



ADVANCED SALES COMMENT

Life Insurance in Qualified Plans

Qualified retirement plans can satisfy many different needs of the business, business owner, and employees. One advantage that a qualified plan may offer is the opportunity to purchase life insurance on the participants in the plan. Adding life insurance may enhance a retirement plan by providing a pre-retirement death benefit in addition to assets that will provide a retirement benefit. The life insurance death benefit can provide the insured's beneficiary with income replacement in the event of an untimely, premature death.

Why add life insurance to a qualified plan? There are many factors to consider when adding life insurance as part of the qualified plan's overall investment strategy.

Due to the complexity involved in this process, producers need to be conversant with the appropriate tax regulations that apply to these transactions. Participants should consult with their tax advisor about the tax consequences associated with the purchase of life insurance in a qualified plan and to determine the proper methodology to use in executing such a plan.

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Increased Death Benefits

Without life insurance, the retirement plan's benefits are usually based on the value of the investments that have built up under the plan. But these amounts may be modest, especially in the early years of plan participation. Depending upon the plan design, adding life insurance can increase the participant's account balance and provide distributions from the retirement plan at death that exceed the participant's account balance. However, death benefits will be included in the estate of the participant. If a permanent policy is transferred to a trust or other alternate ownership arrangements the death benefit proceeds may be kept out of the taxable estate.

Contributions Used to Pay Premiums are Tax Deductible to the Business

Employer contributions to a qualified plan are deductible to the business. This allows the business to accumulate wealth for the participants' retirement, using tax-deferred dollars.

When life insurance is purchased as part of the overall investment strategy, premiums paid by the business as part of its plan contribution are generally tax deductible by the business, subject to some limitations on the amount of insurance the plan can own.

Limits on Amount of Life Insurance

Life insurance is permitted in qualified plans if the provision of a death benefit is "incidental" to the primary purpose of the plan, which is to provide retirement benefits to employees and their beneficiaries. To that end, the IRS has established incidental death benefit limits that dictate the maximum amount of life insurance available under a qualified pension or profit-sharing plan.

- **Defined Benefit Plans**

In general, the maximum face amount of the insurance may be as great as 100 times the projected monthly retirement benefit. This rule applies regardless of the premium amount or type of insurance product (whole life, UL, VL, etc.). Usually, defined benefit plans express the death benefit in terms of a multiple of the monthly pension benefit (25 times, 50 times, and so on, up to the 100 times maximum).

Over the years, practitioners have used an alternative rule in lieu of the standard 100x rule (stated previously), based upon an interpretation of IRS Revenue Ruling 74-307. This ruling allows for life insurance amounts that, based on an actuarial calculation, may exceed the standard 100 times maximum limitation.

- **Defined Contribution Plans**

In a defined contribution plan, the incidental death benefit limit is based on the premium paid, not on the policy face amount. Up to 50% of the aggregate contributions for each participant may be used as premium to purchase life insurance, provided the product is whole life. For all other products, including universal life, variable life, variable universal life, or term, no more than 25% of the aggregate contributions may be used to purchase insurance.

- **Seasoned Money Rule**

In a series of Revenue Rulings, the IRS has stated that a profit-sharing plan may permit life insurance premiums to be paid with in-service distributions of funds that have been in the plan for at least two years, or all funds if the participant has participated in the plan for at least five years. In a profit-sharing plan permitting such in-service distributions, participants may pay premiums using this “seasoned money” without regard to the incidental death benefit limit. The plan document must permit in-service withdrawals.

Note: The seasoned money rule does not apply to 401(k) salary deferrals or employer qualified matching contributions. Only employer profit-sharing contributions can qualify as seasoned money.

- **Rollover Money**

Additional pre-tax premium dollars may be available to a profit-sharing plan if rollover money exists in the plan (rollovers from another qualified plan or IRA). These rollover dollars are not subject to the IRS incidental limits discussed previously. Therefore, these dollars can be used to pay premiums without being subject to the limits discussed previously. It is very important that this is discussed with the Third-Party Plan Administrator (TPA) to ensure the plan document has appropriate language to allow this.

Life insurance limits are based on the type of qualified plan. The test is a cumulative test, based on all contributions and all premiums over the life of the plan. It is critical to work with a TPA who is familiar with life insurance as a component of qualified plans to ensure compliance with all IRS requirements. See general parameters below:

Type of Plan	Life Insurance Limits	Seasoned and Rollover Money for Premium
Profit-Sharing	50% of employer contributions for whole life 25% of employer contributions for all other types of insurance	100% of seasoned money (profit-sharing contributions after two years. All profit-sharing amounts after five years of participation) 100% of eligible rollover money from another qualified plan or IRA
Defined Benefit (Traditional, Cash Balance, and 412(e)(3))	100 times the projected monthly retirement benefit or 50% of the contribution based on calculations of a pension actuary	Not applicable
Combination Cross-Tested Plans (e.g., Cash Balance Defined Benefit, and Profit-Sharing)	Actuary will calculate the amount of insurance available for each participant (may not be the limits noted above)	Check with TPA
SIMPLE IRA, SEP IRA, and 403(b) Plans	Life insurance is not allowed	Not applicable

Participants Pay Tax on Economic Benefit of Life Insurance

Life insurance provided in a qualified plan creates a current taxable event to the participant, known as the “economic benefit.” Plan participants report income on the economic value of the death benefit provided. The IRS sets out the current guidance on measuring the economic benefit of the death benefit protection provided by a qualified plan. Generally, IRS Table 2001 is used. If the issuing company has qualifying non-convertible term rates, they can be used. Since the participant pays tax annually on the death benefit coverage, their beneficiaries will be able to receive the net death benefit income tax free.

Protection Available Beyond Retirement

The need for life insurance often continues beyond retirement. In fact, that’s when insurance protection may be needed most. After retirement, the plan can no longer own the policy. The plan document will specify what distribution options are available to retirees. If they want to continue the policy outside of the existing qualified plan there are some options:

- **Roll over the policy to another qualified plan.** If a plan participant is eligible to participate in a new qualified plan and it will accept both rollover plan assets and the life insurance policy, this may be an attractive option. This option is dependent on the new plan accepting life insurance rollovers. This is a non-taxable event since there is not an actual distribution to the participant.
- **Sell the policy to the participant for its fair market value.** The amount paid to the plan for the purchase of the policy is combined with the other investments under the plan and distributed according to the plan document. If this is a defined benefit plan, work closely with the TPA to determine what (if any) are the ramifications of adding the policy’s fair market value money to the plan. The TPA will identify if the participant will be able to recoup those dollars deposited in the plan and avoid tax consequences to the employer. The policy will be individually owned going forward, and nothing is taxable to the plan or the individual since the fair market value of the policy remains in the qualified plan.
- **Plan distributes the policy to the participant.** The policy is distributed directly to the participant, which is a taxable event to the participant. A 20% withholding tax and, if under 59½, a 10% premature distribution penalty may apply. A common practice to reduce the taxable amount distributed is for the trustee to first take a policy loan — ideally, leaving only the amount equal to the participant’s policy cost basis (the taxable economic benefit). The loan dollars will remain in the plan with the other plan assets. The loan in effect may reduce the taxable portion in the policy when distributed to the participant. Loan interest will continue to accrue on the policy while it is outside of the plan and owned by the individual. The individual will either pay loan interest or can pay off the loan.

Beneficiaries May Receive the Money Income Tax Free

When life insurance benefits are paid to the beneficiary, the pure life insurance protection of the policy (the death benefit minus the cash value) is generally free of federal income tax. Distribution of non-insurance protection portions of a qualified plan are generally subject to income tax. As a result, a qualified retirement plan with an insurance component can provide a significant death benefit, often without an increase in income taxes.

Note: The entire value of the policy death benefit will be included in the participant's taxable estate.

Plan Document Requirements When Life Insurance is in a Qualified Plan

Proper plan documentation is critical to the successful ownership of any life insurance by the plan. The qualified plan document must have suitable language authorizing the use of contributions and fund balances for the payment of premiums and appropriate distribution of death benefits. Depending on the plan provisions, many types of insurance can be purchased in a qualified plan (whole life, universal, or variable life, and under certain circumstances survivorship life in a profit-sharing plan).

Plan Administrator is Needed

Qualified plans are an attractive tool for business owners and provide a valuable benefit to the employees. There are many requirements, plan documents, and IRS filings, and overall day-to-day administration is required. It is recommended that a professional third-party plan administrator be hired to do all of this. Although there is a cost to this service, it is important to ensure the qualified plan stays in compliance and retains its tax qualified status.

If there will be life insurance in the plan, it is very important to work with a TPA who is familiar with life insurance as a component of qualified plans to ensure compliance with IRS requirements.

Bottom Line

Life insurance in a qualified plan may meet a variety of needs. However, it may not be an investment option for all business owners. Discussing the factors highlighted in this article with your business owner clients may help them decide if adding life insurance in their qualified plan would help meet their personal and business goals.

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