When Insurance Products Meet Retirement Plans

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PART I: LIFE INSURANCE INSIDE A RETIREMENT PLAN

This PART I explains the tax consequences (to the participant and beneficiaries) of life insurance held inside a retirement plan. ¶ 8.2 explains the *income tax* rules applicable to the plan participant and his beneficiaries when life insurance is held in a qualified retirement plan (QRP). ¶ 8.3 discusses the choices regarding the policy that arise at the participant's retirement. See ¶ 8.4 for the *estate tax* consequences and other planning considerations with respect to plan-owned life insurance.

This Report discusses plan-owned life insurance only from the perspective of the participant and beneficiaries. Rules that are of concern only at the plan level (such as the limits on how much life insurance may be purchased in a QRP, and ERISA fiduciary investment rules) are beyond the scope of this Report. For other sources, see the Bibliography. Similarly, the analysis of insurance products is beyond the scope of this Report.

8.2 Plan-Owned Life Insurance: Income Taxes

This ¶ 8.2 explains the *income tax* and income tax -related rules applicable to the plan participant and his beneficiaries when life insurance is held in a qualified retirement plan (QRP).

8.2.01 ***Tax consequences to participant: During employment***

In this Report, **Current Insurance Cost** means "the amount the participant is required to include in gross income (or pay himself) because of the plan-held life insurance."

A. **Income taxes due on "Current Insurance Cost."** When a retirement plan owns a life insurance policy on the participant's life, payable to the participant's beneficiary, the participant must pay income tax, each year, on the portion of the employer's plan contribution (or of the plan earnings) that is deemed to be providing pure life insurance protection for him (as opposed to adding cash value in the policy). Reg. § 1.402(a)-1(a)(3); § 1.72-16. This is an exception to the normal rule that an employee pays no income tax on his employer's contributions to a retirement plan, or on plan earnings, until these are actually distributed to him. § 402(a). The participant can avoid the imputed income by paying the cost of the pure insurance protection himself, rather than having it paid by the plan.

The Current Insurance Cost is determined, for each year that the policy is held in the plan, in two steps. The first step is determining the <u>amount of life insurance protection</u> that the participant due to the plan-owned policy. The second step is to determine the <u>amount applied to purchase</u> such life insurance protection. § 72(m)(3)(B); Reg. § 1.72-16(b).

1. **How to determine the amount of life insurance deemed provided.** The amount of life insurance protection that the plan is deemed to have purchased for the employee in any year is the amount of the *death benefit* payable under the policy ("at any time during the year"), minus the *cash surrender value* (CSV) of the policy (determined as of the end of the year). Reg. § 1.72-16(b)(3). It is not clear how to

determine this amount (which is sometimes called the "net amount at risk" or "pure insurance") if the death benefit changes during the year.

2. **How to determine the amount applied to purchase the pure insurance.** Once the amount of "pure insurance" is thus determined, the IRS next tells us how much of the employer contribution and plan earnings are deemed to be applied to purchase this life insurance protection. According to Notice 2002-8, 2002-4 I.R.B. 398, the cost of the pure insurance may be determined using Table 2001 (¶ 8.2.02), *or* (if certain conditions are met) may be based on the insurer's actual term insurance rates, if lower (¶ 8.2.03).

B. **10 percent penalty if under age 59½.** Generally, retirement plan distributions to the plan participant are subject to a 10 percent "additional tax" if made while the participant is younger than age 59½. § 72(t)(1). There are more than a dozen exceptions to this general rule. One of the exceptions is that the deemed distribution resulting from the Current Insurance Cost is not subject to the penalty. IRS Notice 89-25, 1989-1 C.B. 662, A-11. For more on the premature distributions penalty and the exceptions thereto, see Chapter 9 of *Life and Death Planning for Retirement Benefits*.

C. **Minimum required distributions.** Generally, a plan participant must start taking annual distributions from his retirement plan(s) at approximately age 70½ (or in the case of some plans and some participants, upon retirement if later). § 401(a)(9). The Current Insurance Cost that the employee must include in his gross income each year is *not* treated as a distribution to him for purposes of satisfying this minimum distribution requirement. Reg. § 1.401(a)(9)-5, A-9(b)(4), (6). For more on minimum required distributions, see Chapter 1 of *Life and Death Planning for Retirement Benefits*.

8.2.02 ***Current Insurance Cost: From P.S. 58 to Table 2001***

The rules for determining the Current Insurance Cost have changed over the years.

Originally, Rev. Rul. 55-747, 1955-2 C.B. 228, provided a table, called "P.S. 58," to calculate the amount includible in the participant's gross income. This ruling was later modified by Rev. Ruls. 66-110, 1966-1 C.B. 12, and 67-154, 1967-1 C.B. 11, which expanded Table P.S. 58 and also provided that the insurer's lowest published rate for one-year term insurance available on an initial issue basis for "all standard risks" could be used if that rate was lower than the "P.S. 58 cost." Although the "P.S. 58-or-insurer's-actual-rates-if-lower" regime lasted for several decades, there was a continuing problem: The P.S. 58 table rates were unrealistically high, while some parties were tempted to use alleged "insurer's actual rates" that were unrealistically low, in the sense that the insurer rarely if ever sold one-year term insurance at such rates.

In Notice 2001-10, 2001-5 I.R.B. 459, the IRS revoked Rev. Rul. 55-747, thus killing Table P.S. 58; published a new table, "Table 2001," with considerably lower rates; and announced its intention to issue further rules on this subject, and to prevent abuse of the "insurer's actual rates" alternative.

8.4.08 ***Plan-owned life insurance subject to spousal ERISA rights***

Under a qualified retirement plan, the surviving spouse of a deceased employee/participant is given certain inheritance rights, which may be as much as 100 percent of the death benefit under the plan. See § 401(a)(11) and § 417, and Regs. § 1.401(a)-20 and § 1.417(e)-1. The spouse can waive this right if various requirements are met. For full details on spousal rights under plans, including how to waive such rights, see ¶ 3.4 of *Life and Death Planning for Retirement Benefits*. The plan death benefit for this purpose *includes* proceeds of any life insurance policy held in the plan. Reg. § 1.401(a)-20, A-12(b).

PART II: MINIMUM DISTRIBUTION RULES FOR ANNUITIZED PLANS & IRAS

Most practitioners are familiar with the minimum required distribution (MRD) rules for Defined Contribution (DC) plans, also called individual account plans. Those rules are explained in Chapter 1 of *Life and Death Planning for Retirement Benefits*. This PART II explains the completely different MRD rules that apply to defined *benefit* plans and to defined contribution plans that are annuitized.

10.1.04 ***What a "Defined Benefit plan" is***

A Defined Benefit (DB) plan is a type of qualified retirement plan (i.e., qualified within the meaning of § 401(a)). Under a DB plan, also called a "defined benefit pension plan," the employer promises to pay the employee a specific pension, starting at retirement, and continuing for the employee's life. Social Security is similar to a DB plan.

A. **"Classic" DB plan.** Under the classic type of DB plan, the amount of the pension is based on a formula, such as "a monthly pension for life, beginning at age 65, equal to 1/12th of 1 percent of final average compensation times years of service, reduced by 10 percent for each year of service less than 10 if the employee has less than 10 years of service, and up to an annual maximum of 40 percent of career average compensation."

The formula may award a lower percentage for compensation below the Social Security tax wage base than for compensation in excess of such base. This is called the "permitted disparity." The formula will contain adjustments for early or late retirement.

The employer hires an actuary to tell it, each year, the minimum amount it *must* contribute to the plan (and how much extra it *may* contribute) (both limits being set by the tax Code) in order to amortize the employer's future obligations to retiring employees under the plan.

B. **Cash balance DB plans.** There is another type of DB plan, called a **cash balance plan**, which uses a different type of formula. "A cash balance plan is a defined benefit plan that defines benefits for each employee by reference to the employee's hypothetical account. An employee's hypothetical account is determined by reference to hypothetical allocations and interest adjustments that are analogous to actual allocations of contributions and earnings to an employee's account under a defined contribution plan." Reg. § 1.401(a)(4)-8(c)(3)(i).

Under a cash balance plan, contributions are more uniform across age groups, making cash plans more attractive than classic DB plans for younger employees (and less generous for older employees). …

D. **Investment and longevity risks.** Under a DC plan, the participant owns identifiable assets held in an account with his name on it. The value of the account fluctuates depending on investment results, but no party to the proceedings has any money staked on the question of how long the participant will live. With a DC plan, the risk that the participant will outlive his money falls on the participant.

With a DB plan, the plan (or insurance company issuing the annuity contract used to fund the benefits) takes the excess-longevity risk. See Wanda Example, ¶ 10.2.05.

Theoretically, under a DB plan, the plan also takes all the investment risk. If the plan's investments go down in value, the employee's promised benefit remains the same; the employer must contribute more money to the plan to fund that benefit. There are two exceptions to this statement. First, under one type of annuity, the variable annuity, the participant also has investment risk; see PART III(A)(1). Second, the employee has the risk that the employer will default on its obligation to fund the plan. If the plan becomes insolvent and/or the employer goes bankrupt, the employee may find his benefits limited to the amount insured by the government's pension insurer, the Pension Benefit Guarantee Corporation (PBGC). The employee will not receive the full benefits promised by the plan.

10.1.05 ***What a "Defined Contribution plan" is***

A Defined Contribution (DC) plan is, along with the Defined Benefit plan, one of the two broad categories of qualified retirement plan (QRP). DC plans are also called "individual account plans." § 414(i). IRS regulations use the terms individual account plan and defined contribution plan interchangeably; thus even individual account plans that are NOT QRPs (such as IRAs and 403(b) plans) may be considered DC plans.

Under a DC plan, the employer may commit to making a certain level of contribution to the plan (such as "10% of annual compensation," an example of a Money Purchase plan formula), or (under a profit-sharing plan) may make such contributions periodically on a discretionary basis or based on profit levels. 401(k) plans and ESOPs are other examples of DC plans.

Once the employer has contributed to the DC plan, the contributions are allocated among accounts for the individual participants who are members of the plan. What the participant will eventually receive from the plan is determined by (1) how much is allocated to his account under the contribution formula and (2) the subsequent investment performance of that account. The employer does not guarantee any level of retirement benefits. If the plan's investments do well, the profits will increase the participant's account value. If the plan's investments do poorly, the participant will receive less at retirement.

If the plan is **self-directed**, each participant makes the investment decisions for his own account in the plan, from a menu of alternatives permitted by the plan. The menu may be broad or may be limited to a few mutual funds. If the plan is not self-directed, the investments are determined at the plan level by the trustee of the plan…