



# WRMarketplace

## An AALU Washington Report

Thursday, January 22 2015

WRM# 15-02

The *WRMarketplace* is created exclusively for AALU Members by the AALU staff and Greenberg Traurig, one of the nation's leading tax and wealth management law firms. The *WRMarketplace* provides deep insight into trends and events impacting the use of life insurance products, including key take-aways, for AALU members, clients and advisors.

---

### **TOPIC: The Use of Life Insurance Inside Qualified Retirement Plans.**

**MARKET TREND:** The recent volatility of the securities markets has created apprehension for retirement plan participants. Life insurance as an alternative investment option could provide a reasonable rate of return, stability, and comfort to some participants.

**SYNOPSIS:** To satisfy their fiduciary obligations, qualified retirement plan sponsors have an obligation to provide stable and secure investment alternatives. Life insurance vehicles are allowable investments under qualified retirement plans and can be an effective option as one of a menu of possible investment vehicles, assuming the life insurance and the plan meet specific requirements. Plan sponsors, however, may not fully appreciate or even understand the potential benefits of including life insurance as an asset class under a plan.

**TAKE AWAYS:** Advisors to qualified retirement plan sponsors and fiduciaries can assist their clients in looking at life insurance as an additional investment option. Careful advice and planning is necessary because of the special requirements applicable to life insurance under qualified plans. Advisors must become knowledgeable about these special requirements in order to guide clients in this analysis.

**MAJOR REFERENCES:** [\*Internal Revenue Code \("Code"\) §§ 101\(a\), §401, §402, §402A, §403, §404, §404A, §405, §406, §407, §408, §408A and §409.\*](#)

Life insurance vehicles under qualified retirement plans can be an effective option as one of a menu of possible investment vehicles, assuming the life insurance and the plan meet specific requirements. When considering life insurance as a qualified plan investment option, however, sponsors and advisors must understand the limitations based on plan designs, legal limitations, tax treatment, and continuation at retirement.

### ***INCIDENTAL BENEFITS***

Qualified retirement plans are meant to serve primarily as a source of retirement benefits. Any non-retirement benefit provided under a plan, such as death benefits, must be "incidental." A plan may provide for the payment of incidental death benefits through life insurance or otherwise.

## **Application to Defined Contribution Plans**

Under defined contribution plans: (1) the amount that is contributed (often pre-tax) each year on behalf of a participant is established, (2) these contributions are held in accounts established for participants and invested (generally, as the participant directs), and (3) the amount of retirement income ultimately payable to a plan participant is determined by the balance credited to his or her account under the plan. The most basic type of defined contribution plan is the profit sharing plan. Under this type of plan, the employer sponsoring the plan makes a contribution in an amount either set forth in the governing plan document or as determined by the employer for the year. This contribution is allocated among plan participants in the manner described in the plan document – generally, in proportion to the amount of compensation earned by the participant for the year.

**Percentage Limitation Test.** A “percentage limitation test,” which looks at the percentage of plan contributions that are used to buy life insurance, applies to determine whether death benefits that are payable under a defined contribution plan are incidental. For this purpose, a defined contribution plan will be considered to provide incidental death benefits where the plan requires, at or before a participant’s retirement, for conversion of the entire value of the life insurance contract to provide periodic income or cash, and/or for a sale or distribution of the contract to the participant, as well as the following:

- (1) If funded with whole life insurance, the aggregate premiums for life insurance in the case of each participant are less than  $\frac{1}{2}$  of the aggregate contributions allocated to the participant at any particular time;
- (2) If funded with other life insurance products (*e.g.*, universal), the premiums paid are less than 25% of the aggregate contributions allocated to the participant; and
- (3) If funded with a combination of whole and other life insurance products, then half of the premiums for the whole life insurance plus all premiums paid for the other policies must be under 25% of the aggregate contributions allocated to the participant.

**Exception to Limitations.** A defined contribution plan may have so-called “seasoned money,” which are funds accumulated within a defined contribution plan for a “fixed number of years.” While plans may vary with regard to the number of years for “seasoning,” the minimum amount of time is two years. On the other hand, all plan contributions become “seasoned,” whether or not in the plan for less than two years, if the participant holds the account for five years and distribution of all contributions may be deferred at that time.

If a plan allows the use of only seasoned money to pay life insurance premiums, the percentage limits described above do not apply. If “non-seasoned,” or current, money can be applied, however, the percentage limits do apply. A plan can separate current money from seasoned money and can apply all seasoned money to the acquisition of life insurance within the plan.

## **Application to Defined Benefit Plans**

A defined benefit plan works essentially in the opposite manner of a defined contribution plan: (1) a specified benefit is payable to a participant at retirement, and (2) the amount contributed to the plan for any year is an amount actuarially determined to be necessary for the plan to be adequately funded to pay benefits when they become due, as determined in accordance with the

rules established under relevant provisions of the Code. Annual contributions to a defined benefit plan may vary depending on the plan's investment performance – better performance (*i.e.*, in excess of the assumed rate of return) means lower contributions while worse performance means higher contributions.

Defined benefit plans that provide death benefits that are funded through life insurance may be called “split funded,” since the burden of funding those benefits is shared between the plan's life insurance and other investments.

***Alternative Incidental Benefits Tests.*** Similar to defined contribution plans, life insurance death benefits provided under a split-funded defined benefit plan are deemed incidental assuming the cost of providing the death benefit is less than 25% of the aggregate cost of funding all benefits of the plan. Since, as noted above, the cost associated with funding benefits in a defined benefit plan can vary depending on the plan's investment performance, the IRS has applied the following alternate tests to determine whether a defined benefit pension plan provides “incidental” death benefits:<sup>1</sup>

- **100-to-1 Test.** With this test (the most commonly used), the plan's death benefit will be incidental if the participant's insured death benefit does not exceed 100x his or her anticipated monthly retirement benefit. The cost of this death benefit cannot exceed 25% of the cost of all benefits.
- **1/3rd Test.** With this test, the plan sponsor must determine the annual contribution amount assuming no life insurance will be used in the funding. Then one-third of this amount (or two-thirds if whole life insurance is purchased) can be set aside as available to buy life insurance. Finally, the full plan contribution amount is re-determined including life insurance as one of the plan investments and should increase, since the plan is now providing an added benefit. The life insurance contribution should roughly equal 25% of the new total contribution amount (50% if whole life insurance is used).

## ***TAX TREATMENT TO PLAN PARTICIPANTS***

For life insurance held by a qualified retirement plan, a participant is taxed on the cost of current life insurance protection paid by the plan from deductible employer contributions or plan earnings if the proceeds are payable to the participant's estate or beneficiary (or payable to the plan and then required to be paid to the participant's estate or beneficiary). The amount taxed to the participant includes only the cost of current insurance protection. For policies with cash surrender value, current life insurance protection equals the amount payable on death to the extent it exceeds the cash surrender value at year-end. This protection may be valued as the lesser of the insurer's qualifying published rates for one-year term insurance<sup>2</sup> or based on amounts set forth in IRS tables (*i.e.*, Table 2001).

## ***TAX TREATMENT OF DEATH BENEFITS***

Assuming the participant has included in income the costs of life insurance protection, death benefits received by the participant's beneficiary are divided into and taxed as two parts. An amount equal to the policy's cash surrender value just before the participant's death is taxed as a distribution (generally reduced by the total cost of life insurance protection previously taxed to the participant, as a return of basis), while the remainder is excluded from gross income as life insurance death benefits under Code §101(a).

## ***CONTINUING LIFE INSURANCE COVERAGE AT RETIREMENT***

In general, a plan may not continue to hold life insurance on a participant who is not an active employee. If ongoing insurance coverage is desired after employment, the participant can take the policy as a plan distribution, paying tax on the policy's fair market value or purchase (or have another party purchase) the policy at fair market value, in each case as determined under Rev. Proc. 2005-25.

### ***TAKE AWAYS***

- Life insurance can be an attractive investment option under qualified retirement plans for both business owners and employees.
- The nature of life insurance, which is somewhat insulated from market volatility, can make it a relatively stable investment option.
- Advisors can provide significant value by recommending and helping to analyze the utility of including life insurance under a qualified retirement plan.
- While the requirements and limitations for life insurance under a qualified retirement plan are complex, they are manageable, if considered carefully by the advisors and plan sponsors working together on the life insurance funding.

### ***NOTES***

---

<sup>1</sup> Note that another alternate version of a life insurance-funded defined benefit plan is a qualified, fully-insured plan under Code § 412(i). There has been significant IRS scrutiny of so-called "412(i) plans," however, with certain of these transactions designated as listed transactions by the IRS. Given the complexity and scrutiny of such plans, a detailed discussion is beyond the scope of this report.

<sup>2</sup> Based on IRS guidance, an insurer's term rates may be used if the insurer (1) has a one-year term product available to all standard risks, (2) generally makes such rates available to term applicants, and (3) regularly sells term insurance at such rates through the insurer's normal distribution channels.

General References: Bittker & Lokken, Federal Taxation of Income, Estates and Gifts (Thomson Reuters/Tax & Accounting, 2d/3d ed. 1993-2014, updated January 2015); Chapt. 61; "Qualified Retirement Plans – Basic Rules;" Voya Financial, Sept 2014, "White Paper: Using Life Insurance as an Asset in Qualified Retirement Plans."

### **DISCLAIMER**

**This information is intended solely for information and education and is not intended for use as legal or tax advice. Reference herein to any specific tax or other planning strategy, process, product or service does not constitute promotion, endorsement or recommendation by AALU. Persons should consult with their own legal or tax advisors for specific legal or tax advice.**

The AALU *WRNewswire* and *WRMarketplace* are published by the Association for Advanced Life Underwriting® as part of the Essential Wisdom Series, the trusted source of actionable technical and marketplace knowledge for AALU members—the nation's most advanced life insurance professionals.

---

**WRM #15-02 was written by Greenberg Traurig, LLP**

Jonathan M. Forster

Martin Kalb

Richard A. Sirius

Steven B. Lapidus

Rebecca Manicone

***Counsel Emeritus***

Gerald H. Sherman 1932-2012

Stuart Lewis 1945-2012