

## A Guide to Life Insurance in Qualified Plans

Life insurance may be included in any qualified retirement plan (not SEPs or SIMPLEs). Including life insurance can make the plan self-completing in the event of pre-mature death and premiums are paid with tax-deductible plan contributions. Care must be taken to stay within prescribed incidental limits.

### Why Use Life Insurance in a Qualified Plan?

- Deductible employer contributions fund the life insurance premium. If the same life insurance premium were paid outside of the qualified plan it would be paid using after-tax dollars requiring more money to be earned to net the premium amount after taxes.
- At the time of death, the beneficiary will receive the current value in the plan account and the death benefit from the life insurance. The “pure death” benefit portion of the life insurance will be paid income-tax free.
- At retirement, the insurance policy can be transferred to the participant as part of their retirement distribution.
- If the participant’s life insurance need has changed at retirement, the life insurance policy can be surrendered inside of the plan and the policy cash value added to their fund account.
- Life insurance can be selected in lieu of another conservative trust asset. Life insurance cash value can produce a similar / guaranteed return. (Guarantees are based on the claims-paying ability of the issuing insurance company)
- Death benefits can self-complete the plan benefit for the insured participant.
- The small tax paid annually on the “economic benefit” provided by the policy in the plan may be recovered income tax-free at retirement.
- In defined contribution plans premiums do not increase the contribution.

#### Example: Defined Contribution Plan

*Business Owner, Age 58*

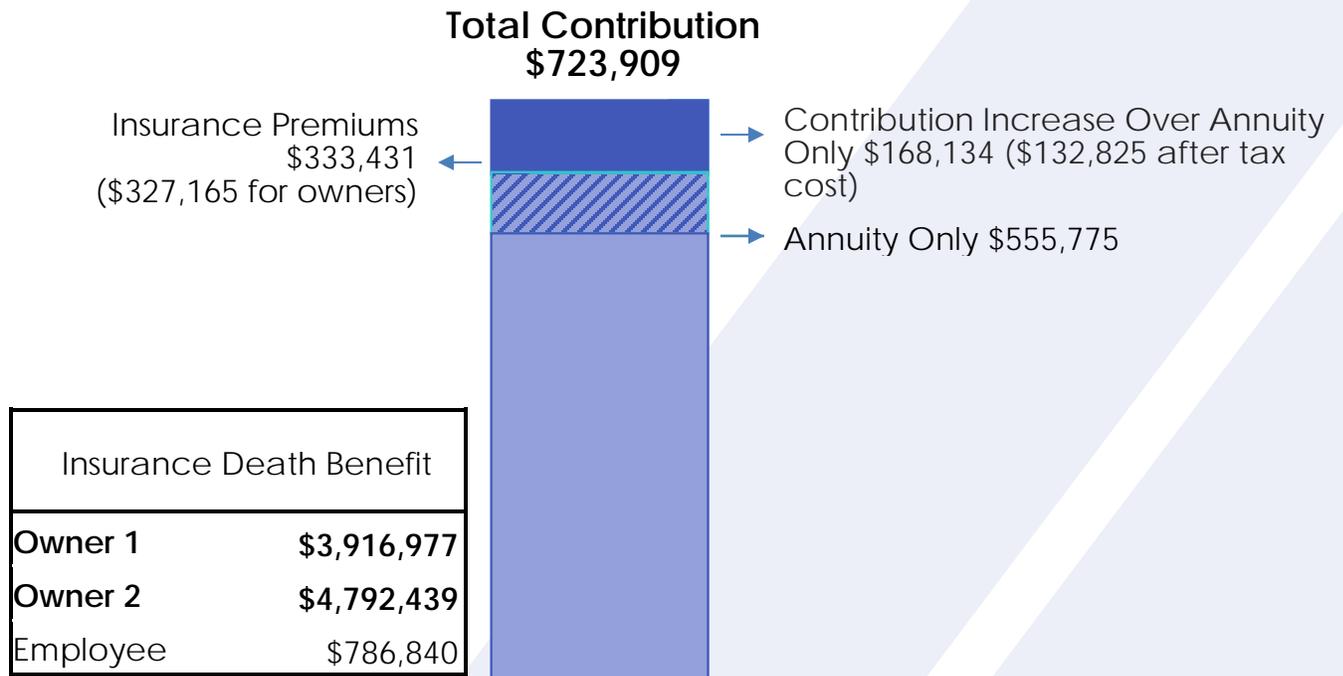
Life Insurance Face Amount	\$512,153
Life Insurance Premium	\$ 17,299
Taxable Income Needed to Pay Premium	\$ 26,211

Buying life within the qualified plan allows the difference that otherwise would have been lost to taxes to grow in the Plan \$8,912 (26,211 – 17,299).

- Life insurance in a defined benefit plan increases the deductible contributions.

Example: Defined Benefit Plan

	Age	Salary	Annual Contribution Without Life Insurance	Annual Contribution With Life Insurance	Insurance Death Benefit	Lump Sum at Retirement
<b>Owner 1</b>	61	\$280,000	\$279,000	\$378,181	\$3,916,977	\$1,327,021
<b>Owner 2</b>	57	\$280,000	\$266,330	\$335,872	\$4,792,439	\$2,084,396
Employee	27	\$45,000	\$10,445	\$9,856	\$786,840	\$521,099
<b>Total</b>			<b>\$555,775</b>	<b>\$723,909</b>		



The above summary is purely hypothetical and for illustrative purposes only. The example shown above does not reflect the results of any particular plan and your results will likely differ.

## Life Insurance Incidental Limits

A qualified retirement plan (other than a SEP, SAR-SEP, or SIMPLE-IRA) may purchase life insurance on the lives of the plan's participants. The plan must allow for the purchase of insurance and the life insurance benefit must be incidental to the main purpose of the plan, which is to provide for retirement benefits. There are several tests to utilize in making the determination that the life insurance is incidental.

## Defined Contribution Plans

- Percentage of the contributions. In this method the life insurance will be incidental if the total premium is less than 50% of the contribution when using whole life or does not exceed 25% of the contribution when using universal or variable universal life insurance. This test is a cumulative test, applied to cumulative contributions and premiums over the life of the plan.
- Rollover Contributions. If a participant has money that was from a may be used towards premiums.
- Employee voluntary, after-tax, non-Roth contributions may be used to purchase life insurance in excess of the incidental limits.
- ESOP's that are not funded with an exempt loan may purchase life insurance in excess of the incidental limits.

## Profit Sharing Plans Special Rules

- Exception to the percentage of contribution requirement is available in certain profit sharing plans. If a profit sharing plan has "seasoned money" it may allow for the use of 100% of the seasoned money to be used toward the life insurance premium. "Seasoned money" is money (contributions and earnings) that have been accumulated for at least two years.
- Years of Participation. Once someone has been a plan participant for more than 5 years, the incidental limitations no longer apply and all funds may be used to pay premiums.

## Defined Benefit Plans

Testing whether life insurance benefits are incidental can be done by one of two methods:

- Percentage of contributions. Revenue ruling 74-307 permits up to two-thirds of the theoretical contribution to be used for whole life insurance premiums, or one-third for universal life insurance premiums. An actuary will calculate the equivalent contributions used to fund the participant's benefit and compare those contributions to the premium.
- 100-Times Method. The life insurance benefit provided, without regard to premium, can not be more than 100 times the anticipated monthly annuity benefit.

## Policy Issue Requirements

- Life insurance in a defined contribution plan may be purchased at the option of each participant or purchased at the direction of the plan administrator
- Life insurance in a defined benefit plan must be provided in a non-discriminatory basis to all plan participants
- Life insurance policies must be unisex
- Life insurance in a qualified plan is issued with the plan trust as owner and beneficiary.

## Taxation of Life Insurance in a Qualified Plan

When life insurance is provided in a qualified plan there is a current taxable event to the participant known as the "economic benefit." This is usually the Table 2001 cost (previously known as the P.S.58 cost) or an alternative rate (insurer term rates applicable to all insureds) that is generally available. The theory of the income taxation of the "economic benefit" is that the participant is currently receiving a benefit (the life insurance protection) under the plan and a current benefit should be taxed as opposed to a future benefit which is deferred.

Example:

Using the Table 2001 term rate, a 50 year old would pay an economic benefit of \$3.91 per \$1,000 of coverage.

Plan death benefit	\$300,000
Cash value	\$100,000
Net insurance amount	\$200,000
Taxable economic benefit	\$782 (200 x \$3.91)
Tax paid by participant (40%)	\$312

**Income-Tax Free Death Benefit**

Should the insured die before retirement with the life insurance held in the plan, the beneficiary will receive the net death benefit as an income-tax free death benefit. The cash surrender value of the policy is taxed to the beneficiary in the same manner as any other distribution from the plan. The taxable term cost that has been paid may be applied as basis to the taxable amount.

**Distribution Choices**

Life insurance cannot continue after the normal retirement date or later if the participant decides to retire at a later date. Depending on the client's needs at the time there are five choices that he/she will have in deciding what to do with the life insurance.

## 1. Surrender the contract

The life insurance contract may be surrendered by the plan Trustee. In a defined contribution plan, the participant will now have the cash surrender value added to his/her other plan balance for distribution. In a defined benefit plan, the cash value will be integrated with other plan assets. There is no longer a death benefit.

The participant can now:

- Take the lump-sum distribution and pay tax on the entire amount;\*
- Directly transfer the full amount into an IRA;
- Take the lump sum minus the withholding and within 60 days transfer the full amount into an IRA;
- Leave the amount in the plan and take periodic distributions; or
- Annuitize.

## 2. Distribute the contract from the plan in-kind if the plan allows for this. The life insurance contract may be distributed intact, to the participant. This

would be accomplished by the Trustee changing ownership of the life insurance contract from the Trust to the individual. Spousal consent must be attained prior to the distribution. The individual now has a life insurance contract that they own. With this option, there is a taxable event to the individual. He/she will be taxed on the fair market value of the contract. There is no option to defer the tax on the life insurance contract; it may not be transferred to an IRA for further tax-deferral.

Example:

Policy Death Benefit	\$300,000
Cash Value	\$100,000
Basis (accumulated taxable term costs)	\$ 8,000
Taxable Distribution Value*	\$ 92,000
Personal Income Tax (40%)	\$ 36,800

The above example is purely hypothetical and for illustrative purposes only. Your client's results likely will differ.

3. Distribute the contract from the plan in-kind and convert if the life insurance contract is distributed from the plan and within 60 days is irrevocably exchanged to a non-transferable annuity contract where no life insurance proceeds are distributable after death, there would be no taxation on the cash value. This rule also applies to any portion exchanged.
4. Purchase the contract from the plan. The plan may sell the contract to the participant, if the insurance contract, but for the sale, would be surrendered by the plan. The sale may also be made to a relative of the insured or to a trust or family partnership. The amount paid to the plan for the contract must be equal to the amount necessary to equal the fair market value of the property, the contract. If the contract is purchased for its fair market value, there will be no tax owed on the transfer. If it is determined that the life insurance contract was purchased at a bargain price, the difference will be treated as a distribution subject to taxation. The cash the participant paid for the policy is now part of their retirement benefit in a defined contribution plan and can be distributed or rolled to an IRA along with the rest of their plan benefit. In a defined benefit plan, the participant will receive cash in place of the policy if a lump sum is distributed.

5. Exchange when offered by insurer. If there is still a need for life insurance protection, the exchange may be used. An exchange privilege generally allows the Trustee to surrender the life insurance contract and provide the participant with the availability to maintain life insurance coverage for the net amount at risk outside the plan (face value – cash value) without having to purchase it from the plan. The new policy is issued at current age but with no additional medical underwriting.

### **Fair Market Value (FMV)**

Whenever a life insurance policy is distributed or sold from a qualified plan its value must be determined. Prior to February 13, 2004, the "value" of a life insurance policy was either the policy's cash surrender value or in certain cases the policy reserves. However, the IRS grew concerned with the use of what were commonly referred to as "springing cash value" policies which were distributed with very low cash values that would later jump to a much greater amount, thus avoiding taxes at the time of distribution. As a result, after February 12, 2004, the value used for the policy is the "fair market value" which is the policy cash value and all other rights under such contract. Rev. Proc. 2005-25, 2205-17 I.R.B. 962, provides a safe harbor formula for valuing a life insurance policy. The safe harbor value for a policy is "the greater of A or B." "A" is the sum of the interpolated terminal reserve (a number which must be obtained from the insurance company) and any unearned premiums, plus a pro rata portion of a reasonable estimate of dividends expected to be paid for that policy year based on company experience. "B" differs depending on the type of policy; it is a formula which can be summarized as "PERC" (Premiums + Earnings - Reasonable Charges) times a certain permitted factor for surrender charges.

The formulas basically disallow excessive, waivable, or "disappearing" surrender charges as an offset against value. The "greater of A or B" formula determines the fair market value of the policy.

The formula provided by Rev. Proc. 2005-25 is a safe harbor but is not required to be used. Taxpayers may choose to determine fair market value by another method such as getting an appraisal of the policy from an independent company that is in the business of evaluating insurance policies.