

The PRS Report

LIFE INSURANCE WITHIN QUALIFIED PLANS

A popular, often overlooked, feature in qualified Plans is the option for a participant to buy life insurance within the Plan.

Advantages of Life Insurance in a Qualified Plan

- **Premiums are tax deductible.** Contributions to a Plan, which are tax deductible, can be used to pay life insurance premiums.
- **Affordability of insurance.** For some participants, the only access to a large enough sum of money that can provide the insurance coverage the participant needs, is in the participant's qualified Plan.
- **Estate planning strategies.** Policy proceeds are estate tax free if paid to the spouse. Some participants purchase second-to-die life insurance for estate planning purposes. Clients should rely on the advice of their own tax and legal professionals before deciding to use this complex arrangement.

Income Taxation

- Pension plans are designed to provide retirement benefits, and contributions toward those retirement benefits are tax deductible. Since insurance coverage is considered a current benefit, a portion of the coverage is taxed currently to the participant. This taxable portion of the insurance coverage is commonly known as the table 2001 cost (fka PS 58) and is usually a small amount.
- Upon death, the pure death benefit is not subject to income tax. However the cash value of the policy is subject to income tax minus the table 2001 cost previously taxed.
- If the life insurance policy is distributed to the Participant, then like other distributions, income tax is due on its fair market value.



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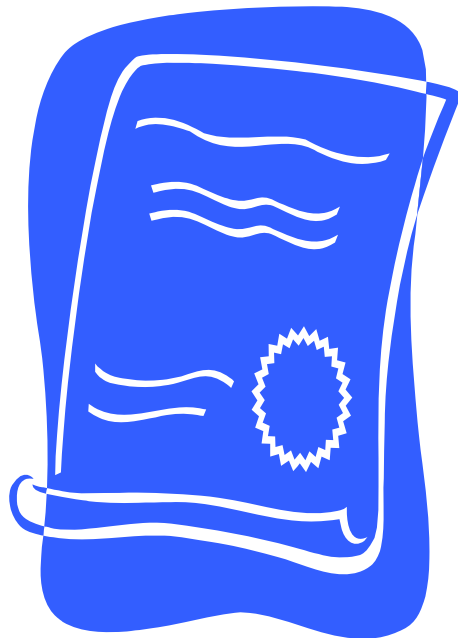
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Disposition of the Policy Prior to Death

- **Surrender the Policy.** The cash surrender proceeds remain an asset of the Plan.
- **Purchase the Policy.** The participant can purchase the policy from the Plan for its fair market value. The Policy is then maintained outside of the Plan.
- **Distribution of the Policy.** As mentioned under Income Taxation, if the life insurance policy is distributed to the Participant, he or she may elect to maintain it outside of the Plan. Income tax at the time of distribution is paid on the fair market value of the policy less the accumulated table 2001 costs.

These three options also apply upon termination of employment.



Important Considerations

- Life insurance in a qualified Plan must be incidental to the qualified Plan. Generally, this means that in a Defined Contribution Plan (eg. profit sharing or 401(k) Plan), total cumulative premiums must not exceed a certain percentage of the total cumulative contributions and forfeitures for the participant (50% on whole life insurance and 25% on term or universal life policies). It should be noted that the incidental rules do not apply to “seasoned” monies. Seasoned monies refer to rollover accounts as well as monies that have accumulated in the Plan for at least two years, or in the participant’s account if he has been a participant for at least five years.
- The Plan document must allow for the purchase of life insurance. If the Plan document doesn’t allow for the purchase of life insurance, usually the Plan can be amended.
- Life insurance in a qualified Plan must be non-discriminatory and as such must be offered to all participants of the Plan if offered to one participant. Thus if the owner of the company is offered the option to purchase life insurance within the Plan, the same option must be granted to the other participants.

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Conclusion

The brief outline above summarizes some of the key points about life insurance in a qualified Defined Contribution Plan. Some of these points differ if the Plan is a Defined Benefit Plan. Since life insurance in a qualified Plan has its place in the pension arena and since the subject matter can be complicated, we are available to answer questions on this subject should the need arise. An employer interested in offering life insurance in the Plan should contact us and his or her insurance agent for guidance.



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