

# **New Guidance on Life Insurance Valuation and Uses of Life Insurance in a Qualified Plan**

## **Introduction**

On February 13, 2004, the Treasury Department issued guidance, in the form of proposed regulations and a revenue proceeding, concerning the valuation of life insurance as it applies to IRC § 402 (transfers from qualified plans, including 412(i) Plans), § 79 (taxation of permanent benefits provided under group-term life insurance) and § 83 (transfers from employers to employees as compensation). Of a more immediate concern, the Treasury Department also issued two revenue rulings addressing various qualified plan issues such as plan discrimination, excessive funding, and excessive life insurance.

## **How Does the Guidance Affect Transfers of Life Insurance From a Qualified Plan?**

Prior to the issuance of this new guidance, the Treasury Department stated, in Notice 89-25, that the fair market value of a life insurance policy, when transferred from a qualified plan, was the cash surrender value, unless the total policy reserves represented a much more accurate approximation of the policy's value.<sup>1</sup> New guidance, in the form of proposed regulations and a revenue procedure, redefines the term as "fair market value" when the policy is transferred to the participant or a beneficiary of the plan.

## **What Do the Proposed Regulations Mean by "Fair Market Value?"**

The proposed regulations do not define the term "fair market value." The revenue procedure does, however, define the term and provide interim guidance until final regulations are published. According to the revenue procedure, which is currently the law effective February 13, 2004, the fair market value (FMV) of a life insurance policy under sections 402, 79, and 83, appears to be essentially equivalent to the policy's accumulated value.<sup>2</sup> The revenue procedure states, in relevant part:

"Cash value (without reduction for surrender charges) may be treated as the fair market value of a contract as of a determination date provided such cash value is at least as large as the aggregate of: (1) the premiums paid from the date of issue through the date of determination, plus (2) any amounts credited (or otherwise made available) to the policyholder with respect to those premiums, including interest, dividends, and similar income items (whether under the contract or otherwise), minus (3) reasonable mortality charges and reasonable charges (other than mortality charges), but only if those charges are actually charged on or before the date of determination and are expected to be paid.

In those cases where the contract is a variable contract (as defined in § 817(d)) cash value (without reduction for surrender charges) may be treated as the fair market value of the contract provided such cash value is at least as large as the aggregate of: (1) the premiums paid from the date of issue through the date of determination, plus (2) all adjustments made with respect to those premiums during that period (whether under the contract or otherwise) that reflect

investment return and the current market value of segregated asset accounts, minus (3) reasonable mortality charges and reasonable charges (other than mortality charges), but only if those charges are actually charged on or before the date of determination and are expected to be paid.”<sup>3</sup>

Based on the above definition, the revenue procedure appears to indicate that the fair market value of the policy, both variable and non-variable, is the accumulated value.

### **What if the Participant Buys the Policy from a Qualified Plan for Less Than FMV?**

In the case of a purchase from a qualified plan, the difference between the purchase price and the policy’s fair market value is treated as a taxable distribution to the participant.<sup>4</sup> This distribution is also subject to all the limitations of the Code, including the restrictions on in-service distributions from certain types of qualified plans, such as defined benefit plans, and the penalty for early withdrawals.

### **How Does “Excessive Funding” Impact 412(i) Plans?**

A 412(i) plan is excessively funded with life insurance and annuity contracts if the benefits provided under those contracts exceed the participant’s benefit at normal retirement.<sup>5</sup> The result of this excessive funding is a violation of the 412(i) requirements.<sup>6</sup> The plan, if it provides for benefits in excess of those benefits permitted to be paid to the participant at retirement, can no longer qualify as a 412(i) plan and will therefore be treated as a traditional defined benefit plan.

### **What is “Excessive Life Insurance” Inside a Qualified Plan?**

An excessive amount of life insurance death benefit is that amount above the participant’s death benefit provided by the plan.<sup>7</sup> This may be the case where a qualified plan purchases a life insurance policy on the participant with a death benefit in excess of the amount that may be paid to the participant’s heirs as an incidental benefit. The existence of this excess death benefit does not mean the plan violates the incidental benefits test as long as it is payable to the plan, rather than the participant’s heirs. This does not result in the loss of the plan’s 412(i) status, but it may be a listed transaction under the tax shelter regulations. (see *Listed Transaction* question below)

### **Are Plan Contributions for Excessive Life Insurance Deductible?**

Rev. Rul. 2004-20 states that the current cost of excess life insurance used to provide excess death benefit<sup>8</sup> is a nondeductible plan contribution. These nondeductible amounts may be carried forward and deducted in later years when the employer’s contribution is less than the maximum amount permitted. One example of this situation, provided in the revenue ruling, is when the participant dies and the excess death benefit is used by the plan to reduce the employer’s obligation to make future contributions.

## **Is There a Penalty for Nondeductible Contributions?**

IRC § 4972 generally imposes a 10% excise tax on nondeductible contributions to a qualified plan, including nondeductible contributions carried over from preceding years.

## **Is Holding Life Insurance Inside a Qualified Plan a Listed Transaction?**

Holding life insurance inside a qualified plan is a listed transaction in only limited situations. Rev. Rul. 2004-21 states that only if the qualified plan itself is benefited by life insurance death benefit in excess of \$100,000 (not including the amount paid to the participant's heirs as an incidental death benefit), the arrangement is identified as a listed transaction. Please note that this revenue ruling deals with two situations, excessive retirement benefit funding, and excessive death benefit. The revenue ruling only holds that the excessive death benefit situation may result in a listed transaction. A "listed transaction" for the tax shelter regulations has both reporting requirements for the taxpayer and listing requirements for the sellers. It is unclear at this time who is required to list the transaction. Please contact your legal tax advisor for information regarding your individual situation.

## **Is a Plan Discriminatory if it Offers Different Types of Life Insurance Policies on Highly Compensated Employees versus Nonhighly Compensated Employees?**

A plan may hold different types of life insurance policies as long as the plan does not discriminate in favor of highly compensated employees. Revenue Ruling 2004-21 determined that a plan may be found discriminatory if the policies offered to the highly compensated employees (HCE) have features of greater value than those policies offered to nonhighly compensated employees (NHCE). Such life insurance contract features include differences in cash value growth terms, exchange features, or purchase rights. Therefore, either the same policies must be offered to all plan participants, or if different policies are used, the policies offered to the NHCEs must have features of equal or greater value than those policies offered to the HCEs.

## **How Does The Guidance Affect 412(i) Plans in General?**

412(i) defined benefit plans, along with all other qualified plans holding life insurance must comply with the new guidance. This new guidance does not indicate that 412(i) plans may not hold life insurance. Taxpayers need to be aware, however, of the tax affects of a distribution or a purchase of a life insurance policy from the qualified plan to a participant or a beneficiary of the plan. The policy will now be valued at the policy's accumulated value, rather than the cash surrender value or the tax reserve amount. Additionally, taxpayers should be careful to avoid the plan discrimination, excessive funding and excessive life insurance issues detailed in the revenue rulings. Plans that currently have excess insurance, excess funding, or are discriminatory, may need to be amended accordingly. Despite this guidance, 412(i) plans continue to be a valuable

retirement planning tool. If done properly, a 412(i) defined benefit plan can provide a guaranteed retirement benefit to the participants.

### **What About 412(i) Plans Funded with 100% Life Insurance?**

If funding the 412(i) plan with 100% of life insurance results in a death benefit in excess of the amount paid to the participant, which may be likely in a 100% design, then according to Rev. Rul. 2004-20, this plan may now be a listed transaction for the tax shelter regulations. Additionally, the cost of this excessive life insurance is not currently deductible by the employer as a plan contribution.<sup>9</sup>

### **How Does the Guidance Affect the Taxation of Permanent Benefits in Sec. 79 Group Term Life Insurance Plans?**

The proposed regulations have affected Sec. 79 plans providing permanent benefits that use individually-owned cash value life insurance. Under existing regulations, group term life insurance may be combined with other permanent benefits, such as the cash value in the policy. The employee is taxed on the Table 1 costs for the death benefit in excess of \$50,000 and the permanent benefit. The amount of the permanent benefit is derived through a calculation in the Sec. 79 regulations. This calculation previously used the term “cash value” as one of its factors. Some people have interpreted this to mean cash surrender value. The proposed regulations and revenue procedure, however, replace the term “cash value” with “fair market value” (i.e. accumulated value). The result of this change is generally an increase in the taxable amount to the employee.

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### **How Does the Guidance Affect Transfers of Life Insurance From an Employer?**

The proposed regulations have amended § 1.83-3(e), which had provided that when an employer transfers a life insurance policy as compensation to an employee, only the *cash surrender value* is taxable to that employee. The proposed regulations replace the term “cash surrender value” with “policy cash value.” The proposed regulation, however, does

not define the term “policy cash value.” The preamble to the proposed regulations, and Rev. Proc. 2004-16 indicate, that taxpayers must use the policy’s accumulated value, rather than the cash surrender value, to determine the proper taxable amount.

### **What if the Employee Buys the Policy from the Employer for Less Than FMV?**

If the policy is purchased for less than fair market value, the difference between the purchase price and the fair market value (equivalent to the accumulated value) is included in the employee’s income.

### **How is the Flexible Key Person Strategy Affected?**

The only item that has changed is the value of the policy when and if it is transferred to the key employee. In the Flexible Key Person strategy an employer purchases a life insurance policy insuring against the loss of a key employee. When and if the employer no longer needs the coverage provided by the policy, they may choose to transfer the policy to the key employee. The employer may decide to either sell the policy to the employee or distribute the policy as a taxable bonus. Prior to the issuance of the proposed regulations and the revenue procedure, the amount taxable to the employee at transfer was the cash surrender value. Now, however, the employee is taxed on the policy’s accumulated value.

### **What is the Effective Date for the Guidance?**

The proposed regulations, if they become law as written, are effective for all transfers made from a qualified plan to a plan participant or beneficiary under § 1.402(a)-1(a)(2), and from an employer to an employee under § 1.83-3(e), on or after February 13, 2004.<sup>10</sup> Similarly, the amendment to § 1.79-1 is effective for any permanent benefits provided under a group term plan on or after February 13, 2004. While the proposed regulations do not define the term “fair market value,” Rev. Proc. 2004-16 provides a definition of “fair market value” a taxpayer must rely upon as interim guidance until final regulations are published. Notwithstanding the proposed regulations, the revenue procedure is law and is effective for all transfers made on or after February 13, 2004. Perhaps of more important and immediate impact, the revenue rulings, addressing issues such as plan discrimination and excessive life insurance, are also law and effective now.

### **Is There Any Grandfathering?**

There is no grandfathering for existing arrangements. The new guidance addresses all policy transfers on or after February 13, 2004.

<sup>1</sup> Notice 89-25 Q&A-10.

<sup>2</sup> Rev. Proc. 2004-16 section 3.

<sup>3</sup> Rev. Proc. 2004-16 Section 3.

<sup>4</sup> Prop. Reg. § 1.402(a)-1(a)(1)(iii).

<sup>5</sup> Rev. Rul. 2004-20 Situation 1.

<sup>6</sup> IRC § 412(i) (3).

<sup>7</sup> Rev. Rul. 2004-20 Situation 2.

<sup>8</sup> Rev. Rul. 2003-105 reserved the issue of the cost of current life insurance protection for future guidance. Until such guidance is issued, Notice 2002-8 states that taxpayers may continue to use the insurance carrier's published one year term rates or the Table 2001 rates for arrangements entered into prior to January 28, 2002. For arrangements entered into after that date, taxpayers are generally limited to the Table 2001 rates.

<sup>9</sup> Rev. Rul. 2004-20. See *What Happens When a Qualified Plan Holds an Excessive Amount of Life Insurance* question above.

<sup>10</sup> Although the proposed regulations are effective for transfers from a qualified plan under § 1.402(a)-1(a)(2), the determination of the taxable distribution amount when the policy is purchased for less than the fair market, under § 1.402(a)-1(a)(1)(iii), is not effective until the publication of final regulations. However, Rev. Proc. 2004-16 provides interim guidance for § 402, which would presumably cover § 1.402(a)-1(a)(1)(iii)