reported as part of assets
- Schedule A reporting if not owner only plan
- Taxable term cost and 1099R reporting
- Basis tracking
- Accounting in DC plans

- Insurance additions for DB plans with benefit changes
- Face amount reductions if benefit restrictions cause policy to exceed limitations
- Like policy life insurance for employees
- Insurance elections for terminated participants
- Policy surrenders
**Guidance Regarding Insurance**

- **Rev. Rul. 2004-20**: eliminates the current deduction for the premium attributable to insurance in excess of the participant’s death benefit under the plan.
- **Reg. 402(a) and Rev. Proc. 2004-16**: requires that the true FMV of the policy be included in income at the time the policy was sold or distributed to the participant.
- **Rev. Rul. 2004-21**: requires that all participants in the plan have identical types of insurance policies.

**Transfer of A Policy from a Qualified Plan to a Participant**

A policy must be valued at its “fair market value” when transferred from a Qualified Plan to a Participant under IRC Section 402(a) and IRS Treasury Regulation 1.402(a)-1(a).

**Fair Market Value**

**Rev. Proc. 2005-25:**

The fair market value for transfer from a qualified plan to a participant is the GREATER of:

1. the interpolated terminal reserve plus any unearned premium OR
2. the so-called PERC amount multiplied by the Average Surrender Charge Factor which can be no less than 70% (a 30% discount).
What is the PERC Amount?

The PERC amount is defined as:

Deductibility

If the plan uses deductible employer contributions to pay the insurance premiums, the participant will be taxed on the current insurance benefit. This taxable portion is referred to as the P.S. 58 cost. Insurance premiums paid by self-employed individuals are not deductible.

How Life Insurance Works in Qualified Plans

• Permanent life insurance purchased by the plan can be available to the EE after retirement.
• The EE's beneficiary receives the net death benefit (face amount less the policy cash values) income-tax-free if the EE dies while their insurance policy is still in the plan, and the EE pays income tax each year, for the economic benefit of life insurance provided in the plan.
Life Insurance at Retirement or Termination

- Incidental death benefit rules require that a life insurance policy cannot be held beyond retirement of the EE.
- Documents control the distribution options available to retirees.
- Since IRA’s can’t own life insurance contracts, rolling the participant’s qualified plan into an IRA holding life insurance is not an option.

Exit Options

1. Surrender the policy inside the plan: Cash values become part of the plan assets and are used to pay retirement benefits due. Cash Value can be rolled to an IRA.
2. EE purchases policy from the qualified plan for fair market value: The amount paid to the plan for the purchase of the policy is combined with the EE/insured’s investment account inside the plan.
3. Plan distributes the policy to EE in lieu of retirement benefits: This is called a partial distribution of plan assets. This is a taxable transaction, at ordinary income tax rates, and the ownership of the policy changes from the qualified plan to the EE/insured. There is a 20% mandatory withholding on the taxable benefit. Payment of the 20% withholding can be accomplished by a distribution from the policy or using other qualified plan proceeds.

Purchase Price for Policy: Fair Market Value

OR

The insured may choose to order a formal valuation by a recognized valuation expert specializing in insurance policy valuations.
Sale of life insurance or annuity contracts
PTE 92-6

- Permits, under certain conditions, the sale of life insurance or annuity contracts by a qualified plan to the plan participant, a relative of the participant, and to the employer/sponsor.
- On September 3, 2002, the DOL expanded PTE 92-6, permitting the sale of life insurance by a qualified retirement plan to a trust established by or for the benefit of the plan participant or his/her family members.

The conditions to be met under 92-6 are:
(i) the contract, but for the sale, would have been surrendered by the plan;
(ii) the plan receives no less than the policy’s cash value; and
(iii) the sale must not, in effect, discriminate in favor of participants who are officers, shareholders or highly compensated.

Purchase of life insurance or annuity contracts
PTE 92-5

- Individual life insurance or annuity contracts may be purchased by the plan from the participant or employer (PTE 92-5)
- The plan may purchase from the participant a life insurance policy or annuity contract issued on the participant’s life, or it may purchase policies from the employer that insure the employer’s employees who are covered by the plan
- The policies must be held by the plan for the benefit of the participants who are insured under the policies
412(e)3 Parameters

- Guaranteed benefits defined in plan document
- Fully insured by purchase of life and/or annuity contracts
- Can provide certainty in required contributions
- No actuarial certifications

412(e)3 Requires

(A) the plan is funded exclusively by the purchase of individual insurance contracts,
(B) such contracts provide for level annual premium payments to be paid extending not later than the retirement age for each individual participating in the plan, and commencing with the date the individual became a participant in the plan (or, in the case of an increase in benefits, commencing at the time such increase becomes effective),
(C) benefits provided by the plan are equal to the benefits provided under each contract at normal retirement age under the plan, and are guaranteed by an insurance carrier (licensed under the laws of a State to do business with the plan) to the extent premiums have been paid,
(D) 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,
(E) no rights under such contracts have been subject to a security interest at any time during the plan year, and
(F) no policy loans are outstanding at any time during the plan year.

412(e)3 Products

- Guaranteed annuity products (not variable)
- Whole life insurance policies
- No automatic premium loans
412(e)3 Advantages

• Transfers investment risk to the insurance company
• Higher deductible contributions allowed
• Funding remains consistent with benefits promised
• No full funding limitation
• No actuarial certifications required
• No quarterly contributions
• No variable rate PBGC premiums

412(e)3 Disadvantages

• No flexibility in contributions year to year
• Investment returns limited to guaranteed rates of product
• Must monitor 415 limits if lump sum desired rather than annuity
• Interest rates in today’s low rate environment
• No policy loans allowed

QUESTIONS?