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White paper

Why have life insurance in a qualified plan?

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Employees and employers often face the challenge of accumulating sufficient assets for a comfortable retirement, while at the same time protecting families in the event of the employee's untimely death. Typically, they will first turn to qualified retirement plans "qualified plans" (e.g. 401(k)) as a means of saving for their retirement, and then to life insurance as a means of providing for their family in the event of their death.

In some circumstances it may be possible to do both within a qualified plan. The Internal Revenue Code ("IRC") requires that the primary purpose of a qualified plan is to provide retirement benefits, but also allows for the ownership of life insurance in qualified plans. Treasury Regulations specify that if the qualified plan document allows for life insurance, then the death benefits must be secondary or "incidental", as defined below.

Despite this restriction, plan participants will often find that using qualified plan assets may provide an effective means in helping them satisfy an unmet life insurance protection need while at the same time continued opportunity for retirement planning, especially when using a life insurance policy with a cash accumulation component. The purpose of this White Paper is to explain the pros and cons of using qualified plan assets to purchase life insurance.

The "incidental benefit" limitation rule

A qualified plan may offer life insurance as an investment option provided that the death benefit is an "incidental benefit". The amount of life insurance coverage that can be purchased differs depending on whether the affected plan is a defined contribution or a defined benefit plan, the type of life insurance policy used, whether the contributions are from the employee or employer, and how long the employee has been a plan participant.

Life insurance in a defined contribution plan
The most common test for incidental death benefits for a defined contribution plan is based on a measurement of the cumulative premiums paid; however, alternative testing can be done based on the level of death benefit. The test based on cumulative premiums is:

- For term and universal life insurance, the total premiums paid must be less than 25% of the contributions to the plan for each participant.
- For whole life insurance, the total premiums paid must be less than 50% of the contributions to the plan for each participant.

Also, if the death benefits are funded with both whole life and term or universal life 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 must be less than 25% of the contributions to the plan for each participant.

Life insurance in a defined benefit plan

The most common test for whether a death benefit in a defined benefit qualified plan is incidental is termed the 100-to-1 Test. Under this test a death benefit is considered incidental so long as the plan participant's insured death benefit is no more than 100 times his or her anticipated monthly retirement benefit. Therefore, if an employee has a projected monthly retirement benefit of $2,500, a maximum of $250,000 in life insurance may be purchased on that employee. Although this test may also be used for defined contribution plans, it is more commonly associated with defined benefit plans. There is an alternative test which measures the total death benefit from life insurance and accrued benefits; however, it is a very complex calculation using actuarial formulas and is not discussed here.

Exceptions to the incidental benefit limitation — seasoned money in profit sharing plans

There are two exceptions to the incidental benefit limitation rule specific to a profit-sharing plan — the two-year rule and the five-year rule.

- Two Year Rule (Seasoned Funds) – Money in a profit-sharing plan held for at least two years consisting of contributions, forfeitures, and earnings, may be used to purchase life insurance without applying the incidental benefit limitation rules, if the plan provisions so provide.

Note that funds which accumulate in a participant's profit-sharing plan may be segregated into current contributions and into seasoned money. If the profit-sharing plan permits current contributions to purchase life insurance, then the purchase must comply with the above listed "incidental benefit" limitations. However, if the profit-sharing plan permits only the use of seasoned money, then all seasoned money may be used to purchase life insurance on behalf of the employee.

- Five Year Rule (Seasoned Participant) – Any participant who has participated in a profit-sharing plan for at least five years may withdraw all amounts credited to their account including all employer contributions, if the plan provisions so provide. Therefore, the entire account balance in these circumstances could be used to purchase life insurance.

The participant's income tax consequences

From an income tax perspective, plan assets that are used to fund life insurance death benefits are treated differently than other plan assets held to provide for retirement benefits. That is because, although plan assets generally are not taxable to the participant (or beneficiary) until they are distributed, the provision of current life insurance protection is treated as a taxable benefit. Consequently, the participant is required to include in gross income the value of the pure (or "at-risk") life insurance protection element of the coverage during the tax year; which is determined by using the lower of the government's Table 2001 rates (which replace the former P.S. 58 rates) or the insurer's alternative one-year renewable term rates.

Estate tax consequences

In accordance with IRC § 2042, an insured's gross estate includes the amount of any death benefit from a policy in which the insured had incidents of ownership which, among other things, include the right to name a beneficiary. The result is that because participants under a qualified plan usually have the right to name a beneficiary for their coverage, the death benefit will be included in their gross estate.

Additionally, whereas the death benefit from a life insurance policy generally would be income tax free to the policy beneficiaries, those held within a qualified plan may be subject to partial income tax inclusion on distribution to the beneficiary; i.e., the amount of the pure insurance protection is received by the beneficiary free of income tax, while the amount of the policy's cash value paid as a death benefit is taxable. The beneficiary will be entitled to an income tax deduction for the estate tax attributable to the life insurance that was included in the participant's estate.

Qualified plan exit strategies

When considering the purchase of life insurance inside a qualified plan, it is important to also consider what happens if you need to remove the life insurance from the plan or no longer want the death benefit protection. There are several options:

Take a taxable distribution

If the participant is otherwise eligible for a distribution from the plan, the life insurance policy could be distributed to the plan participant directly from the qualified plan and the participant may continue to maintain the policy as a stand-alone insurance policy. The result is that, upon distribution, income tax is due on the fair market value of the policy. Keep in mind that income tax paid on the distribution will further increase the basis in the policy thus providing greater tax advantaged access to policy values.

Purchase the policy

The life insurance policy may be purchased for its fair market value and maintained outside of the plan unchanged. This purchase is not a taxable event as long as the policy is purchased for its fair market value by the insured participant, his or her spouse, a relative who is a beneficiary under the plan, or an irrevocable trust established by the participant.

Additional estate tax benefits may be achieved by a sale to an Irrevocable Life Insurance Trust. If there is a funded trust, then those assets may be used to purchase the policy for its fair market value and thus remove the eventual death benefit from inclusion in the estate of the insured participant.

Surrender the policy
If the plan participant no longer needs or desires life insurance protection, the plan may surrender the life insurance contract and retain the cash surrender value inside the qualified retirement account. Keep in mind the plan participant will have, for the purposes of taxation on distributions from the plan, a basis for income taxes previously paid for the insurance death benefit protection and will only be taxed on previously untaxed amounts.

Advantages of life insurance in a qualified plan

- The plan participant can obtain life insurance coverage with existing assets
- The current cost of life insurance to the plan participant is less than if the policy were purchased with after tax dollars
- The plan participant does not have to administer the policy. The plan trustee handles the administration
- Qualified plan contributions may be tax-deductible to the business

Disadvantages of life insurance in a qualified plan

- The value of the cost of the pure term insurance is income taxable annually to the plan participant
- A portion of the death benefit may be subject to income tax to the beneficiaries
- The death benefit will be included in the plan participant's gross estate for estate tax purposes as compared to a policy held in an irrevocable trust
- There is a limit on the amount of life insurance death benefit that may be held
- If the employee changes jobs, the plan may not be able to continue to the own the policy and it may have to be surrendered or transferred to the employee in a taxable transaction

Conclusion

Life insurance is a unique asset, and its inclusion in qualified plans can be an effective planning tool that helps to provide a death benefit via an existing asset while at the same time, if used effectively, provides continued accumulation for retirement planning purposes.

Please remember that purchasing life insurance in a qualified plan gives rise to complex tax considerations that need to be carefully analyzed when evaluating the advisability such an investment and the extent to which funds should be committed to its purchase.

Also note, not all life insurance companies allow their policies to be held in qualified plans due to reporting and potential policy valuation considerations. At this time Nationwide does not allow its policies to be held in qualified plans.

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