Life insurance in a qualified retirement plan

In brief

INTRODUCTION

Note

Northwestern Mutual no longer sells its permanent life insurance policies to qualified retirement plans.

Can the plan buy life insurance?

- A qualified plan can only buy life insurance if the plan document allows for the purchase. If the plan does not permit the purchase of insurance, the plan generally can be amended to allow it.
- An individual retirement account ("IRA") cannot own life insurance. Internal Revenue Code (I.R.C.) § 408(a)(3).

Providing life insurance protection to beneficiary vs. providing "key person protection" to entire plan

- Life insurance owned by a qualified plan is typically structured so that the plan participant (hereinafter "employee") has the right to name a beneficiary to receive a portion of the death proceeds income tax-free.
- By contrast, a qualified plan may purchase the policy as "key person" protection, where the plan is applicant, owner, and beneficiary of the policy. With a key person policy, the proceeds are payable to the plan to provide benefits that are allocated among all plan participants.

Advantages of life insurance in a qualified plan

- The employer may deduct contributions to a qualified plan. If the qualified plan owns life insurance, this would be an indirect way to deduct the premiums.
- When the employee names a beneficiary for the policy's death proceeds (as opposed to when the policy is used as "key person" coverage), the tax results are similar to those of an endorsement split dollar plan where the endorsed amount is the policy's death benefit exceeding cash value. I.R.C. § 72(m)(3)(B); Treasury Regulation (Treas. Reg.) § 1.72-16(b).
  - The employee is income taxed only on the "cost of insurance" relating to the portion of the policy's death benefit that exceeds its cash value.
  - The beneficiary receives income tax-free the portion of the death benefit that exceeds the cash value.

- Unlike with normal split dollar plans, however, the cumulative cost of insurance that has been included in the employee's income effectively adds to basis. This means that:
  - If the policy is distributed from the plan before death, the employee is taxed on the policy's fair market value, minus the cumulative cost of insurance; and
  - If the beneficiary receives the policy's death proceeds, the taxable amount is the portion that equals the policy's cash value, minus the cumulative cost of insurance.
  - Note: The tax results are different for owner-employee/self-employed taxpayers.

Disadvantages of life insurance in a qualified plan

- The policy must be converted to cash or distributed to the participant at or before retirement (this rule does not apply to key person policies).
- The life insurance proceeds increase the value of the employee's gross estate.
- Life insurance in a qualified plan increases the cost and complexity of plan administration.

LIMITS ON LIFE INSURANCE IN A QUALIFIED PLAN

The primary purpose of a qualified plan is to provide retirement benefits, and any life insurance provided is meant to be incidental to that primary purpose. Treas. Reg. § 1.401-1(b)(1)(i) and (ii). Correspondingly, there are various "incidental death benefit rules" that apply when life insurance is owned in a qualified plan. See Revenue Ruling (Rev. Rul.) 54-51; Rev. Rul. 57-213; Rev. Rul. 66-143; Rev. Rul. 68-24; Rev. Rul. 68-31; and Field Service Advice 1999-633. These rules are generally described below.

Premium limits with defined contribution plans

- For term and universal life insurance, the aggregated total premiums paid must be 25% or less of the plan's aggregated contributions and forfeitures.
- For whole life insurance, the aggregated total premiums paid must be less than 50% of the plan's aggregated contributions and forfeitures.

Death proceeds limit with defined benefit plans

- For term, universal, and whole life insurance, the amount of insurance coverage generally cannot exceed 100 times the employee's estimated monthly normal retirement benefit.

The above limits do not apply in certain situations

- These limits do not apply to premiums paid with voluntary after-tax employee contributions.
- These limits do not apply to key person policies.
- For profit-sharing plans, there are no limits where employer contributions have accumulated for at least two years in the plan or where an employee has participated in the plan for at least five years ("seasoned money").

Policy must be surrendered or distributed from qualified plan upon retirement

- Life insurance policy generally must be converted to cash or distributed from the plan at the time of the insured employee's retirement.

TAX CONSEQUENCES TO NON-OWNER EMPLOYEES

The federal tax consequences can differ for non-owner employees vs. owner-employees or the self-employed. Below, the effects on non-owner employees are described first.

Taxation during insured's life while policy is in a qualified plan

- If the plan purchases the policy as key person protection, the plan is applicant, owner, and beneficiary of the policy. This arrangement creates no tax consequences for the employee while the policy is in the plan.
- If the plan instead provides life insurance coverage to the employee:
  - The employee is income taxed each year on the cost of insurance relating to the portion of the policy's death benefit exceeding its cash value.
  - As with endorsement split dollar plans, the cost of insurance is generally determined by using either (i) the government-issued Table 2001 or (ii) the insurer's lower published term rates that are available to all standard risks and are also regularly sold through normal distribution channels. See Notice 2002-8, Notice 2002-59, Revenue Ruling 2003-105, and Treas. Reg. §1.61-22(d)(5).

Taxation if employee dies while policy is in a qualified plan

- If the insured employee dies while the policy is in the plan, the employee's beneficiary generally receives income tax-free from the following portions of the death benefit: the amount exceeding the cash value just before death, and the cumulative cost of insurance (one-year term rates) that the employee had included in income while alive. Treas. Reg. § 1.72-16(b).
- This income tax-free treatment is enjoyed by the beneficiary only if the employee had included in income (or paid for) the cost of insurance relating to the death benefit exceeding cash value, and the policy's entire proceeds – including the taxable portion – is distributed from the plan directly or indirectly.
- Mechanically, the policy's death benefit is often first paid to the qualified plan itself, which then distributes two separate amounts to the beneficiary:
  - The income tax-free portion, equal to the death benefit exceeding the cash value, plus the cumulative cost of insurance, and
  - The income taxable portion, equal to the policy's cash value, minus the cumulative cost of insurance. The beneficiary might roll this tax-free to an inherited IRA via a direct rollover.
- If the employee does not include the cost of insurance in income, then the proceeds are taxable as ordinary income to the beneficiary. This is the same result that would happen if the plan purchased the policy as key person protection, where the death proceeds would be paid to the plan, but then would be subject to normal qualified plan distribution rules when paid to the beneficiary.
- For estate tax purposes, the death proceeds are included in the insured's estate under "incident of ownership" principles. I.R.C. § 2042.

Taxation when policy is distributed to employee

- If a life insurance policy is distributed from the plan while the insured employee is alive, the employee is income taxed on the fair market value of the policy, less the cumulative cost of insurance previously taxed to the employee (and less amounts paid, if any, by the employee to the plan).

- The policy's fair market value is equal to its cash value *plus* all other contract rights, including any supplemental agreements and whether or not guaranteed. Treas. Reg. § 1.402(a)-1(a)(1)(iii). Revenue Procedure 2005-25 provides a safe harbor for valuing policies, where the employee includes in income the larger of:
  - PERC (Premiums plus Earning, minus Reasonable Charges), or
  - ITR (Interpolated Terminal Reserve plus unearned premiums plus expected dividends).
- An employee who is under age 59½ is generally also subject to the 10% penalty tax on any taxable distribution, unless some other exception applies.
- The policy cannot be transferred in-kind from the plan to a Traditional IRA or a Roth IRA (often called a direct rollover) because IRAs cannot own life insurance.
- Upon taking ownership of the policy, the employee's basis in the policy will generally equal its gross fair market value (that is, the net value of the policy that is taxed to the employee, plus any loan on the policy, plus any amount the employee paid to buy the policy from the plan).
  - As such, the employee's actual basis almost certainly will not equal the insurance company's records for the policy's "basis," which will generally simply equal the cumulative premiums paid into the policy.
  - This could easily mean that, if the employee/policyowner later surrenders the policy, any Form 1099-R issued by the insurance company would show more taxable income than the employee/policyowner genuinely has, but it is up to the employee/policyowner to keep good tax records with their accountant.

TAX CONSEQUENCES TO OWNER-EMPLOYEES OR SELF-EMPLOYED

- When a life insurance policy is in a qualified plan for an "owner-employee" or "self-employed" person, the federal tax consequences differ slightly from what is described above.
- For this purpose, the relevant Internal Revenue Code and Treasury Regulation sections use the terms "owner-employee" and "self-employed" somewhat interchangeably and imprecisely, but ultimately it seems to refer to partners in a partnership or a sole proprietor (or owner of LLC taxed as either), but not to an owner of a corporation. See I.R.C. §§ 401(c)(3), 404(e), 1402(a), and Treas. Reg. § 1.72-17.
- In such situations, the amount that equals the cost of insurance relating to the death benefit exceeding the policy's cash value is treated differently in three ways:
  - The cost of insurance amount is not deductible when contributed to the qualified plan;
  - The owner-employee does not have to include the cost of insurance amount in income; and
  - When the policy or death benefit is distributed to the owner-employee or to the beneficiary, there is no "basis credit" for cumulative cost of insurance, so it does not reduce the income taxable amount.

TECHNIQUES TO REDUCE INCOME TAX WHEN PLAN TRANSFERS POLICY

Buy the policy rather than have it distributed

To avoid a large income tax hit when the policy is distributed, and a potential 10% penalty, the employee might *buy* the policy from the plan.

- The employee's purchase of the policy from the plan normally would be a prohibited transaction under ERISA and income tax rules, but the sale is permitted as long as the employee pays an amount that puts the plan in at least the same cash position it would have been in if it had simply surrendered the contract. There are other requirements as well, including that the parties generally must assert that, but for the sale, the policy would have been surrendered by the plan. See Department of Labor Prohibited Transactions Exemption (PTE) 77-8, amended by and re-designated as PTE 92-6, as modified by ERISA Opinion Letters 98-07A and 2006-03A.
- If the employee buys the policy by paying the qualified plan merely the cash value of the policy, that might satisfy the Department of Labor requirement that the plan end up in at least the same cash position it would have been if it had surrendered the policy, but that amount might be lower than the policy's fair market value under Treasury Regulation § 1.402(a)-1(a)(1)(iii) and Revenue Procedure 2005-25. If so, paying merely cash value could mean the employee is income taxed to the extent the policy's fair market value exceeds cash value. It is unclear how to best resolve this "inequality," but it might be wise to pay the higher fair market value amount. This avoids income tax to the employee, and would still provide the plan "at least" the same amount of cash it would have received upon surrendering the contract, so it seems to still satisfy the requirements of PTE 92-6.
- To avoid the estate tax 3-year-look-back rule of I.R.C §§ 2035 and 2042, the employee could first give money to an irrevocable trust, which could then buy the policy directly from the plan. This would be a transfer-for-value that could render the death benefit income taxable under I.R.C. § 101, but it would meet the "to the insured" exception if the trust were a "grantor trust" with respect to the insured. See Rev. Rul. 2007-13.

Have the plan first borrow from the policy, then transfer it out of the plan

- If a loan exists on the policy when it is transferred from the plan:
  - The loan on the policy reduces its value by the amount of the loan; and
  - The employee is deemed to be paying the qualified plan the amount of the loan.
- The reduced value of a policy due to having a loan lowers any income tax hit upon distribution, or permits the employee to pay a lower amount if buying the policy from the plan.
- Presumably, the qualified plan can take the cash it recently borrowed from the policy and roll it over tax-free to an IRA. The IRA can distribute the cash to the employee little-by-little in multiple future years. This spreads the employee's income tax over many years, and the employee can use the cash received to repay the policy loan.
- The technique of the plan borrowing from the policy just before distributing it seems to have been approved by Private Letter Ruling PLR 7727003 (April 6, 1977), but it did not rule on whether it might constitute a "prohibited transaction" under I.R.C. § 4975. A more likely danger (although not necessarily probable) is that the plan's act of borrowing from the policy might constitute a form of unrelated business taxable income known as "debt-financed income." See I.R.C. §§ 514 and 516. It is not easy to see how the plan would be generating income from first borrowing from the policy – it will remain in the same cash position – but tax advisors should first review this topic before the plan borrows from any policy in any event.

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