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Life Insurance in Qualified Retirement Plans

Why consider life insurance in a qualified retirement plan

Many people need more life insurance coverage, but identifying how to pay policy premiums can be difficult. Consider the business owner saving for retirement. If the worst should happen—especially during working years—life insurance can help replace lost future retirement income.

Qualified retirement plans offer unique solutions when enhanced with the power of life insurance. A qualified plan offers the ability to purchase life insurance with potentially tax-deductible dollars, possibly increasing buying power while maintaining cash flow for the participant.

How it works

First, the qualified plan document must allow for the purchase of life insurance. The sponsoring business works with a third-party administrator (TPA) experienced with life insurance in qualified plans to determine if life insurance is an appropriate fit. As a general rule, life insurance must be offered to all plan participants on a uniform and non-discriminatory basis.

Next, the plan applies for life insurance on the life of the plan participant. Although the plan itself is the owner and beneficiary of the insurance policy, the participant names a personal beneficiary for plan benefits which will include the life insurance policy death benefits.

There are limits on how much life insurance a plan can own. These rules—known as the "incidental benefit" rules—require life insurance be merely an incidental benefit to the plan.

For defined benefit plans

the most common test is the "100-to-1 test." This test looks to the participant's monthly retirement benefit anticipated under the plan. The life insurance policy death benefit cannot exceed 100 times the expected monthly benefit.

For defined contribution plans

the most common test compares plan contributions to the annual policy premium, and the test varies by the type of life insurance used. For whole life insurance, policy premiums can't exceed 50% of annual plan contributions. For term life insurance, the percentage drops to 25%.

There may be exceptions for profit-sharing plans with money that is considered "seasoned." Generally speaking, seasoned money refers to funds that can be distributed to the plan participant after a time limit is met. For seasoned money, the incidental benefit limits may not apply.

Each year the participant generally pays tax on the value of the death benefit received through the plan. This is called the cost of current life insurance protection or reportable economic benefit (REB) and tends to be relatively small, especially during the participant's working years.

In the future

At retirement, the plan participant has several options. The most common include:

1. **Distribute the policy from the plan to the individual:** The participant pays tax on the fair market value (FMV) of the policy and may then continue coverage outside the plan for personal estate planning.
2. **Purchase the policy from the plan:** If the participant wants to keep the insurance coverage but avoid a taxable event, the participant can buy the policy from the plan for its FMV. Even further, if the participant has a need for wealth transfer planning, their grantor trust could potentially purchase the policy directly from the qualified plan.
3. **Surrender the policy inside the plan:** If the insurance is no longer needed, the plan can surrender the policy. The surrender proceeds can potentially be rolled to an IRA alongside the remainder of the participant's retirement benefit.

If the participant dies during working years, a portion of the death benefit passes income-tax-free to the participant's beneficiaries assuming the participant properly reported REB. The income-tax-free[1] amount is generally the amount in excess of the cash value of the contract known as the "net amount at risk." The remainder is generally income taxable.

The ideal clients

- Many business owners with predictable income streams
- Former business owners or executives with a sizeable IRA containing funds that used to be in an ERISA plan under the Employee Retirement Income Security Act of 1974

Considerations:

The rules on life insurance in qualified plans are complex, and these strategies are not for everyone. Individuals considering these strategies should always work with a TPA experienced with life insurance in qualified plans to help navigate these rules and determine if life insurance is a fit.

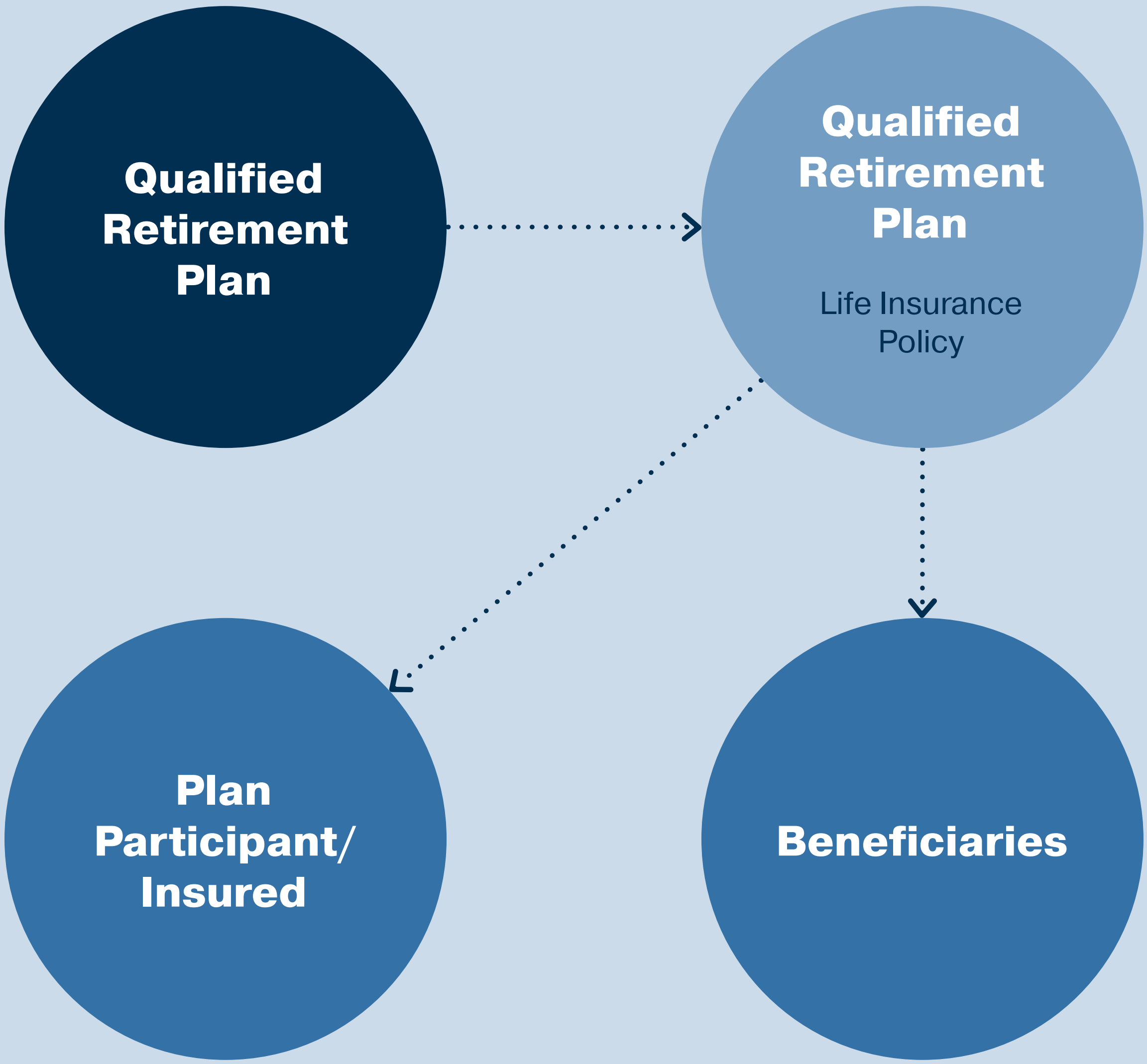
- Not everyone qualifies for life insurance. Age, health, and other factors will determine if life insurance is available and cost-effective.
- There are costs associated with life insurance in qualified plans including TPA fees, possible monthly policy charges, and paying tax on the REB. Individuals should consider the long-term goals for the insurance coverage and weigh the costs against buying life insurance outside the plan.
- Qualified plan assets are included in the estate of the participant. Individuals with a taxable estate might instead consider life insurance owned by an irrevocable trust or other ownership arrangements.

Benefits:

- If the participant dies during working years, life insurance can help self-complete the retirement benefit and make up for lost years of savings.
- When a defined benefit or cash balance plan includes life insurance, the business can potentially get a larger income tax deduction for defined benefit plan contributions without reducing the retirement benefit.
- Life insurance premiums are usually not tax deductible. However, when purchased in a qualified retirement plan, contributions to the qualified plan may potentially be deductible. This means the life insurance premiums may be paid with pre-tax dollars.
- Buying life insurance in a qualified plan can potentially unlock dollars to pay policy premiums. For the right individual, this may be an efficient way to buy life insurance.
- By paying tax on the REB, the participant can help ensure a portion of the policy's death benefit is paid income-tax-free[2].
- While state laws vary on the creditor protection of life insurance, qualified plans typically receive federal creditor protection under ERISA.

Legal documents needed

The qualified plan document must allow for the purchase of life insurance. If the qualified plan document does not currently allow for life insurance, it could possibly be amended to do so.



Steps to Set-Up

1. Plan document allows plan to own life insurance
2. Plan offers life insurance as additional benefit
3. Working with TPA, plan buys life insurance
4. Participant pays tax on REB
5. At retirement, participant can buy policy from the plan or take a taxable distribution
6. At death, benefits pass to named beneficiaries

Important Information for Illustration

Does the plan document allow the plan to own life insurance?

Any prior plans from previous employers (including funds rolled to an IRA)**?**

What is the name of the pension trust and state of domicile for the company?

Employee's Vital Information

Name:

Gender:

Date of birth:

Underwriting classification:

Is the employee an owner of the employer? If yes, what %?

Is the employee related to an owner of the employer? If yes, relationship?

What are the combined federal and state income tax rates of the employee?

Premium amount:

Mode of payment:

Note: The Third Party Administrator (TPA) should provide the premium or death benefit requirements per employee.

How long will premiums be paid?

Do you want to specify a death benefit?

What is the death benefit, level or increasing and any changes?

What is the solve goal?

What is the rate of return, if applicable?

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[1]Accessing cash value will reduce your policy death benefit and values, may result in certain fees and charges and may require additional premium payments to maintain coverage. Ask your financial professional for details on accessing your cash value, including how it might impact the coverage guarantees and situations when the values you access could be taxable. Always consult your tax advisor before accessing your policy's cash value.

[2]For federal income tax purposes, life insurance death benefits generally pay income tax-free to beneficiaries pursuant to IRC Sec. 101(a)(1). In certain situations, however, life insurance death benefits may be partially or wholly taxable. Situations include, but are not limited to: the transfer of a life insurance policy for valuable consideration unless the transfer qualifies for an exception under IRC Sec. 101(a)(2)(i.e. the transfer-for-value rule); arrangements that lack an insurable interest based on state law; and an employer-owned policy unless the policy qualifies for an exception under IRC Sec. 101(j).

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