Advanced Sales

White Paper: Using Life Insurance as an Asset in Qualified Retirement Plans

January, 2012

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Employees and business owners alike face the challenge of accumulating sufficient assets to provide for their needs in retirement. They often turn to qualified retirement plans (or **"Qualified Plans"**[1]) as a tax efficient means of providing retirement benefits. But employees and business owners face another problem: What happens to their families if they die before reaching retirement age? Death benefit coverage provides for family members what retirement savings give to employees and owners. And so employees and business owners often ask: Would it be more efficient to provide death benefit protection using the same dollars being used to provide retirement benefits? If so, can money which is contributed to Qualified Plans be used to purchase life insurance?

Qualified pensions and profit-sharing plans were created by Congress to help employees accumulate assets for retirement and provide certain tax advantages for contributions made by employers. Qualified Plans are subject to significant rules and regulations under the Internal Revenue Code (**"IRC"**) as well as to all of the complexities of the Employee Retirement Income Security Act of 1974 (**"ERISA"**).[2] For example, Qualified Plans are subject to reporting and disclosure requirements,[3] vesting and participation requirements,[4] funding requirements,[5] fiduciary responsibilities,[6] and administration and enforcement requirements.[7] Thus, when considering what investments to use in a Qualified Plan, employers and plan participants should seek advice from tax or legal counsel, or seek the services of a third-party administrator (**"TPA"**).

Those considering the purchase of life insurance within a Qualified Plan must understand the *"incidental benefit"* limitations for various types of plan designs, ERISA and labor law limitations for purchasing life insurance in Qualified Plans, the tax treatment of life insurance protection while participating in a plan, the tax treatment of death benefits when paid out, and the options for continuing life insurance coverage at retirement.

[1] For purposes of this white paper, the term "Qualified Plans" shall be used to refer to qualified pension and profit-sharing plans created under IRC § 401.
[2] See, IRC §§ 401-409, and 29 USC 1001-1461.
[3] 29 USC 1021, et seq.
[4] 29 USC 1051, et seq.
[5] 29 USC 1081, et seq.
[6] 29 USC 1101, et seq.
[7] 29 USC 1131, et seq.

Purchasing Life Insurance in Qualified Plans – The "Incidental Benefit" Limitation

There are no limitations within the Internal Revenue Code on the types of assets that may be purchased by Qualified Plans to fund plan benefits,

> *No specific limitations are provided in section 401(a) with respect to investments which may be made by the trustees of a trust qualifying under section 401(a). Generally, the contributions may be used by the trustees to purchase any investments permitted by the trust agreement to the extent allowed by local law.*[8]

There are, however, limitations on the types of benefits which may be included in a Qualified Plan. It is the limitation on benefits which restricts the amount of life insurance that can be held within a Qualified Plan.

Qualified pension and profit-sharing plans are meant primarily to be a source of retirement benefits. Therefore any benefit provided by a Qualified Plan which is not a retirement benefit should be limited in scope; in other words such benefits should be "incidental."

> *A pension plan within the meaning of section 401(a) is a plan established and maintained by an employer primarily to provide systematically for the payment of definitely determinable benefits to his employees over a period of years, usually for life, after retirement. … A pension plan may provide for the payment of a pension due to disability and may also provide for the payment of* ***incidental death benefits*** *through insurance or otherwise.*[9]

This restriction is commonly referred to as the *"incidental benefits"* rule and the various standards which the IRS has developed to measure such benefits may be referred to as *incidental benefits tests*.

Determining whether a particular level of death benefits is incidental – and choosing which incidental benefits test to apply – depends upon the type of plan under consideration. Qualified Plans are categorized either as defined contribution plans or defined benefit plans, based upon whether the plan specifies an employer contribution rate or guarantees a specified benefit level. The IRS has developed different standards for applying the incidental benefits rule to defined contribution and defined benefit plans.

[8] Treas. Reg. § 1.401-1(b)(5)(i). But see ERISA and Labor Law considerations in purchasing life insurance in a Qualified plan below.
[9] Treas. Reg. § 1.401-1(b)(1)(i) (emphasis added).

Incidental Benefits for Defined Contribution Plans

Defined contribution plans provide benefits based upon the establishment of individual accounts for participants which are funded by pre-tax contributions from either employers, participants, or both depending upon the specific plan. Because the actual benefit from defined contribution plans is indeterminate, the test used to resolve whether death benefits are incidental is based on the percentage of plan *contributions* which are used to purchase life insurance. This is known as the *percentage limitations* test.

Under the percentage limitations test, death benefits provided under a defined contribution plan will be considered incidental so long as:

(1) Where the death benefits are funded with whole life insurance, the premiums paid are less than 50% of the contributions to the plan for each participant;[10]

(2) Where the death benefits are funded using other types of life insurance (such as term insurance or universal life insurance), the premiums paid are less than 25% of the contributions to the plan for each participant;[11]

(3) Where the death benefits are funded using both whole life insurance and other types of insurance, the sum of one-half of the premiums paid for whole life insurance plus the full amount of premiums paid for other types of life insurance is less than 25% of the contributions to the plan for each participant;[12] and

(4) The plan requires the trustee to convert the entire value of all life insurance contracts into cash or periodic income at or before each participant's retirement and/or to sell or distribute each life insurance contract to the insured participant at or before retirement.[13]

The IRS first issued guidance on the incidental benefits rule in 1954.[14] Taxpayers had asked the IRS for advice concerning the purchase of life insurance within a profit-sharing plan. According to the representations made by the taxpayer, "less than one-half of each amount annually allocated to each respective insurable participant's account [was] 'invested' in an ordinary life insurance contract on his life."[15] Additionally, the trustee under the plan was required to convert the life insurance policy to an "insurance income contract" one year prior to a participant's normal retirement date.[16]

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[10] Rev. Rul. 54-51 (1954-1 C.B. 147).
[11] Rev. Rul. 70-611 (1970-2 C.B. 89), Rev. Rul. 61-164 (1961-2 C.B. 99), and Rev. Rul. 66-143 (1966-1 C.B. 79).
[12] Rev. Rul. 61-164 (1961-2 C.B. 99).
[13] Rev. Rul. 74-307 (1974-2 C.B. 126) and Rev. Rul. 54-51, (1954-1 C.B. 147).
[14] Rev. Rul. 54-51 (1954-1 C.B. 147).
[15] Rev. Rul. 54-51 (1954-1 C.B. 147).
[16] Rev. Rul. 54-51 (1954-1 C.B. 147).

The IRS ruled that the purchase of ordinary life insurance within a profit-sharing plan would be considered incidental "where (1) the aggregate premiums for the life insurance in the case of each participant were less than one-half of the aggregate of the contributions allocated to him at any particular time; and (2) the plan shall require the trustee to convert the entire value of the life insurance contract at or before retirement to provide periodic income so that no portion of such value may be used to continue life insurance protection beyond retirement."[17]

The IRS has explained its reasoning from Rev. Rul. 54-51 by indicating that it considers a non-retirement benefit to be incidental to a Qualified Plan if the cost of the benefit is less than 25% of the total cost of the benefits provided by the plan.[18] The use of 50% of plan contributions to purchase ordinary (or whole life) life insurance contracts was considered incidental in Rev. Rul. 54-51 because the IRS deemed that "approximately one-half of the premiums paid for such policies are for pure insurance protection."[19] Consequently, under the percentage limitations test, the purchase of life insurance to fund death benefits within a defined contribution Qualified Plan will be considered incidental so long as the aggregate premiums paid for ordinary (whole life) insurance are less than 50% of the total contributions or where the aggregate premiums paid for other types of life insurance (term life or universal life) are less than 25% of the total contributions.[20]

"Seasoned Money" in Profit-Sharing Plans

There is an exception to the percentage limitations test for funds which have been accumulated within a profit-sharing plan for the period required by the plan document for deferred distributions. These funds are often referred to as "seasoned money." Where a profit-sharing plan restricts the purchase of life insurance to funds which have been accumulated for a "fixed number of years" (i.e., where only seasoned money can be used to pay life insurance premiums), there is no limit to the amount of life insurance that can be purchased within the plan.[21] This is the "seasoned money" exception.

Funds which are accumulating in a profit-sharing plan can be segregated into current funds and seasoned money. If a plan allows current funds to be applied towards the purchase life insurance, then the purchase must comply with the incidental benefit rule and the percentage limitations test. If, however, only seasoned money is permitted to be used in the purchase of life insurance, then there is no incidental benefits limitation. All seasoned money may be used to purchase life insurance in a profit-sharing plan.

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[17] Rev. Rul. 54-51 (1954-1 C.B. 147).

[18] Rev. Rul. 70-611 (1970-2 C.B. 89), Rev. Rul. 61-164 (1961-2 C.B. 99), and Rev. Rul. 66-143 (1966-1 C.B. 79).

[19] Rev. Rul. 70-611 (1970-2 C.B. 89), discussing Rev. Rul. 61-164 (1961-2 C.B. 99) and Rev. Rul. 66-143 (1966-1 C.B. 79).

[20] The IRS has twice ruled informally that other types of life insurance may be considered ordinary or permanent insurance. See PLR 9014068 (discussing a variable universal life insurance contract) and PLR 8725088 (discussing adjustable life insurance). However, in more recent field service advice (FSA 1999-633), the IRS revised its position and indicated that universal life insurance policies should be subject to the 25% of contributions limit.

[21] Rev. Rul. 60-83 (1960-1 C.B. 157). *See also* Rev. Rul. 61-164 (1961-2 C.B. 99).

Seasoned money is money which has been in a profit-sharing plan for a "fixed number of years."[22] According to the IRS, a fixed number of years must be at least two years.[23] Alternatively, all contributions to a profit-sharing plan may be considered seasoned money (even contributions that are less than two years old) if the participant has been in the plan for at least five years and the plan document permits deferred distribution of all contributions at that time.[24]

Thus, for profit-sharing plans, the rules for purchasing life insurance are as follows:

(1) If the plan document makes use of the seasoned money exception:

(a) Where the funds used to purchase life insurance have been in the plan for two or more years, there is no limit to how much life insurance can be purchased within the plan;[25]

(b) Where the plan participant has participated in the plan for five or more years, there is no limit to how much life insurance can be purchased within the plan.[26]

(2) If the plan document allows current contributions to be applied towards the purchase of life insurance:

(a) Where the death benefits are funded with whole life insurance, the premiums paid are less than 50% of the contributions to the plan for each participant;[27]

(b) Where the death benefits are funded using other types of life insurance (such as term insurance or universal life insurance), the premiums paid are less than 25% of the contributions to the plan for each participant;[28]

(c) Where the death benefits are funded using both whole life insurance and other types of insurance, the sum of one-half of the premiums paid for whole life insurance plus the full amount of premiums paid for other types of life insurance is less than 25% of the contributions to the plan for each participant;[29] and

(d) The plan document must require the trustee to convert the entire value of all life insurance contracts into cash or periodic income at or before each participant's retirement and/or to sell or distribute each life insurance contract to the insured participant at or before retirement.[30]

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[22] 118 Treas. Reg. 39.165-1(a)(2).
[23] Rev. Rul. 54-231 (1954-1 C.B. 150) and Rev. Rul. 71-295 (1971-2 C.B. 1984).
[24] Rev. Rul. 68-24 (1968-1 C.B. 150).
[25] Rev. Rul. 60-83 (1960-1 C.B. 157), Rev. Rul. 61-164 (1961-2 C.B. 99), Rev. Rul. 54-231 (1954-1 C.B. 150), and Rev. Rul. 71-295 (1971-2 C.B. 1984).
[26] Rev. Rul. 60-83 (1960-1 C.B. 157), Rev. Rul. 61-164 (1961-2 C.B. 99), and Rev. Rul. 68-24 (1968-1 C.B. 150).
[27] Rev. Rul. 54-51 (1954-1 C.B. 147).
[28] Rev. Rul. 70-611 (1970-2 C.B. 89), Rev. Rul. 61-164 (1961-2 C.B. 99), and Rev. Rul. 66-143 (1966-1 C.B. 79).
[29] Rev. Rul. 61-164 (1961-2 C.B. 99).
[30] Rev. Rul. 74-307 (1974-2 C.B. 126) and Rev. Rul. 54-51 (1954-1 C.B. 147).

Incidental Benefits for Split Funded Defined Benefit Plans

Defined benefit plans are employer sponsored qualified pension plans that guarantee participants a specified benefit at retirement. Employers fund the promised benefits by making annual contributions to the plan. The size of the deductible annual contributions is based on the amount of level contributions necessary to build the lump sum amount required to fund the promised benefit based on the number of years remaining until retirement age and on an assumed rate of investment return.[31] Annual contribution amounts may have to be adjusted depending upon the plan's actual investment experience: if return rates are greater than the assumed rate of return, annual contribution levels will decrease; if return rates are less than the assumed rate of return, annual contribution levels will increase. The maximum annual benefit allowable for defined benefit plans is $195,000 (as of 2010).[32]

When death benefits are added to defined benefit pension plans and life insurance is purchased to fund such benefits, the plans are often referred to as "split funded" plans because funding for the plan benefits is split between life insurance and other investment assets.[33] The same basic rule applies to life insurance purchased inside split funded defined benefit plans as is applied to defined contribution plans: death benefits from the purchase of life insurance will be considered incidental to the plan if the cost of providing the death benefit is less than 25% of the total cost of funding all of the benefits provided by the plan.[34] With defined benefit plans, however, it is often easier to focus on the benefit amount provided than on the cost of funding the benefit (which may be dependent on investment experience). Consequently, alternative tests have been applied to defined benefit pension plans: (i) the 100-to-1 test,[35] and (ii) the *1/3rd* test.[36]

100-to-1 Test

The most common test applied to defined benefit plans is the 100-to-1 test. Under this test a death benefit is considered incidental within a defined benefit pension plan so long as the participant's insured death benefit is no more than 100 times the anticipated monthly retirement benefit.[37] The IRS has determined that the cost of providing such a death benefit will not exceed 25% of the cost of providing all benefits under the plan.[38] Based on the maximum annual benefit limitation of $195,000 (as of 2010);[39] the maximum death benefit allowable under the 100-to-1 test would be $1,625,000.[40]

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[31] IRC § 404(a).

[32] IRC § 415(b)(1)(A).

[33] *See e.g.*, Rev. Rul. 68-453 (1968-2 C.B. 163), Rev. Rul. 73-501 (1973-2 C.B. 127), and Rev. Rul. 74-307 (1974-2 C.B. 126).

[34] Rev. Rul. 61-164 (1961-2 C.B. 99), Rev. Rul. 70-611 (1970-2 C.B. 89), and Rev. Rul. 66-143 (1966-1 C.B. 79).

[35] Rev. Rul. 60-83 (1960-1 C.B. 157) and Rev. Rul. 61-121 (1961-2 C.B. 65).

[36] Rev. Rul. 74-307 (1974-2 C.B. 126), and IRS Publication 6392 (Rev. 12-2006).

[37] Rev. Rul. 60-83 (1960-1 C.B. 157) and Rev. Rul. 61-121 (1961-2 C.B. 65).

[38] Rev. Rul. 66-143 (1966-1 C.B. 79), Rev. Rul. 60-83 (1960-1 C.B. 157), and Rev. Rul. 61-121 (1961-2 C.B. 65). *See also* Raymond J. Moore, et al. v. Commissioner, 45 B.T.A. 1073 (1941).

[39] IRC § 415(b)(1)(A).

[40] Maximum allowable monthly benefit would be $16,250 ($195,000/12). This amount multiplied by 100 yields the maximum allowable death benefit of $1,625,000. Not all participants are eligible for the maximum benefit amount. The maximum benefit for any particular participant depends on the participant's average level of compensation, the number of years participating in the plan, and the participant's age at retirement. IRC § 415(b).

1/3rd Test

Defined benefit plans may also rely on the *percentage limitations* test typically applied to defined contribution plans: death benefits for such plans will be considered incidental so long as premiums paid for the insurance is less than 25% of the cost of the plan (50% if whole life insurance is used). While this standard may not seem directly applicable to defined benefit plans because contributions are not allocated to participant accounts, the IRS has provided a method for doing so:

> *To apply the "50 percent" rule of Rev. Rul. 74-307 to defined benefit plans, an amount representing the "employer contribution for a participant" must be computed. This amount is the "theoretical contribution" which is the contribution that would be made on behalf of the participant, using the individual level premium funding method from the age at which participation commenced to normal retirement age, to fund the participant's entire retirement benefit without regard to preretirement ancillary benefits. The theoretical contribution is computed based upon reasonable actuarial assumptions (i.e., interest rate, mortality) that must be stated in the plan.*
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> *The "amount credited to the participant's account at the time of death" for this purpose is the theoretical individual level premium reserve that is computed using the theoretical contribution. The theoretical individual level premium reserve is the reserve that would be available at time of death if for each year of plan participation a contribution had been made on behalf of the participant in an amount equal to the theoretical contribution.*
>
> *In applying Rev. Rul. 74-307 to defined benefit plans the maximum premiums for ordinary life insurance may be no more than 66 (33 if term and/or universal life insurance) percent of the theoretical contribution. The death benefit payable may not exceed the face amount of the insurance policies plus the theoretical individual level premium reserve less the cash value of the insurance policies.*[41]

The *1/3rd* test can be applied to defined benefit pension plans using a three-step process: First, the plan actuary calculates the annual contribution amount for the plan assuming that no life insurance will be used in the funding. Second, 33% of this amount (66% if whole life insurance is used) may be used to purchase life insurance inside the plan. Third, the total plan contribution amount is recalculated with the assumption that life insurance is one of the investments. The total permissible contribution amount will increase because the plan is providing an additional benefit and the contribution for life insurance should end up being approximately 25% of the new contribution amount (or 50% if whole life insurance is purchased).

[41] IRS Publication 6392 (Rev. 12-2006), applying Rev. Rul. 74-30 (1974-2 C.B. 126).

Fully Insured Defined Benefit Plans

Another alternative for using life insurance in a defined benefit plan is to use a "fully insured" plan under IRC § 412(i). Where a defined benefit pension plan qualifies as a fully insured plan under § 412(i), the incidental benefit limitations restricting the use of life insurance in qualified retirement plans do not apply. As a matter of fact, if structured properly, a fully insured plan under § 412(i) can be funded 100% with life insurance.

To qualify as a fully insured plan, a defined benefit plan must meet the following requirements:

- The plan must be funded exclusively by the purchase of life insurance contracts, annuity contracts, or a combination of both.[42]
- The contracts must provide for level annual (or more frequent) premiums.[43]
- The plan benefits must be equal to the contract benefits and must be guaranteed by a licensed insurance company.[44]
- No policy loans can be allowed from the contracts funding the plan.[45]

It should be noted, however, that a fully insured plan must be funded with life insurance or annuity contracts that offer certain minimum guarantees (and typically require a whole life product if life insurance is used).[46]

ERISA and Labor Law Considerations for Purchasing Life Insurance in Qualified Retirement Plans

When the Employee Retirement Income Security Act ("**ERISA**") was passed in 1974, it included separate titles for labor law considerations[47] and income tax considerations.[48] The labor law considerations fall under the supervision of the Department of Labor ("**DOL**") while the income tax provisions are under the jurisdiction of the Internal Revenue Service ("**IRS**"). The discussion of "incidental benefit limitations" above is based on its guidance and interpretation of benefits and investments permissible within Qualified Plans under ERISA.

[42] Treas. Regs. §§ 1.412(i)-1(b) and 412(i)-1(c).
[43] Treas. Reg. § 1.412(i)-1(b)(2)(ii).
[44] Treas. Reg. § 1.412(i)-1(b)(2)(iii)-(iv).
[45] Treas. Reg. § 1.412(i)-1(b)(2)(vii).
[46] See Treas. Reg. § 1.412(i)-1. The ING Life Companies do not offer a life insurance product that can be used in a fully insured pension plan.
[47] Chapter 18 ("Employee Retirement Security Program") of Title 29 of the United States Code (29 USC §§ 1001-1461).
[48] 26 USC §§ 410-415.

Unfortunately, there is considerable uncertainty about the position of the DOL on the use of life insurance within Qualified Plans. At times, the DOL has contended that it is a breach of fiduciary duty to fund death benefits in qualified pension plans with permanent life insurance indicating that less expensive insurance should be used to fund retirement benefits.[49] However, as Zaritsky and Leimberg point out, this position seems "both harsh and unreasonable:"

> There are no written guidelines on the appropriate use of life insurance in ERISA plans, and the DOL is unlikely to issue any, according to its director of enforcement, who noted that ERISA does not bar the use of whole life insurance in qualified pension or profit-sharing plans.[50]

In any case, employers considering the purchase of life insurance as an asset within a Qualified Plan should seek the advice of tax or legal counsel familiar with the requirements of ERISA.

Investment Fiduciaries and Prohibited Transactions

Insurance agents and other financial advisors working with Qualified Plans need to be aware of their potential status as "fiduciaries" of these plans and the duties and liabilities that could attach to being treated as fiduciaries. Some relief from the adverse impact of being considered a plan fiduciary may be available to agents under Prohibited Transaction Exemption ("PTE") 84-24.

One of the fundamental provisions of ERISA is its requirement that "fiduciaries" for retirement, medical, life insurance, and other employee benefit plans perform their duties exclusively in the interest of plan participants.[51] ERISA regulations provide that a person who has discretionary management or control over a plan's investments, or who regularly renders investment advice for a fee, is considered a fiduciary.[52] There is no clear distinction in the regulations between an agent who is simply making a sale to a Qualified Plan and an agent who, because of his or her relationship to the principals at the employer, is considered to be "regularly rendering investment advice" to the Qualified Plan. Thus an insurance agent can unwittingly become a plan fiduciary which would prohibit that agent from furnishing goods or services to the Qualified Plan.[53]

To avoid this "inadvertent fiduciary" problem, the DOL has issued PTE 84-24 (originally PTE 77-9) to provide an exemption for insurance sales to Qualified Plans. To qualify for the protection offered under PTE 84-24, the insurance agent must, among other things, provide written disclosures of product features and surrender charges, the agent's relationship to the issuing insurance company, and the fees and commissions the agent will receive as compensation for the insurance sale.[54] Additionally, an independent plan fiduciary must acknowledge these disclosures and approve the insurance purchase in writing.[55]

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[49] *See* Brock v. Shuster, No. 87-259 (DDC 1987), Dole v. Gibson, No. 90-0532C (WDNY 1990), and Dole v. Dziedzic, No. 90-0533C (WDNY 1990). See also DOL News Release 90-171.

[50] Zaritsky, H. & Leimberg, S., *Tax Planning With Life Insurance at* 6-367 (Warren, Gorham & Lamont 2009).

[51] ERISA § 404(a)(1)(a); 29 USC 1104(a)(1)(a).

[52] DOL Reg. § 2510.3-21(c).

[53] See ERISA § 406(a)(1); 29 USC § 1106(a)(1).

[54] PTE 84-24, section V.

[55] PTE 84-24, section V.

Title VII and the Need for Unisex Rates

Title VII of the Civil Rights Act of 1964 makes it an unlawful employment practice "to discriminate against any individual with respect to his compensation, terms, conditions, or privileges of employment, because of such individual's race, color, religion, sex, or national origin."[56] The United States Supreme Court has held that certain employee insurance and annuity benefits are terms, conditions and privileges of employment and are thus subject to Title VII.[57] Where life insurance is considered a benefit of employment and subject to Title VII, the employer must provide benefits to employees on a unisex basis (i.e., there must be no distinction in the rates charged for males and females covered in the plan).[58] Consequently, where life insurance is purchased within a qualified retirement plan, unisex rates must be used for the pricing of the policies.

Tax Treatment of Current Life Insurance Protection to the Qualified Plan Participant

When life insurance is purchased inside of a qualified retirement plan, the plan participant – in addition to the other benefits provided – enjoys the benefit of current life insurance protection. According to the IRS, this benefit has an economic value which is subject to income taxation. Consequently, qualified plan participants must include in gross income each year the cost of life insurance protection (or the "economic benefit") for the death benefit provided under the plan.[59]

A participant in a qualified retirement plan must include in income the cost of life insurance protection for insurance held by the plan if the proceeds are either payable to the participant's estate or beneficiary or are payable to the plan's trustee and the plan requires the trustee to pay the proceeds to the employee's estate or beneficiary.[60] The economic benefit is measured based only on the cost of the "pure amount at risk" – i.e., only the net death benefit above the policy's cash value is used to determine the taxable cost of life insurance protection.[61]

The cost of life insurance protection is determined by applying a 1-year premium term rate for a person of the insured's age to the difference between the face amount of insurance and the cash surrender value at the end of the year.[62] In most cases, the appropriate 1-year premium term rate will be found in "Table 2001" which was first published by the IRS in Notice 2001-10 and then re-published in Notice 2002-8. Until further guidance is issued, it may also be possible to utilize the one-year term rates published by the insurance carrier that issued the policy held in the qualified plan.[63] According to IRS guidance, an insurance carrier's rates may be substituted for the rates prescribed under Table 2001 if the insurer has a one-year term product available to all standard risks, the insurer generally makes the availability of such rates known to persons who apply for term insurance coverage from the insurer, and the insurer regularly sells term insurance at such rates to individuals who apply for term insurance coverage through the insurer's normal distribution channels.[64]

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[56] 42 USC 2000e-2(a)(1).
[57] Arizona Governing Committee v. Norris, 463 US 1073 (1983).
[58] Arizona Governing Committee v. Norris, 463 US 1073 (1983).
[59] IRC § 72(m)(3)(B); Treas. Reg. § 1.72-16(b).
[60] Treas. Reg. § 1.72-16(b)(1).
[61] Treas. Reg. § 1.72-16(b)(3).
[62] Treas. Regs. §§ 1.72-16(b), 1.402(a)-1(a)(3), and 1.403(a)(1)-(d).
[63] Treas. Reg. § 1.61-22(d)(3). *See also* Notice 2002-8.
[64] Notice 2002-8.

Example: Participant's qualified plan holds a life insurance policy insuring Participant's life and the death benefits are payable to Participant's estate. At the end of the year Participant is 45 years old. The policy has a face amount of $300,000 and a cash surrender value of $50,000. The Table 2001 1-year premium term rate for a 45-year old is $1.53 per $1,000 of insurance protection. Participant must recognize $382.50 of income for the cost of life insurance protection [((300,000 – 50,000)/1,000) x 1.53 = 250 x 1.53 = 382.50].

Tax Treatment of Death Benefits When Paid From Life Insurance Held Inside of a Qualified Retirement Plan

Assuming the participant has included the costs of life insurance protection as an element of current income,[65] the portion of the life insurance proceeds payable at death which is in excess of the policy's cash value immediately prior to death will be excluded from the recipient's income under IRC § 101(a).[66] Additionally, a portion of the benefits received from the policy equal to the aggregate amount of income recognized as economic benefits for the cost of life insurance will be treated as basis in the plan and thus can also be received income tax free.[67]

All of the remaining death benefits – i.e., the portion equal to the cash value of the policy immediately prior to death minus the aggregate economic benefits recognized as income – will be treated as a taxable distribution of plan assets and treated as income in respect of a decedent (or "IRD").[68]

Example: Participant's qualified plan holds a life insurance policy insuring Participant's life. The policy has a face amount of $300,000 and a cash surrender value of $100,000. Participant has been paying income taxes annually on the cost of life insurance protection and has recognized aggregate economic benefits income of $9,000. If Participant dies, the policy's $300,000 death benefit will be paid directly to Participant's spouse. $200,000 will be excluded from income as a benefit payable by reason of death under IRC § 101(a). $100,000 will be treated as a plan distribution, but $9,000 of this amount will be excluded from income as basis created by the recognition of the cost of life insurance protection in the Participant's annual income. Thus the Participant' spouse must recognize $91,000 from the policy death benefits as IRD.

Options for Continuing Life Insurance Coverage at Retirement

Once a participant is no longer an active employee of the plan sponsor, a qualified retirement plan may generally no longer hold the life insurance policy as a plan asset.[69] A participant who wants life insurance protection to continue after termination of employment has two options: (i) take the policy out of the plan as a plan distribution, or (ii) allow the plan to sell the policy to the participant or a permissible third party.

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[65] Treas. Reg. § 1.72-16(c)(4).
[66] *See* IRC § 72(m)(3) and Treas. Reg. § 1.72-16(c)(2)(ii).
[67] Treas. Reg. § 1.72-16(b)(4). *See also* Let. Rul. 8539066.
[68] Treas. Reg. § 1.72-16(c)(2)(ii).
[69] *See* Rev. Rul. 74-307 (1974-2 C.B. 126) and Rev. Rul. 54-51 (1954-1 C.B. 147). There is an exception, however, for defined benefit plans which may provide a post-retirement death benefit if life insurance premiums paid for the insurance have been less than 10% of the cost of the plan. Rev. Rul. 60-59 (1960-1 C.B. 154).

Receiving the Life Insurance Policy as a Plan Distribution

If the participant desires to keep the life insurance coverage in force after terminating employment, and if permissible under the terms of the plan, the policy may be transferred from the plan to the participant as a plan distribution. The fair market value[70] of the life insurance contract must be included in the participant's income to the extent it exceeds the participant's basis in the contract.[71] For this purpose, the participant's basis includes any non-deductible premium payments he or she made towards the life insurance contract and the amount of economic benefit income recognized for the cost of life insurance protection.[72]

Selling the Life Insurance Policy to the Participant or a Permissible Third Party

A second option for removing a life insurance policy from a qualified retirement plan would be through a sale of the policy, provided the sale is structured to satisfy the requirements of ERISA. Normally the sale of property from a Qualified Plan to a participant or someone closely related to a participant would violate the rules of ERISA[73] and be characterized as a prohibited transaction.[74] Violation of the prohibited transaction rules subjects the disqualified person to a tax equal to as much as 100 percent of the value of the property involved in the transaction.[75]

However, the Department of Labor ("DOL") has issued an exemption (known as a prohibited transaction exemption or "PTE") that permits the sale of life insurance policies from qualified plans to plan participants and certain other individuals.[76] Under PTE 92-6, life insurance policies may be purchased from qualified retirement plans by the insured participant, his or her spouse or relative who is a beneficiary under the policy, an irrevocable trust established by the participant, or to an employer whose employees are covered by the qualified plan if all of the following conditions are met:

- The life insurance policy would, but for the sale, be surrendered by the plan;
- The amount received by the plan as consideration for the sale is at least equal to the amount necessary to put the plan in the same cash position as it would have been had it retained or surrendered the contract; and
- If the sale is to someone other than the participant insured:
    - The participant must first be given notice of the proposed sale and given the opportunity to purchase the policy from the plan, and
    - The participant must deliver a written document to the plan indicating that he or she does not wish to purchase the policy and that he or she consents to the sale to the spouse, relative, employer, or trust in question.[77]

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[70] See below for a discussion of how to determine a policy's fair market value.
[71] Treas. Reg. §1.402(a)-1(a)(2).
[72] Treas. Reg. § 1.72-16(b)(3). *See also* Let. Rul. 7922109.
[73] Employee Retirement Income Security Act of 1974.
[74] ERISA § 406(a)(1).
[75] IRC §§ 4975(a), 4975(b), and 4975(c). *See also* Commissioner v. Keystone Consolidated Industries, Inc., 502 US 152 (1993).
[76] PTE 92-6. *See also* DOL Advisory Opinions 98-07A and 2006-03A.
[77] PTE 92-6, DOL Advisory Opinion 98-07A, and DOL Advisory Opinion 2006-03A.

Determining a Life Insurance Policy's "Fair Market Value" Upon Distribution or Sale

For all distributions or sales from qualified retirement plans after February 12, 2004, the fair market value of a life insurance contract includes the policy cash value and all other rights under the contract and is determined using the "PERC" calculation prescribed by the IRS in Rev. Proc. 2005-25.[78]

In its 2005 guidance, the IRS indicates that for income tax purposes, a life insurance policy must be valued at the ***higher*** of (i) the interpolated terminal reserve value, or (ii) the PERC value multiplied by an "Average Surrender Factor" (for which the IRS supplies a formula).[79] Where the transfer is governed by IRC §§ 79 or 83, no adjustment to the PERC is allowed for policy surrender charges.[80]

The interpolated terminal reserve value is an extrapolation of a policy's reserve value at a given point in time based on the policy's reserve value at the point the last premium was paid and the projected reserve value for the point at which the next premium is due. Then, to arrive at the full policy valuation, add to this the proportionate amount of the premium covering the time remaining until the next payment is due. This calculation is demonstrated by *Example* (4) of Regulation 25.2512-6(a):

> *A gift is made four months after the last premium due date of an ordinary life insurance policy issued nine years and four months prior to the gift thereof by the insured, who was 35 years of age at date of issue. The gross annual premium is $2,811. The computation follows:*

Terminal reserve at end of tenth year	*$14,601.00*
Terminal reserve at end of ninth year	*12,965.00*
Increase	*1,636.00*
One-third of such increase (the gift having been made four months following the last preceding premium due date), is	*545.33*
Terminal reserve at end of ninth year	*12,965.00*
Interpolated terminal reserve at date of gift	*13,510.33*
Two-thirds of gross premium ($2,811)	*1,874.00*
Value of the gift	*15,384.33*[81]

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78 Rev. Proc. 2005-25 (2005-17 I.R.B. 962). *See also* Treas. Reg. § 1.402(a)-1(a)(2)(iii).
79 Rev. Proc. 2005-25, Sections 3.02, 3.03, and 3.04.
80 Rev. Proc. 2005-25, Section 3.04(1).
81 Treas. Reg. 25.2512-6(a), Example (4).

The other possibility for policy valuation is to use the PERC calculation, where PERC stands for **P**remiums, **E**arnings, and **R**easonable **C**harges. The PERC formula is expressed as follows:

> *The PERC amount is the aggregate of: (1) the premiums paid from the date of issue through the valuation date without reduction for dividends that offset those premiums, plus (2) dividends applied to purchase paid-up insurance prior to the valuation date, plus (3) any amounts credited (or otherwise made available) to the policyholder with respect to premiums, including interest and similar income items (whether credited or made available under the contract or to some other account), but not including dividends used to offset premiums and dividends used to purchase paid-up insurance, minus (4) explicit or implicit reasonable mortality charges and reasonable charges (other than mortality charges), but only if those charges are actually charged on or before the valuation date and those charges are not expected to be refunded, rebated, or otherwise reversed at a later date, minus (5) any distributions (including distributions of dividends and dividends held on account), withdrawals, or partial surrenders taken prior to the valuation date.*[82]

The earnings component for variable contracts also includes "all adjustments … that *reflect the investment return and the market value of segregated asset accounts."*[83]

If the transfer involves a sale or distribution of a policy from a qualified retirement plan under IRC § 402, the PERC amount may be adjusted to reflect some surrender charges. The largest discount allowed for surrender charges is 30% (meaning the policy's cash surrender value is 70% of the PERC amount (which gives a surrender factor of 0.70).[84] The Average Surrender Factor is defined as *"the unweighted average of the applicable surrender factors over the 10 years beginning with the policy year of the distribution or sale."*[85] For each policy year, the applicable surrender factor is the greater of either the actual surrender factor (determined by dividing the policy's cash surrender value for that year by the policy's PERC amount for that year) or 0.7.[86]

> **Example:** Consider a policy that is being transferred in its fourth year. The insurance company applies a surrender charge that is 100% in year 1 and then drops by 10% a year until the tenth year when there is no more surrender charge. The Average Surrender Factor could then be calculated using the following chart:

Year:	4	5	6	7	8	9	10	11	12	13
Surrender Charge:	60%	50%	40%	30%	20%	10%	-	-	-	-
Surrender Factor:	0.70	0.70	0.70	0.70	0.80	0.90	1.00	1.00	1.00	1.00

> For this policy transfer, the Average Surrender Factor is **0.85** [(0.70 + 0.70 + 0.70 + 0.70 + 0.80 + 0.90 + 1.00 + 1.00 + 1.00 + 1.00) / 10].

[82] Rev. Proc. 2005-25, Section 3.02.
[83] Rev. Proc. 2005-25, Section 3.03.
[84] Rev. Proc. 2005-25, Section 3.04.
[85] Rev. Proc. 2005-25, Section 3.04.
[86] Rev. Proc. 2005-25, Section 3.04.

Conclusion

While life insurance can help qualified retirement plan participants to meet both retirement planning and income protection goals, those considering the purchase of life insurance within such plans need to understand the various rules and restrictions that are applicable to such an investment, including the *"incidental benefit"* limitations for various types of plan designs, the tax treatment of life insurance protection while participating in a plan, the tax treatment of death benefits when paid out, and the options for continuing life insurance coverage at retirement.

The following table provides a summary of these rules:

How Much Life Insurance Can a Qualified Retirement Plan Hold? "Incidental Benefit" Limitations	
Defined Contribution Plans	**Whole Life Insurance:** Premiums must be less than 50% of total plan contributions. **Other Insurance:** Premiums must be less than 25% of total plan contributions.
Profit Sharing Plans Seasoned Money Exceptions	**If permitted by the plan document:** **Seasoned funds** - Where the funds used to purchase life insurance have been in the plan for two or more years, there is no limit to how much life insurance can be purchased within the plan. **Seasoned participant** - Where the plan participant has participated in the plan for five or more years, there is no limit to how much life insurance can be purchased within the plan.
Defined Benefit Plans	**100-to-1 Test:** Death benefit can be no more than 100 times the anticipated monthly retirement benefit. **1/3 Test:** Premiums for life insurance may be no more than 1/3 of the theoretical contribution for the defined benefit (2/3 if whole life insurance is used).
Income Tax Consequences for Life Insurance Held in Qualified Retirement Plans	
Income Taxation While Participating in Plan	Participant taxed annually on economic benefit costs of "Net Death Benefit" for life insurance held in qualified plan. Cost of life insurance protection is measured using IRS Table 2001 or, if appropriate under IRS Notice 2002-8, the insurance carrier's published one-year term rates.
Income Taxation of Death Benefits	The portion of the death benefit equal to the cash value of the policy immediately prior to death – minus the aggregate economic benefits recognized as income – will be taxed as income in respect of a decedent (or "IRD"). The remaining death benefits received income tax-free.
Income Taxation of Policy Distribution	Fair market value of policy – minus the aggregate economic benefits recognized as income – taxed to the participant as ordinary income.
Income Taxation of Policy Sale	If the sale's price is less than the policy's fair market value, the participant recognizes as ordinary income the difference between the sale's price and the fair market value of the policy (minus the aggregate economic benefits recognized as income).
Fair Market Value of Life Insurance Policy Held in Qualified Retirement Plan	
Transfer or Distribution from Qualified Retirement Plan (IRC § 402(a))	**Higher** of: (i) interpolated terminal reserve + unpaid premiums or (ii) PERC * Average Surrender Factor

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