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Life Insurance in Qualified Plans

Legal Limitations

Personal Plans

- **IRAs:** IRAs, IRA rollovers, Roth IRAs, SEPs, and SIMPLE IRA arrangements may not pay the premium for life insurance policies.
- **Tax sheltered annuities:** 403(b) plans may not invest in contracts that provide incidental life insurance protection. See Reg. Sec. 1.403(b)-8(c)(2).[1]

Business Plans

- **Defined contribution plans:** The percentage of the total annual employer contribution that can be allocated to life insurance premiums varies with the type of policy. There is no limit on the face amount.

    - **Term, variable, and universal life insurance:** Less than 25% of the annual allocation.
    - **Ordinary whole life insurance:** Less than 50% of annual allocation.
    - **Combination:** One-half of the ordinary life premium and all of the term, variable, and/or universal life premium must be less than 25% of the total.

Special rule for profit sharing plans: Allocations that are more than two years old may, in some cases, be totally invested in life insurance.[2] See Rev. Rulings 61-164 1961-2 CB 99.

- **Defined benefit plans**

    - **Basic rule:** The face amount of the insurance may not exceed 100 times the anticipated monthly retirement benefit. For example, if a $5,000 per month retirement benefit were anticipated, the maximum amount of life insurance would be $500,000.
    - **Alternative rule:** Total premiums for ordinary life must be less than 66 2/3% (or 33 1/3% for term, variable, and universal life insurance) of the assumed aggregate contributions[3] that have been made for the participant from the beginning of his or her participation in the plan. See IRS Rev. Rul. 74-307.
    - **Fully Insured Plan:** Some plans are funded exclusively with annuities or a combination of annuities and life insurance. These plans are known as 412(e)(3) plans, formerly 412(i). Special rules apply to these types of plans.

- **Other general rule:** Insurance must be made available or purchased on a uniform and non-discriminatory basis.

[1] Under regulations issued by the Treasury Department on 7/26/07, annuity contracts issued prior to 9/24/07 may provide incidental life insurance protection; contracts issued on or after that date may not provide any life insurance. See Reg. 1.403(b)-11(f).
[2] The IRS has never formally ruled on the taxability of using aged contributions, in excess of the incidental insurance rules, to purchase life insurance. See also Rev. Ruling 60-83 and Rev. Ruling 68-24.
[3] The assumed aggregate contribution is a special calculation separate from the funding calculations.

Life Insurance in Qualified Plans

Legal Limitations

Advantages to the Employee

- Because income and estate taxes on the death benefit may be very substantial, the non-income-taxable insurance proceeds may be used to pay the income taxes and/or estate taxes due on the other plan assets or estate assets. Life insurance protects the other non-insurance assets.
- It is an easy way to provide additional protection for one's family if death occurs prior to retirement age.
- It frees up other personal dollars now being spent for life insurance outside the plan.
- For cash-value policies, the majority of the premium is not taxable to the employee. Taxable income to the employee is calculated on the difference between a policy's face value and its cash surrender value at year's end. IRS Table 2001 is generally used to determine the dollar amount included in the employee's income.
- The policy can be moved to another plan if the employee changes employment, providing the new plan will accept it.
- At retirement age, the employee may be able to take a fully paid up policy, rather than face the expense of converting his or her group insurance.
- The pure insurance portion (the face amount less the accumulated cash values) of the death benefit passes to the beneficiaries income tax free, but may be subject to estate tax.
- A waiver of premium may be added which will continue to pay the life insurance premiums should the employee become disabled.
- Uninsurable participants may be able to purchase a limited amount of guaranteed-issue insurance. In larger plans it may be a substantial amount.
- When a participant in a defined benefit plan is rated for insurance risk purposes (usually for poor health or occupational hazards), the plan can pay the higher premium without increasing the cost to the participant.
- Table I costs for group insurance reported as income under group coverage in excess of $50,000 are not recoverable. Economic benefit costs incurred for the pure insurance portion of policies in qualified plans may be recovered at the time of distribution.
- Ordinary, variable, or universal life policies can be used as an annuity at retirement age. The insurer will give the participant the higher of either the rate guaranteed in the contract or the then current rates.
- Traditional financial and estate planning seeks a balanced approach to investment portfolios. Ordinary and universal life insurance policies can represent the fixed side of the program. Variable life and variable universal life policies also offer an equity or stock market option for the cash value portion of the policy.

Life Insurance in Qualified Plans

Legal Limitations

Advantages to the Employer

- The premiums are deductible as a part of the plan contribution.
- If the employee has a paid-up policy under the qualified plan at retirement age, he or she may not need to convert group insurance to permanent. With larger, experience-rated group life contracts, there is typically a charge (sometimes substantial) to the experience when a policy is converted.
- Under a defined benefit plan, if the insurance proceeds equal the entire preretirement death benefit and a participant dies, all of the other equity assets for that participant can be used to reduce future employer contributions to the plan.
- If participating whole life contracts are used and dividends are used to reduce the premium, the long-term cost in a defined benefit plan may be very favorable.
- In defined benefit plans the employer may be able to make a larger contribution and deduction by including ordinary life insurance in the plan. This is often helpful because of the restrictions on retirement plan benefits and contributions.[1]
- Corporate retained earnings problems may be lessened by increasing the contribution to a defined benefit plan that provides for life insurance. Pension plan assets do not appear on the corporation's balance sheet.
- Younger employees may look at the protection as a current benefit, whereas retirement age may seem to be a long way off.

Disadvantages to the Employee

- If there is an estate tax problem, the life insurance proceeds will increase the size of the gross taxable estate. If the surviving spouse is the beneficiary, there will be no immediate death tax payable, due to the unlimited marital deduction. However, the surviving spouse's estate will be increased, thus increasing the potential estate tax at his or her subsequent death.
  As an alternative, consider having any additional life insurance owned by an irrevocable life insurance trust, designed to keep the proceeds out of the estates of both spouses.
- It is a tax shelter within a tax shelter. Under current law, the buildup of cash values in a life insurance contract are tax deferred and do not need to be in a qualified plan to get this tax advantage.
- If the employee did not recognize the annual imputed income for the insured death benefit per IRS Table 2001, the death benefits paid from the policy are taxable.

[1] The Pension Protection Act of 2006 modifies the funding rules for defined benefit plans. Recent comments from IRS officials indicate that life insurance may no longer be funded directly as part of the plan's normal cost. In this case, life insurance may not increase plan contributions significantly in the early years of a plan.

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