Life Insurance in Retirement Plans

# A plan may purchase life insurance as a means of providing death benefits under the plan.

* In a defined contribution plan, the purchase of insurance is a charge against the account and held as an earmarked investment for the participant's benefit.
* In a defined benefit plan, the death benefit must be defined in the plan because the plan must provide for definitely determinable benefits. The death benefit can then be funded entirely or partially through life insurance.
* In February 2004 the IRS issued guidance to shut down abuses involving the use of certain specially designed life insurance policies in retirement plans. Generally, these special policies are made available only to highly-compensated employees. The special policies were often used in conjunction with 412(i) plans.
* Rev. Proc. 2005-25 provides guidance on how to determine the fair market value of a life insurance contract, retirement income contract, endowment contract, or other contract providing life insurance protection.

# Qualification Issues

* 1. Availability of benefits, rights, and features. Rev. Rul. 2004-21
		1. §401(a)(4) provides that, under a qualified retirement plan, contributions or benefits provided under the plan must not discriminate in favor of highly compensated employees.
		2. §410(b) provides minimum coverage requirements that are designed to ensure that a qualified plan provides sufficient benefits to a large enough proportion of participants who are non-highly compensated employees.
		3. §1.401(a)(4)-1(b)(3) provides that a plan satisfies the requirements of §401(a)(4) only if all benefits, rights and features provided under the plan are made available under the plan in a nondiscriminatory manner. This rule separately applies to each benefit, right or feature provided under the plan.
	2. Incidental Death Benefits – Life insurance purchased for a participant must be incidental to the primary purpose of providing retirement benefits. This is applicable regardless of whether the benefits are pre-retirement or post-retirement.
		1. Percent-of-contributions rule. This method is used to compare the cumulative premium cost with the aggregate employer contributions allocated to the participant. The insurance is incidental if the cumulative premium cost does not exceed 25% of the aggregate contributions. (Rev. Rul. 54-51, Rev. Rul. 57-213, Rev. Rul. 60-84, Rev. Rul. 61-164).
			1. Defined Contribution Plans - Most defined contribution plans will use this rule. Since the contributions are predominately employer, this method is the simplest for determining whether life insurance is incidental.
				1. In applying the 25% limit, the entire premium cost of term insurance plus one-half of the premium cost of whole life insurance it taken into account.
				2. Universal life insurance is treated as term insurance for purposes of this limitation.
				3. If the insurance is all whole life, the rule is satisfied if the total premium for the whole life is less than 50% of the aggregate contributions, employer and forfeitures.
				4. Employee contributions can also be used to purchase life insurance without this limitation of incidental benefit. NOTE: Elective deferrals are employer contributions.
			2. Defined Benefit Plans – Defined benefit plans are permitted to use this method of determining incidental benefits. Rev. Rul. 74-307, 1974-2 C.B. 126.
				1. The actuary calculates the equivalent contributions used to fund the participant’s benefit and compare those contributions to the premium costs of providing the life insurance benefit.
				2. This is a theoretical contribution. Premiums may not exceed 33% of the theoretical contribution if you’re using term or universal life insurance.
				3. For whole life insurance the threshold is 66%.
				4. The incidental death benefit requirement is satisfied by not having the death benefit exceed the incidental reserve.

*Theoretical contribution – The contribution that would be made on behalf of a participant, using the individual level premium (ILP) funding method from the age at which the participant commenced to normal retirement age, to fund the participant’s entire retirement benefit without regard to pre-retirement ancillary benefits. The entire retirement benefit for this purpose is based upon a straight life annuity and assume continuation of current salary (no salary scale).*

*Incidental reserve – The incidental reserve is:*

*The sum of:*

*The proceeds of insurance policies purchased on the participant’s life, and*

*The theoretical ILP reserve,*

*Minus the cash value of the policies purchased. Note that if the qualified pre-retirement survivor annuity (QPSA) is payable, the incidental reserve is further reduced, but not below zero, by the present value of the QPSA in accordance with the incidental benefit rule under Rev. Rul. 85-15.*

*Theoretical ILP reserve – The reserve that would be available at the time of death if for such year of plan participation, a contribution had been made on behalf of the participant equal to the theoretical contribution.*

* + 1. Pension plans – An alternative method for pension plans is to show life insurance benefits are incidental on a benefits basis.
			1. 100-times rule – Under this rule, life insurance benefits are incidental if the insurance benefit is no more than 100 times the anticipated monthly annuity benefit. Rev. Rul. 60-83, 1960-1 C.B. 157.
				1. If the pension plan is a money purchase or target benefit plan, the anticipated monthly annuity benefit is determined by projecting the accumulated account balance at normal retirement age based on the plan’s contribution formula.
				2. This rule is more often used by defined benefit plans because the benefit is already stated in the form of an annuity at normal retirement age.
			2. Auxiliary fund – A defined benefit plan may demonstrate that the life insurance benefits are incidental by defining the death benefit as the greater of:
				1. The insurance proceeds, or
				2. The sum of the reserve under the insurance contracts plus an auxiliary fund. Rev. Rul. 68-453, 1968-2 C.B. 163.
		2. Qualified Pre-retirement Survivor Annuity (QPSA) – If the QPSA is payable then the QPSA, plus any additional death benefits must satisfy this incidental benefit requirement. Rev. Rul. 85-15.
			1. Since the QPSA is always considered to be an incidental benefit.
			2. If the sum of the QPSA and additional death benefits would violate the incidental death benefit limit, then the Rev. Rul. 85-15 requires a reduction in the additional death benefits.
				1. Defined Contribution Plans – The total death benefit under a DC plan will never exceed the account balance.

Since the life insurance must be take into account to value the QPSA, the plan should have the life insurance proceeds paid to the participant’s account and have the plan disburse the death benefits. This will ensure that the proceeds are not paid entirely as part of the non-QPSA death benefit where a portion of the benefits may be needed to satisfy the QPSA liability to the surviving spouse.

Any life insurance benefits purchased on a participant’s life must also satisfy the incidental insurance limits.

* + - * 1. Defined Benefit Plans – An incidental benefit issue may arise depending on how a defined benefit plan defines the total death benefit. The QPSA benefit is always permissible under the incidental death benefit requirement if it is the sole death benefit. If it is the sole death benefit, then the incidental death benefit limit is deemed to be satisfied.

If there is any additional non-QPSA death benefit, the it must be structured in a way not exceed the incidental death benefit limit when the death benefit is added to the QPSA.

A DB plan may not offer both the QPSA benefit and a non-QPSA benefit that equals the maximum permissible incidental benefits. If the non-QPSA benefit equals the maximum permissible incidental benefit, the plan will need to provide that the value of that non-QPSA benefit is offset by the value of the QPSA benefit so the two together will meet the incidental death benefit limitation.

If life insurance benefits are purchased on a participant’s life, not only must the insurance satisfy one of the incidental benefit rules, but to the extent the QPSA is payable, the sum of the QPSA and the insurance benefits may not exceed the applicable incidental benefit rule.

If the plan is relying on the contribution method, the incidental reserve is reduced by the present value of the QPSA.

If the plan is relying on the 100-times rule, then any death benefit payable in addition to the QPSA must be reduced by the present value of the QPSA.

* + 1. QDRO – The IRS has not addressed how the incidental limits should be applied when a portion of a participant’s benefit is awarded to an alternate payee pursuant to a QDRO. The IRS has, however, taken the position that benefits paid to an alternate beneficiary are taken into consideration when determining whether the IRC §415 limits are exceeded, with respect to the participant. Following this line of reasoning, awarded benefits are part of the participant’s benefits for the incidental life insurance limits. The payment of a QDRO would impact the limit under the percent-of-contributions rule or the 100-times rule.
		2. Life Insurance can’t continue beyond retirement. Life insurance must be incidental to retirement benefits and converted to retirement income or distributed to the participant no later than the normal retirement date under the plan. Rev. Rul. 54-51, Rev. Rul. 57-213.
		3. Plan Qualification – Compliance with the incidental life insurance limits is a qualification issue because they are imposed under the IRC §401 regulations. Corrective steps should be taken to reduce the face amount of life insurance in order to maintain compliance with the incidental life insurance limits.
		4. Excess death benefits under fully-insured plan. Providing excess death benefits under a fully-insured plan does not cause the plan to fail to satisfy the incidental death benefit rules as long as the excess benefits are not payable under the terms of the plan to the participant’s beneficiary. The excess death benefits must be applied to the employer’s premium obligations for funding the benefits of other participants. Rev. Rul. 2004-20.
	1. Exception for Certain Profit Sharing Plans
		1. Seasoned contributions – The incidental life insurance benefit limits do not apply if life insurance premiums are paid with “seasoned contributions”. Rev. Rul. 71-295, 1971-2 C.B. 184, and Rev. Rul. 60-83, 1960-1 C.B. 157.
			1. Only profit sharing contributions are considered.
			2. Must have accumulated in the trust for at least two years.
	2. Employee contributions to purchase life insurance – The incidental life insurance limitation does not apply to insurance purchased with voluntary employee contributions. Rev. Rul. 69-408, 1969-2 C.B. 58.
		1. Employee contributions are not elective contributions and are made on an after-tax basis.
		2. Rollover contributions can be used to purchase life insurance without applying the incidental benefit limit.
	3. ESOPs
		1. An ESOP may not use proceeds from an exempt loan to purchase life insurance. Exempt loan proceeds must be used exclusively to:
			1. Acquire qualifying employer securities,
			2. To repay an exempt loan,
			3. To repay a prior exempt loan
		2. An ESOP may use ESOP assets that are not derived from an exempt loan to purchase life insurance as long as the plan otherwise satisfies its requirement to:
			1. Invest “primarily” in employer securities
			2. The incidental limits are not violated

# Pros of life insurance in a qualified plan.

1. Access to Insurance:
	1. Affordability – May not be able to afford to purchase with funds outside of the plan.
	2. Guaranteed-issue option for uninsurable participants
2. Tax-deductibility for premiums:
	1. Pretax dollars can be used to purchase permanent insurance.
	2. A portion of the company’s contribution can be applied toward the premiums.
		1. Only P.S. 58 cost (term insurance cost) is includable in the participant’s gross income.
	3. Once cash values become “meaningful”, usually after the expiration of the surrender change, the participant may want to get the contract out of the plan, so tax-deferred buildup continues outside the plan.

# Cons of life insurance in a qualified plan.

1. Tax shelter within a tax shelter – Cash value accumulations in a life insurance contract are tax-deferred so there is no additional tax benefit of the contact being in the plan.
2. P.S. 58 costs – The term insurance cost (P.S. 58) is includable in the employee’s taxable income.
3. Reduction of retirement assets – Investment returns of insurance contracts, and P.S. 58 costs, can result in lower account balances at retirement.
4. Administrative issues – Other than the complexities of maintaining compliance, commissions must be reported on Schedule A of IRS Form 5500.
5. Fiduciary issues – The DOL has questioned the prudence of investing a significant percentage of plan assets in whole life insurance contracts.
6. Estate planning issues – Proceeds on the life insurance will be includible in the participant’s gross estate if the participant dies while the insurance contracts are held in the plan.