Life Insurance in Qualified Defined Contribution Plans

By Elizabeth A. LaCombe

At first blush, offering life insurance in a qualified defined contribution plan sounds like a cost efficient way to provide your employees with life insurance protection. While that may be true, there are certain considerations that need to be taken into account before you decide whether to offer life insurance as an investment option under a qualified plan.

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In this article we will explore what a plan sponsor should consider from a practical perspective before offering life insurance as an investment option under a qualified defined contribution plan. Specifically, Part I will address the federal income tax qualification issues associated with offering life insurance under a qualified plan, and Part II will address special considerations associated with plans that are covered by the Employee Retirement Income Security Act of 1974 [29 U.S.C.A. § 1051].

Part I: The Internal Revenue Code

The Nondiscrimination Rules

It is well established that life insurance is a benefit, right, and feature under a qualified plan. Accordingly, in order to offer life insurance as an investment option under a plan, it must be offered in a manner that is not discriminatory, both in form and in effect. Code Section 401(a)(4) states that either the contributions or benefits provided under a plan must not discriminate in favor of the highly compensated employees. Specifically, all benefits, rights, and features under a plan must be *currently* and *effectively* available in a nondiscriminatory manner [Treas. Reg. § 1.401(a)(4)-1(b)(3)].

The regulations promulgated under Code Section 401(a)(4) reflect that the currently available requirement is satisfied if the group of employees to whom a benefit, right or feature is offered satisfies the mathematical tests of Section 410(b). In a nutshell, Code Section 410(b) indicates that, in order for a plan to be qualified, either:

1. The plan benefits at least 70% of the NonHighly Compensated Employees (NHCEs);
2. The percentage of NHCEs who benefit under the plan is at least 70% of the Highly Compensated Employees (HCEs) that are benefiting under the plan; or
3. The plan satisfies the nondiscriminatory classification test under the average benefit test of Treasury Regulation Section 1.410(b)-5.

For this purpose, "an employee is treated as benefiting only if the benefit, right or feature is currently available to the employee" [Treas Reg. § 1.401(a)(4)-1(b)(1)]. As indicated by the IRS in numerous private letter rulings, the intent of the plan sponsor is not conclusive in determining whether a benefit is currently available. It simply makes sense to offer life insurance to all NHCEs. Even if no NHCEs accept the offer, the life insurance benefit should satisfy the current availability test.

The effectively available requirement is satisfied, if, based upon the facts and circumstances, the group of employees to whom the benefit, right, or feature is effectively available, does not substantially favor highly compensated employees [Treas. Reg. § 1.401(a)(4)-4(c)]. The Treasury Regulations provide an example of a benefit offered under a plan that substantially favors HCEs, and is therefore not effectively available to the NHCEs. In that example, an age and service condition precludes all but two NHCEs from qualifying for the plan's early retirement benefit, and is therefore not effectively available to the NHCEs. If a plan sponsor offered life insurance, carte blanche, to all participants, it would be difficult to argue that this benefit is not "effectively available" to all employees or that it discriminates in favor of highly compensated employees.

To summarize, if life insurance is offered under a tax qualified plan, it must be currently and effectively available to all employees on a nondiscriminatory basis. Plan fiduciaries should familiarize themselves with the nondiscrimination rules before offering life insurance as an investment option under the plan. The failure to satisfy the Section 401(a)(4) rules is difficult to correct under the Employees Plan Compliance Resolution System, or EPCRS, and may result in plan disqualification [Rev. Proc. 2008-50, 2008-2 C.B. 464]. However, there is the possibility of retroactive correction within 9½ months following the close of the plan year under Treasury Regulation § 1.401(a)(4)-11(g).

The Incidental Benefit Rule

A plan may offer life insurance as an investment option provided that the death benefit protection is an "incidental benefit;" i.e., a benefit incidental and subordinate to the plan's primary purpose of providing deferred compensation to participants and their beneficiaries. Specifically, Treasury Regulations indicate that "[a] profit-sharing plan within the meaning of Section 401 is primarily a plan of deferred compensation, but the amounts allocated to the account of a participant may be used to provide for him or his family incidental life or accident or health insurance" [Treas. Reg. § 1.401-1(b)(1)(ii)]. In other words, the payment of premiums for life insurance is limited to ensure that the benefit being offered, i.e., death benefit protection, is incidental to the plan's primary purpose of providing deferred compensation.

The amount from a participant's account which may be allocated towards the payment of premium due under a life insurance policy varies in accordance with the type of plan being sponsored, as well as the type of insurance that is being offered. As indicated, for purposes of this discussion, we will assume that life insurance is being offered as an investment option under a defined contribution plan.

An employees' pension, profit-sharing, or stock bonus plan, intended to qualify under Code Section 401, must provide primarily for benefits, the distribution of which is deferred. In Revenue Ruling 60-83, the IRS indicated that a trust forming a part of a profit-sharing plan having once established its qualification under Section 401(a) may subsequently lose its exemption from tax, if its funds are distributed in a prohibited manner [1960-1, C.B. 157]. The use of trust funds to pay for the cost of current benefits, such as life insurance protection, for participants and their beneficiaries, is a distribution [Treas. Reg. § 1.402(a)-1(a)(3)]. The IRS ruled that if the terms of a defined contribution plan provide for the use of trust funds to pay premiums for life insurance, and the contributions have been held for at least two years, the incidental benefit test is satisfied, and the distribution that occurs as a result of purchasing insurance is not one that disqualifies the plan.

If the trust funds that are being used to pay premiums on a whole life insurance policy have not been held for at least two years, the plan must satisfy what is known as the 50%/25% rule. That is, the total amount of premiums paid on a whole life policy must at all times be less than 50% of the aggregate of contributions and forfeitures allocated to the credit to a participant (disregarding trust earnings and capital gains and losses). In addition, the plan must: (a) require the trustee to convert the entire value of the life insurance contract at or before retirement into cash, (b) provide periodic income so that no portion of the value may be used to continue life insurance protection after retirement, or (c) distribute the policy to the participant [Rev. Rul. 73-501, 1973-2 C.B. 127, as modified by Rev. Rul. 74-307, 1974-2 C.B. 126; Rev. Rul. 70-611, 1970-2 C.B. 89, as modified by Rev. Rul. 85-15, 1985-1 C.B. 132; Rev. Rul. 61-164, 1961-2 C.B. 99].

If, instead of purchasing whole life insurance protection, plan assets that have not been held for two years are being used to purchase term or universal life insurance, the rules reflected above generally apply with one exception. That is, the total amount of premiums paid must not exceed 25% of the aggregate of contributions and forfeitures allocated to the credit to a participant (disregarding trust earnings and capital gains and losses) [Rev. Rul. 61-164, 1961-2 C.B. 99, and Rev. Rul. 66-143, 1966-1 C.B. 79].

How to Structure the Deal

Although it may sound simplistic, a best practice in setting up the policy is to designate the plan as the policy owner and beneficiary, and designate the participant as the insured. Because qualified trust funds are being used to fund the policy, the policy itself is a plan asset and, hence, is subject to the "exclusive benefit" and "anti-assignment and alienation" provisions discussed below.

Code Section 401(a)(2) provides that the trust instrument of a qualified trust must make it "impossible, at any time prior to the satisfaction of all liabilities with respect to employees and their beneficiaries under the trust, for any part of the corpus or income to be (within the taxable year or thereafter) used for, or diverted to, *purposes other than for the exclusive benefit of his employees or their beneficiaries.*" This rule, generally referred as the "exclusive benefit rule," ensures that plan assets will be held for the exclusive benefit of plan participants and their beneficiaries.

If the owner or beneficiary of a life insurance policy is someone other than a plan participant, arguably the exclusive benefit rule would be violated as these parties could exercise their rights under the policy to divert plan assets away from the participant, and his or her beneficiaries. In addition, allowing an individual other than a plan participant to serve as the owner or beneficiary of a life insurance policy may cause the plan to run afoul of the anti-assignment and alienation provisions set forth in Code Section 401(a)(13). Those provisions generally prohibit the assignment or alienation of benefits under the plan.

That said, if a participant currently owns an individual life insurance policy, could he or she transfer it to the plan? To the extent the terms of the plan permit, a participant may be able to transfer an existing individual life insurance policy to the plan without running afoul of the prohibited transaction rules set forth under the Internal Revenue Code as well as ERISA.

Specifically, Prohibited Transaction Exemption 92-5 provides that if:

1. A plan pays, transfers, or otherwise exchanges not more than the lesser of: (a) the cash surrender value of the contract; or (b) in the case of a defined contribution plan, the value of the participant's account balance;
2. Such sale, transfer, or exchange does not involve any contract which is subject to a lien which the plan assumes;
3. Such sale, transfer, or exchange does not contravene any provision of the plan or trust document; and
4. A plan does not with respect to such sale, transfer, or exchange, discriminate in form or in operation in favor of participants who are officers, shareholders, or highly compensated employees then, the exemption from the restrictions set forth in ERISA Sections 406(a) and 406(b)(1) and (2) and from the taxes imposed by Code Section 4975(a) and (b), by reason of Code Section 4975(c)(1) (A) through (E), is available.

In other words, as long as the proposed sale, transfer, or exchange of an individual life insurance policy owned by a plan participant to a plan satisfies the conditions set forth above, the participant and the plan will enjoy immunity from the penalties and taxes on prohibited transactions set forth in the Internal Revenue Code and ERISA.

Consider an Exit Strategy

When evaluating the prudence of offering life insurance as an investment option, it would behoove a plan sponsor to consider the federal income tax consequences associated with transferring life insurance out of a plan. Life insurance, unlike other investment options under a plan, is not liquid and presents unique challenges from a tax planning perspective. Accordingly, the plan sponsor should consider the options that are available to plan participants if the participant no longer wants to have insurance through the plan or the plan sponsor wants to cease offering life insurance as an investment option under the plan.

Let's consider the first scenario. Assume that a participant no longer wants or needs death benefit protection, what options does the participant have? If a participant does not want or need death benefit protection, he or she may ask the trustee to cash in the policy and reallocate the proceeds among other investment options under the plan. Because neither the proceeds nor the policy would ever leave the tax qualified trust, the participant would not be subject to federal income taxation on this reallocation of trust funds.

If, in the alternative, a participant wants to own the policy in his or her individual capacity for estate planning purposes, what options does the participant have?

Assuming that the terms of the plan permit, and that there has been a distributable event under the plan, the following options may be available:

1. The participant could request and receive a distribution of the policy from the plan. In 2005, the IRS amended regulations promulgated under Code Sections 79, 83, and 402(a), to address distributions of life insurance and related products from qualified plans. These regulations provide that if a qualified plan transfers property to a plan participant in exchange for consideration that is less than the fair market value of the property, the transfer will be treated as a distribution by the plan to the participant to the extent the fair market value of the distributed property exceeds the amount received in exchange. For federal income tax purposes, the participant would include in income the cash surrender value of the policy distributed less any P.S. 58 costs. P.S. 58 costs are one-year term premiums that are treated as taxable distributions and are reported annual on Forms 1099-R. The participant receives basis or credit for amounts previously subject to taxation to ensure that such amounts are not subject to taxation again.
2. Federal taxation could be avoided if the participant converted the policy into an annuity without a life insurance element, or directly rolled the policy over into a new employer's plan. The latter option would be available if the new employer offered life insurance as an investment option under the plan and the requirements of Department of Labor Prohibited Transaction Exemption 92-6 were satisfied. To qualify for relief from the prohibited transaction rules under ERISA as well as under the Internal Revenue Code, the following requirements must be satisfied: (a) the sale must be to a participant or to a relative of the participant who is a beneficiary under the contract; (b) the plan, but for the sale, would surrender the contract; and (c) the purchase price must put the plan in the same cash position as if it had retained the contract, surrendered it, and distributed the participants vested interest in the plan. [*See* PTE 92-6.] The Department of Labor expanded PTE 92-6 in 2002 to allow transfers of contracts directly to life insurance trusts and other personal trusts.
3. The trustee could cash in the policy and distribute the proceeds of the policy to the participant. The participant would be subject to federal income tax on the cash surrender value of the policy without regard to P.S. 58 costs. In that regard, the distribution is taxed in the same manner as any other distribution from the plan. However, unlike Option 1 above, by cashing in the policy, the participant would be able to roll over the proceeds of the policy to an IRA. Please note that a life insurance policy may not be rolled over into an IRA because life insurance is not a permitted investment for IRAs.
4. Finally, the trustee of the plan could take a loan against the cash surrender value of the policy, leaving just enough cash surrender value to equal the policy's P.S. 58 costs. The plan could then distribute the policy to the participant income tax free. The amount borrowed by the trustee from the policy could be rolled over into an IRA. The participant could then cash in the policy or continue to maintain it using after tax money or withdrawals from the IRA to repay the loan. The participant, of course, would also be responsible for the payment of future premiums due under the policy, as well as repayment of the policy loan.

Selection of which option may be best for the participant depends upon the facts and circumstances of each case with guidance from local tax counsel. For example, if the life insurance policy is a Modified Endowment Contract, or a MEC, as defined under Code Section 7702A, distributions from such policy, including loans, are taxed on an income-out-first basis and, if the participant is not age 59½, may also be subject to a 10% premature distribution penalty. If the policy is a MEC while owned by the plan, the policy will, absent IRS correction, also be a MEC when transferred to the individual. The federal income tax treatment of MECs may dissuade plan sponsors from cashing out such policies, or allow participants to take loans against them, while they are still owned by the plan as they could generate unrelated business income tax for the qualified trust.

Having said that, if a plan sponsor is thinking of offering life insurance as an investment option under a plan, he or she should ensure that the terms of the plan are flexible enough to cover those situations where the participant either no longer desires insurance protection or wants to own such coverage outright.

Taxation of the Death Benefit

Unlike life insurance that is owned outright by an individual, when a qualified plan owns life insurance, only a portion of the death benefit is free from federal income tax. Specifically, the excess of the face amount of the policy over the policy's cash surrender value is excluded from income for federal income tax purposes. [*See* Code Sections 72(m) and 101(a).] The amount included in the beneficiary's gross income is equal to the excess of the cash surrender value of the policy less the insured's cost basis in the policy.

> **Example.** A participant in a qualified plan has a life insurance policy with a face amount of $140,000, and P.S. 58 costs totaling $10,000. The participant dies and the proceeds from the policy are distributed to the participant's spouse as beneficiary. Immediately preceding the insured's death, the cash surrender value of the policy is $35,000.

The federal income tax free portion of the distribution may be calculated as follows:

$140,000 Face Amount
-25,000 Net Cash Value
$115,000

The taxable portion of the distribution may be calculated as follows:

$35,000 Cash Value
-10,000 PS-58 Costs
$25,000

If there were any additions to the policy, or riders, such additional amounts would be included in the determination of the tax-free and taxable portions of the distribution.

Part II: Special Considerations Under ERISA

Is Life Insurance a Prudent Investment?

Under ERISA, plan fiduciaries must discharge their duties solely in the interest of plan participants and beneficiaries. In doing so, fiduciaries must act with the care, skill, prudence, and diligence under the prevailing circumstances that a prudent person acting in a like capacity would use. For our purposes, ERISA requires that fiduciaries diversify the assets of plans so as to minimize the risk of large losses, unless under the circumstances it is not prudent to do so. Finally, plan fiduciaries must act in accordance with the terms of their plan documents, only insofar as such documents are consistent with the prudence and diversification requirements, and they must avoid prohibited transactions.

There are no specific restrictions under the Internal Revenue Code with respect to investments that may be made by the trustees of a trust that qualifies under Code Section 401(a). "Generally, the contribution may be used by the trustees to purchase any investments permitted by the trust agreement to the extent allowed by local law" [Treas. Reg. § 1.401-1(b)(5)(iii)]. Therefore, a plan fiduciary may determine that it is prudent to offer life insurance as an investment option under a plan, provided that the terms of a plan do not prohibit the purchase of life insurance.

Having said that, in Framingham Union Hospital [settled by consent 3/14/90, D.C. Mass.], the Department of Labor charged that the plan sponsor, trustee, insurance carrier, insurance agent, and various executive employees, violated the fiduciary prudence and diversification provisions of ERISA, by, among other things, failing to adequately investigate the propriety of purchasing individual life insurance policies.

Accordingly, before a plan sponsor offers life insurance, he or she may want to review the terms of the plan, and relevant state laws, to ensure that the investment is permissible as well as prudent.

Does Life Insurance Qualify for ERISA Section 404(c) Protection?

In general, ERISA Section 404(c) insulates an employer from liability with respect to participant-directed investment losses. To achieve this protection, an employer must provide an opportunity for a participant or beneficiary to exercise control over the assets in the individual's account. The employer must also "provide a participant…an opportunity to choose, from a broad range of investment options, the manner in which some or all of the assets in his account are invested" [ERISA Reg. § 2550.404c-2(b)(1)(i) and (ii)].

A plan provides a participant with an opportunity to exercise control if, among other requirements, the participant has a reasonable opportunity to give investment instructions to a plan fiduciary who is obligated to follow such instructions. In addition, the participant must be provided with an explanation of the restrictions on transfers to and from an investment alternative. Because life insurance is not a liquid investment option, transfers to or from life insurance are unlikely, and it is doubtful that life insurance would qualify for ERISA Section 404(c) protection.

The possibility that life insurance may not receive ERISA Section 404(c) protection may not be a concern for all plan sponsors, particularly those who have chosen not to comply with ERISA Section 404(c). In those cases, the liability of the plan sponsor for a participant's investment losses will turn upon whether the investment choice was prudent under the circumstances.

Summary

If structured properly, life insurance can be an attractive way to provide death benefit protection to employees through a qualified defined contribution plan. Plan sponsors and fiduciaries must exercise care in selecting the appropriate life insurance product which will pass the nondiscrimination and incidental benefit rules, before offering it as an investment option. In addition, adequately disclosing the advantages and disadvantages of life insurance to plan participants may minimize administrative problems and, hence, may reduce the potential for litigation. ■