Life Insurance in Qualified Plans

Producer Guide

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Life Insurance In Qualified Plans

While qualified plans are a tremendous retirement savings vehicle, they can also be used to facilitate the purchase of life insurance. Finding the funds to pay premiums is usually the biggest obstacle to selling life insurance. As an agent if you can help find the funds to pay premiums without disrupting the policy owner's lifestyle, closing the sale will be much easier.

An Alternative Premium Source

Qualified retirement plan dollars can be used as a source for premium dollars. Many types of qualified plans allow the trustee to purchase life insurance as an investment for plan participants. With an understanding of how this works you can show clients a new way to pay for the death benefits they want their families to have.

Three Alternatives for Paying Premiums

Most people have three potential sources of funds to pay their life insurance policy premiums:

- **Personal Funds:** Premiums can be paid from salaries, bonuses and other after-tax earnings or compensation. This alternative is very simple. The life insurance premiums are an expense that is paid from funds left over after income taxes.
- **Business Funds:** Business owners and their key employees may be able to use business dollars to pay their premiums. The business can provide premium funds as a selective benefit to its key people, including top management, officers, directors and highly compensated employees. For most other employees, using business dollars is not an option.
- **Qualified Plan Funds:** Employees who are participants in certain qualified pension and profit sharing retirement plans may be able to have their plan trustee purchase and pay for their life insurance. In many cases paying premiums through their qualified plan can make good financial sense. Many people are not aware of this possibility.

Using Your Qualified Plan to Pay Premiums Can Be Financially Efficient

The tax treatment of life insurance inside of a qualified retirement plan usually provides an overall cost advantage when compared with life insurance personally owned by the plan participant. This is because using personal funds is usually the most expensive way to pay premiums. In order to use personal funds, the employee needs to use after-tax dollars. This means that the employee must earn more than that policy premium amount so that after taxes sufficient dollars remain to pay the premium. The table below shows a simple example of the gross amount of earnings that will be required to provide enough funds to pay the stated premium.

Annual Policy Premium	15% Tax Bracket	25% Tax Bracket	33% Tax Bracket	35% Tax Bracket
$1,000	$1,176	$1,333	$1,493	$1,538
$3,000	$3,528	$3,999	$4,479	$4,614
$5,000	$5,880	$6,665	$7,465	$7,690
$10,000	$11,760	$13,330	$14,930	$15,380

When the qualified plan trustee owns the policy and pays the premiums, the employee's out-of-pocket cost is not the amount of the premium. Instead, the cost is the income tax due on the economic value of the pure life insurance coverage that is provided each year. Generally the economic value of this coverage increases each year as the employee gets older and the cost to the employee is the additional income tax he or she must pay on it. This value is computed using IRS Table 2001. It is this rate table and three variables that determine the employee's annual out-of-pocket cost:

- Net death benefit payable to the employee's personal beneficiary(ies)
- Employee's age
- Employee's marginal income tax bracket

Here's an example. Suppose John Weston is 45 years of age. His qualified plan trustee is willing to purchase a policy that will pay a $500,000 life insurance death benefit to his family to help ensure financial security at his death. The plan will pay the annual premium of $5,000. The table below shows the value of the $500,000 death benefit (under the heading Taxable Income) and shows the taxes he will have to pay depending on which of three possible marginal income tax brackets he is in. The income tax he will pay is his out-of-pocket cost:

Age	Taxable Income (Based on Table 2001)	Tax Cost in 15% Bracket	Tax Cost in 28% Bracket	Tax Cost in 35% Bracket
45	$765	$115	$214	$268
50	$1,150	$173	$322	$402
55	$2,075	$311	$581	$726
60	$3,255	$488	$911	$1,139
65	$5,950	$892	$1,660	$2,083

It is clear from the Taxable Income column, the taxable value of the $500,000 of net coverage increases as he ages. His tax cost increases as well (provided he doesn't fall into a lower marginal tax bracket). However, when compared to the actual premium costs the plan pays to the insurer for the coverage, Mr. Weston's out-of-pocket cost looks very reasonable regardless of his income tax bracket.

When the Insured Uses Tobacco Products or is Rated

Using qualified plan dollars to pay premiums is even more efficient when the insured is offered a rated policy. When your client applies for a policy, the insurer considers a number of factors including the overall health and use of tobacco products. Policy premiums will be higher if your client uses tobacco products or if the insurer has concerns about his/her health. If your client uses personal dollars to pay the premiums and is rated, he/she will have to earn more money to pay the premiums. On the other hand, if your qualified plan owns the policy and pays the higher premiums, you should be able to obtain the coverage with no immediate impact on your cash flow and standard of living.

For example, suppose Mr. Wescott is in poor health and has to pay $10,000 in annual premiums instead of the $5,000 that would be required if his health was normal. If he is in a 25 percent marginal income tax bracket, he will have to earn $13,330 in order to have $10,000 left over for premiums after income taxes. With normal health, he would have had to earn only $6,665 to pay the $5,000 after income taxes.

The trustee of Mr. Wescott's qualified plan could own the policy and pay the premiums. Mr. Wescott's out-of-pocket cost will not change appreciably because his cost is not based on the policy premiums. It is possible that his qualified plan account balance may be reduced and that there will be less money in his account to pay out when he retires. But this disadvantage may be offset by his ability to obtain the life insurance coverage for his family without changing his present standard of living. Employees with health challenges or policy ratings who are faced with having to pay premiums larger than they expected should consider having their qualified plan own the policy and pay the premiums.

How It Works

There are rules that must be followed in the implementation of the purchase of the policy by the qualified plan trustee. It is the plan trustee that applies for the life insurance policy and is the owner of the policy. The participant names a beneficiary who will receive the pure insurance portion of the policy death benefit at the insured's death.

In order to comply with Title VII of the Civil Rights Act of 1964, life insurance policies purchased by qualified plans must use unisex rather than sex-distinct rates.

Before a qualified retirement plan can purchase a life insurance policy for a participant, three conditions must be satisfied:

- **Law Must Permit the Purchase:** Not all qualified plans may purchase life insurance policies. For example, by law IRAs and Simplified Employee Pensions Plans (SEPs) may not purchase life insurance.
- **Participant's Plan Must Permit the Purchase:** It is not enough for the law to permit the purchase of life insurance; the employee's specific plan itself must allow the trustee to purchase life insurance. If the document establishing the plan doesn't mention life insurance, the plan needs to be amended.
- **The Purchase Must Not Exceed the Legal Limits:** Congress established qualified plans for the primary purpose of allowing participants to accumulate funds for retirement. Life insurance benefits are allowed under the law only to the extent they are incidental to the retirement benefits. An "incidental benefit rule" was established to make sure plan trustees retained the primary focus of providing retirement benefits. The incidental benefit rule limits how much of a participant's account can be used to pay life insurance premiums; the limit varies depending on the type of qualified plan:

- **Defined Benefit Plans:** The life insurance coverage can't be more than 100 times the participant's projected monthly retirement benefit at normal retirement age. That is, if the projected benefit for a participant is $3,000 per month at age 65, then a $300,000 life insurance policy on the participant is warranted.
- **Defined Contribution Plans:** In these plans the total premiums paid must be less than 25 percent of the employer's total contributions to the plan. However, if the policy purchased is a "whole life" policy, the limit is higher. Total premiums must be less than 50 percent of the employer's total contributions. This 50 percent limit does not apply to cash value policies like universal life or variable universal life. Premiums paid into them (and into term insurance policies) can't exceed the 25 percent limit. The 25 percent and 50 percent limitations are applied on a year-to-year basis. That means that the policy premium in any year must consider contributions made during that year. It is not sufficient to take the cumulative premiums paid in relation to cumulative contributions over the life of the participant's participation in the plan. These limitations don't apply to non-deductible voluntary contributions a participant has made to his/her account.
- **Profit Sharing Plans:** These are defined contribution plans that have been afforded more flexibility for premium payments under the law. The 25 percent and 50 percent limitations apply only during the first two years an employee participates in the profit sharing plan. Funds that have accumulated in a participant's account for more than two years may be used to pay life insurance premiums. This is sometimes called "seasoned money." In addition, participants who have been in the plan for more than five years have no premium limitations at all Any or all of the plan contributions and earnings can be used to pay policy premiums, even contributions made during the last two years. Because of their flexibility, profit sharing plans can be the best qualified pension plans for life insurance.

  Profit sharing plans have another important feature. They are the only qualified plan that is allowed to purchase a second-to die-policy for a participant's account.

Life Insurance in Qualified Plans
Tax Consequences and Considerations

Income Tax Consequences

When a qualified plan owns a life insurance policy, the policy is divided into two parts for tax purposes: the cash value portion and the pure insurance portion. The cash value portion is an investment which is part of the participant's retirement account. Even though it is part of the policy itself, at the insured's death, the cash value is paid to the participant's account and is distributed by the plan trustee as part of the group of assets invested for the participant's retirement. The pure insurance portion is deemed to be separate. It alone is controlled by the participant's policy beneficiary designation. Only this portion of the policy death benefit is paid out to the named policy beneficiary income tax free under IRC Section 101 at the insured's death. The pure death protection is valued based on the insured's age according to IRS Table 2001. The cash value portion is not included in the calculation and does not have any income tax consequences while the insured is alive.

Sole proprietors and partners in partnerships are not required to report the annual economic value of the death benefit as taxable income. Instead, the business is not permitted to take a deduction for the portion of the plan contribution equal to the cost of the annual death benefit protection.

The participant is entitled to count the annual value of the death benefit that is taxed to him or her as basis. Thus, the participant's basis in the policy is the cumulative total of the values reported over the years on his/her income tax returns. If the participant makes non-deductible contributions to the plan, those contributions increase his or her basis.

Estate Tax Consequences

Under IRC Section 2042, the participant's taxable estate must include any life insurance death benefits in which he/she had an incident at the time of death. Incidents of ownership include the ability to:

- name or change the beneficiary
- surrender the policy
- pledge policy cash values
- borrow against the policy

Thus, the qualified plan death benefits are generally includible in the participant's taxable estate for federal estate tax purposes if he or she possessed any of these incidents of ownership at death or received a distribution of the policy and transferred it by gift within the three years before death. To the extent the beneficiary is either the deceased participant's spouse or a qualified charity, the estate should be entitled to an offsetting estate tax deduction.

One strategy for keeping the death benefits out of the estate is for the participant to take a distribution of the policy from the plan, pay the resulting income taxes and gift the policy to an irrevocable life insurance trust (ILIT) or to family members. If the gift of the policy occurs more than three years before the participant's death, the death benefits should be estate tax free. Another strategy is for the participant to establish an ILIT and fund it with enough money for the trustee of the ILIT to purchase the policy from the qualified plan prior to the participant's death for its fair market value. If the purchase of the policy does not involve a gift, the three year rule of IRC section 2035 should not come into play.

A sale of the policy by the qualified plan needs to be carefully considered. A sale involves a potential "transfer for value" under IRC section 101 which could cause part of the death benefit to become income taxable. The sale needs to qualify for an exception to the transfer for value rule to avoid income taxes. Fortunately, a sale to an insured or to a grantor trust established by the insured is such an exception.

Prohibited Transactions

Another important issue involves prohibited transactions. ERISA generally prohibits transactions between a qualified plan and a party in interest even if the transaction is at arm's length and for fair market value. A party in interest includes the employer, the participant, a fiduciary of the plan; a relative of any of the above or a corporation or other entity owned more than 50 percent by any of the above. Fortunately, the Department of Labor (which administers ERISA) has granted several exemptions to the prohibited transactions rule.

In 1977 an exemption was granted for sales of individual life insurance policies owned by the plan. This exemption was updated and clarified in Private Transaction Exemptions (PTE) 92-6. This exception permits the sale of a policy by a qualified plan if several conditions are met:

- Policy must first be offered to the participant before it can be sold to any other party
- Plan can only sell the policy if it would otherwise be surrendering it
- Sale must produce cash proceeds to the plan at least equal to what it would have realized upon a surrender of the policy
- Sale must be to:
  - Plan participant insured under the policy
  - Relative of such participant who is a beneficiary under the policy
  - Employer whose employees are covered by the plan
  - Another employee benefit plan

PTE 92-6 has been updated in Advisory Opinion 98-07A and Advisory Opinion 2006-03A. These updates permit the sale of a second to die policy insuring the participant and his or her spouse to an ILIT created by the participant.

Another strategy that is sometimes used is the sub trust strategy. In this strategy the qualified plan is drafted to include a sub trust that owns the life insurance policy. The participant does not name a beneficiary of the policy, nor can he or she exercise any control over it. The idea is to eliminate all incidents of ownership that could potentially cause a problem under IRC section 2042. The sub trust technique has not been tested in court and the IRS has not issued any rulings on it. Consequently, it may have a significant degree of risk and uncertainty; clients should consult their tax and legal advisors before using it.

Advantages of Life Insurance In a Qualified Plan

- **Personal cash flow is improved:** The employee doesn't have to use personal out of pocket dollars to pay premiums
- **Tax-efficiency is increased:** Premiums are paid with pre-tax dollars; efficiency is increased if the employee's health is poor or the policy is rated.
- **The employee doesn't have to administer the policy:** The plan trustee must administer it
- The employee can obtain the amount of life insurance coverage desired without worrying about the premium cost.

Disadvantages of Life Insurance In a Qualified Plan

- **There is a cost for the coverage:** The value of the pure term insurance element is taxable income annually.
- When the employee retires or changes jobs, the plan may not continue to be able to own the policy. It may have to be surrendered or transferred to the employee in a taxable distribution depending on the plan document's provisions.
- When the qualified plan pays the employee's life insurance premiums, the value of other investments in the account may be reduced, providing fewer assets for distribution during retirement.
- If the policy has cash value, the cash value portion will not be distributed income tax free to the policy beneficiary. Instead it remains in the plan and is distributed by the plan trustee to the employee's designated beneficiary as ordinary income.
- The death benefits may be included in the employee's estate for federal estate tax purposes

Removing the Policy From the Plan at Fair Market Value

In general, the policy cannot stay in the qualified plan after the employee retires, changes jobs or ends his or her participation in the plan If the employee needs or wants to maintain the policy, it must be removed from the plan at fair market value.

In 2004 the IRS issued proposed regulations and other guidance designed to end abuses involving life insurance policies in qualified plans. The proposed regulations were finalized on August 29, 2005 and create a uniform standard for valuing a life insurance policy when it is sold or distributed from a qualified plan. Until the issuance of these proposed regulations, it was generally assumed that the fair market value of a life insurance policy was its cash surrender value. The new regulations generally define fair market value as the value of all rights under the policy including supplemental agreements whether or not guaranteed. Revenue Procedure 2005-25 was issued to establish a safe harbor taxpayers could rely on in valuing policies sold or distributed from qualified plans.
It establishes what is known as the PERC formula. Under it, fair market value is determined as follows:

The premiums paid from the date of issue to the date of distribution without reduction for dividends that offset those premiums, plus dividends applied to purchase paid up insurance, plus any amounts credited or otherwise made available to the owner including interest, dividends or adjustments reflecting investment return and the current market value of segregated asset accounts, minus explicit or implicit reasonable mortality charges and reasonable other charges actually charged on or before the valuation date and those charges are not expected to be refunded, rebated or otherwise reversed at a later date, minus any distributions, withdrawals or partial surrenders taken prior to the valuation date.

Cash surrender values, reserves or other measures of value may still be used, but only if they do not arrive at an amount significantly less than the aggregate of the formula components. If the participant uses cash surrender value to value the policy, to the extent it is less than fair market value under the IRS formula, the difference is regarded as a distribution from the plan contrary to PTE 92-6 and as a result, the plan may become disqualified.

Why Purchase Cash Value Insurance in the Qualified Plan?

The qualified plan can purchase either term insurance or cash value insurance for the benefit of a participant. Term insurance makes sense if the participant does not believe he or she will need life insurance protection after retiring or otherwise leaving the plan. When this is the case the policy can be allowed to lapse and there will be no death benefit coverage to continue.

It may be shortsighted, however, to assume at the outset that the participant will not need or want life insurance death benefits after retirement or termination. The future is difficult to predict. The circumstances at retirement may not be as originally anticipated. For example, life insurance after retirement may be needed if:

- Retirement investments did not perform or accumulate as expected.
- Inflation and the cost of living are higher than assumed.
- Retirement funds are limited and the participant's spouse is likely to live beyond normal life expectancy.
- The participant is in poor health with resulting medical expenses that could use up a large portion of the available retirement funds.
- The participant has a child or grandchild with special needs.

Further, even if life insurance may not be needed during retirement, it may still be wanted. The ability of life insurance to pay income tax free death benefits allows it to be used in unique ways to provide an inheritance to children and grandchildren. It can also be used to make a bequest to a valued charity or social cause the participant wishes to benefit.

Cash value life insurance inside the qualified plan may provide a participant with more financial flexibility after retirement.

A Sales Opportunity

Knowing how to use qualified plan dollars to purchase and pay for life insurance policies can add a new dimension to your sales results. When you can show clients a way to pay premiums without changing their cash flow or their lifestyle, you will have more interested buyers. Many working adults participate in qualified retirement plans, so the potential opportunity is huge. Business owners who don't want to pay premiums themselves or who don't want to pay premiums for their key employees with after-tax dollars can adopt a qualified plan or amend their current qualified plan so that pre-tax dollars can be used.

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ReliaStar Life Insurance Company
20 Washington Avenue South
Minneapolis, MN 55401

ReliaStar Life Insurance Company of New York
1000 Woodbury Road, Suite 208
Woodbury, NY 11797

Security Life of Denver Insurance Company
1290 Broadway
Denver, CO 80203

www.ing.com/us

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