I. INTRODUCTION

Individual permanent life insurance has long been a popular feature in qualified retirement plans, particularly those maintained by small businesses. Life insurance provides an immediate and substantial pre-retirement death benefit. It can be funded with tax-deductible dollars. In certain profit sharing plans, the life insurance can be used to fulfill other business needs, such as funding a buy-sell agreement. And when a participant terminates, permanent life insurance is portable; it can be distributed from the plan and continue to provide death benefit protection for personal and estate planning purposes.

When a participant wants to retain this death benefit protection and the life insurance is distributed from a pension or profit sharing plan, there are important tax considerations. This issue of Legal & Tax Trends will focus on the income tax consequences of various methods of distribution, on the preservation of the cost basis built up within the life insurance policy, and on the fair market value considerations which may color the selection of a life insurance product within the qualified plan.
II. WHAT IS AN ECONOMIC BENEFIT?

Generally, employer contributions to a qualified plan do not constitute taxable income to the employee-participant in the year in which such contributions are made. The investment income earned on qualified plan assets is, likewise, exempt from federal income tax until distributed. This is because these amounts are deemed to provide a future, rather than a current, economic benefit to the employee. Employer contributions, and the earnings thereon, are considered to be retirement benefits that are usually not available to plan participants prior to separation from service.

When life insurance is a funding vehicle under a qualified plan, the rules are slightly different. The provision of current life insurance protection under the plan is deemed to provide the employee with a current economic benefit. Therefore, taxable income based on the value of the insurance protection is imputed to the insured employee while a participant in the plan. The amount that is includible in the participant’s income is based on the value of the pure insurance protection portion of the policy and is taxable in the year in which the premium is paid. This pure insurance or “at-risk” portion is generally equal to the excess of the face amount of the policy over its cash value.

To determine the amount that must be currently included in the employee’s gross income, the at-risk portion of the policy (expressed in thousands of dollars of protection) is multiplied by a term insurance factor for each $1,000 of coverage based on the insured participant’s attained age. For this purpose, the IRS has provided factors in Table 2001. This table has replaced the earlier PS-58 rates, as well as the insurance company’s yearly renewable term rates, unless those rates are “generally available” and “regularly sold” by the insurer. For purposes of this discussion, the term “imputed income” will be used to refer to the taxable cost of insurance protection.

III. WHAT IS COST BASIS?

In situations where the life insurance protection under a plan is provided by a cash value policy, the aggregate imputed income that is includible in the participant’s income is treated as non-deductible employee contributions and therefore part of the employee’s cost basis under the plan. This cost basis is recoverable from the plan tax-free upon a subsequent distribution of policy benefits. For these purposes, the law differentiates between common law employees and certain self-employed individuals. An owner-employee who owns a 10 percent or less interest in an unincorporated trade or business is treated in the same manner as a common law employee; that is, the cost of the pure insurance protection provided under the plan is considered part of the owner-

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1 IRC §72(m)(3)(B)
2 Notice 2002-8, 2002-4 I.R.B. 398
3 IRC§72(m); Treas. Reg. §1.72-16(b)
employee’s basis under the plan and is recoverable from the benefits under the policy upon distribution. On the other hand, an owner-employee who is a sole proprietor, or who owns more than a 10 percent interest in an unincorporated entity, is denied the ability to recover tax-free the aggregate imputed income from the benefits under the policy.4

**Separate Contracts**

The regulations5 provide that the aggregate imputed income attributable to life insurance protection provided under a plan can only be recovered from the “benefits under the contract providing the life insurance protection.” In some instances, application of this rule may preclude recovery of any such cost basis; for example, where a qualified plan provides both life insurance protection through a group term policy and retirement benefits funded through group annuity policies, recovery of one’s cost basis will not be possible.5

The regulations7 provide that under these circumstances none of the taxable insurance cost under the term policy would be considered as tax-free basis upon distribution of retirement benefits under the group annuity policy. This is because each benefit, the retirement benefit and the life insurance benefit, is considered as being provided under a separate program or contract within the plan and, upon distribution at retirement, there are no “benefits attributable,” (i.e., cash value) to the program or contract which provided the term life insurance benefit.

The regulations give an example of a plan8 holding retirement income policies to fund life insurance and retirement benefits, and a separate investment fund to provide additional retirement benefits. The example indicates that imputed income would be recoverable against plan distributions made under the retirement income policies with respect to the benefits (i.e., cash value) attributable to those policies. The example also states that the investment fund is a separate program of benefits and is treated as a separate contract for purposes of cost recovery. Therefore, if the aggregate imputed income exceeded the cash value of the policies providing the life insurance benefit, the excess would not be recoverable from the separate investment contract.

**Surrendered Contracts**

The IRS has also ruled on the recovery of basis issue in a different context.9 In that ruling, the trustee of a qualified plan surrendered cash value life insurance policies purchased on behalf of the participant and used the surrender proceeds along with side fund amounts to purchase an annuity that was then distributed to the participant. The Service held that the distribution did not represent benefits

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4 IRC§72(m)(2) and (3), and IRC §401(c)(3)
5 Treas. Reg. §1.72-16(b)(4)
6 It is important to note that there is no tax advantage to using individual term insurance in a qualified plan.
7 Treas. Reg. § 1.72-2(a)(3) Example (6)
8 Example (8) of Treas. Reg.§ 1.72-2(a)(3)
attributable to the contract that provided life insurance protection and, therefore, the imputed income could not be recovered as basis from the annuity distributed. Thus, the ruling disallowed the tracing of the cash value from the surrender proceeds of the life insurance policy to the annuity actually distributed by the trust. The IRS, in effect, imposed the requirement that the “benefits” must be distributed under the same “contract” under which the imputed income was incurred in order to recapture the basis in the distribution.

Many practitioners have disagreed with this Revenue Ruling. Typically, in a split-funded plan where an employee separates from service and elects to take his benefit in the form of an annuity, it is standard practice to combine the insurance policy’s cash value with a sufficient amount from the side fund to provide the annuity. In order to purchase an annuity that not only provides the required plan benefits, but also is cost effective for the plan, the trustee may have to “shop around.” However, it appears that, based on this revenue ruling, the only way for the employee to recover the imputed income tax free from the annuity payments is to provide the annuity via the insurance policy by placing the money, (i.e., cash value plus side fund), under one of the policy’s contractual settlement options. The ruling therefore creates a frustrating situation for the trustee and the employee alike, i.e., whether to provide the annuity via the insurance policy (which may not represent the most cost effective approach) and thereby enable the employee to recover cost basis from the annuity payments, or to shop for a well-priced annuity and consequently jeopardize the employee’s ability to recover the cost. Moreover, application of this revenue ruling is difficult in the “real world” where different insurance carriers may be involved in the same plan (and, therefore, multiple policies with potentially different annuity rates) and where, with the advent of newer and more competitive products, it has become common practice to replace or “upgrade” older, existing policies held under the plan.

**Variable/Universal Contracts**

The existing IRS regulations concerning tax-free recovery of the aggregate imputed income address the recovery of such costs under cash value policies such as whole life and retirement income policies. The regulations were promulgated prior to the demise of the retirement income contract following the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), and prior to the advent of universal life and variable life insurance policies. Thus, the regulations do not specifically address such products. However, the Service has taken the position, via general information letters, that universal life and variable life are considered cash value policies for purposes of the recovery of imputed income. Therefore, the amounts previously included in income should be recoverable; as is the case with any other cash value policy.

Defined benefit plans and profit sharing plans are the types of retirement plans most likely to accommodate a life insurance policy. The selection of the
appropriate product within each type of plan is going to depend upon the client’s risk tolerance, importance of accumulating cash value and the need for guarantees.

IV. WHAT IS FAIR MARKET VALUE?

In Revenue Procedure 2004-16, the IRS issued its first round of guidance regarding the proper valuation of a life insurance policy being sold or distributed from a qualified plan. The IRS issued this ruling to stop the abuses surrounding the marketing concept called “pension rescue”.

In pension rescue, a life insurance policy was purchased inside a qualified plan using tax-deductible dollars to pay the acquisition costs of the policy. After a few years, the policy was distributed from the plan using the policy’s cash surrender value as its value for tax purposes. This amount would often be far less than the policy’s fair market value. In the more egregious cases, carriers would develop special policies that were designed to have temporarily high surrender charges, artificially depressing cash surrender values. With these types of contracts, shortly after the policy was transferred out of the plan, the surrender changes would disappear and the cash values would “spring” upward. The Service stated that a proper measurement of the policy’s fair market value had to be used in these situations, not an artificially depressed value. The most recent, and perhaps most conspicuous abuse involving mis-valuation of life insurance policies has occurred in connection with 412(i) planning.

In Rev. Proc. 2005-25, which superseded Rev. Proc 2004-16, the IRS substantially revised the safe harbor formulas used to calculate an insurance policy’s fair market value for purposes of distributing or selling a life insurance contract from a qualified plan. This Revenue Procedure takes into account previous guidance provided on establishing the market value of variable and non-variable life insurance, retirement income and endowment contracts, and it provides two safe harbor formulas to determine the value on the date of the sale or distribution from the qualified plan.

The formulas, referred to as the PERC (premiums, earnings, reasonable charges) test, are complicated but can be summarized simply as:

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\text{[Premiums paid plus interest less reasonable mortality charges and reasonable other charges less any distributions, withdrawals or partial surrenders].}
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The formula for determining the value of a variable policy differs from the non-variable formula in that it reflects all adjustments, including investment return and market value of segregated asset accounts.

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Fair market value is the greater of the interpolated terminal reserve or the PERC amount. Currently, when a plan sponsor is distributing a life insurance policy to a plan participant, MetLife will provide the trustee (as policy owner) with the Interpolated Terminal Reserve amount, plus any unearned premium, plus pro rata dividend, reduced for any policy loans. The information may include a table of remaining policy surrender charges. At this time, MetLife, like other insurance companies, is not providing the plan sponsor with a safe harbor value; the IRS has yet to provide guidance on what constitutes reasonable mortality and other charges. This information is provided to the plan sponsor, who in turn advises the plan participant.

The type of policy chosen will have a profound effect on the fair market value implications, as well as on the relative cost of the coverage and cash accumulation potential. The fair market value of policies that do not have a guaranteed cash value, and those policies which may offer a secondary guarantee, can increase the value of the contract appreciably. In some instances, the value may be several times greater than the cash surrender value of the policy.

**Summary**

It is clear that the imputed income is recoverable tax-free as basis if the cash value policy (or policies) under which this income is incurred is the one that is actually distributed. The result should be the same where plan proceeds are applied to one of the settlement options under the insurance policy. If the insurance is provided by a term insurance policy, however, the imputed income cannot be recovered from the retirement benefits.

**V. PRESERVING COST BASIS**

There are many reasons why policies may be distributed from a qualified plan, but the two primary reasons are that the participant is leaving the plan, or plan provisions have changed. It is obviously desirable for the participant to retain his or her cost basis regardless of the reason for distribution, and with proper planning, trustees and plan administrators can achieve this, and potentially minimize other taxes as well.

Since the final regulations were issued in April 2002, the rules regarding distributions from qualified retirement plans have changed substantially. Most distributions, except minimum required distributions and lifetime payments are eligible to be rolled over, either into an IRA or an eligible retirement plan. Eligible rollover distributions will be subject to 20 percent withholding if not transferred directly to an IRA or another qualified plan. This may impact participants with life insurance policies, since life insurance may not be rolled into an IRA.
Of course, it is always possible for a trustee or plan administrator to surrender a permanent life insurance policy for its fair market value and make plan distributions in cash. While easy to understand and accomplish, the participant does lose the valuable life insurance protection provided by the policy, and as discussed earlier, also loses its accumulated cost basis. Perhaps the most straightforward way to look at preserving the significant tax advantages available under the qualified plan is to examine various situations in which distributions that include a life insurance policy can occur.

VI. REMOVING THE POLICY FROM THE QUALIFIED PLAN

Rollover to Another Qualified Plan

The easiest rollover to accomplish would be where a plan participant is eligible to participate in a new qualified plan that would accept both rollover plan assets and the life insurance policy. However, this option may not always be available and a rollover to an IRA may be the only alternative.

Rollover to an IRA

If there is a distribution of plan assets that includes a life insurance policy, and there is no new qualified plan to accept the rollover, the 20 percent withholding tax will apply to the taxable portion of the distribution. In this situation, the taxable portion of the policy value (i.e., the fair market value minus the cost basis) will be included in income. To satisfy the withholding requirements, the cash portion of the distribution may be reduced by the amount of tax to be withheld. Within 60 days, the participant can deposit an amount equal to the 20 percent withheld into the IRA, thereby avoiding tax on that portion of the distribution, and possibly the 10 percent premature distribution penalty tax as well.

Distributing a Policy and Retaining Cost Basis

There is a way to make a complete rollover, defer taxes, avoid withholding, retain the life insurance protection, and preserve the participant’s ability to recover cost basis. The trustee or plan sponsor could take a loan against the policy’s fair market value, leaving in the policy only the amount equal to the participant’s cost basis. The proceeds of this loan would then be added to the participant’s other side fund assets, to be rolled into an IRA. The life insurance policy could be distributed directly to the insured on a non-taxable basis, since the value would equal the recoverable cost. Withholding would not apply since the amount received would not be included in income.

But what if the policy in question has a fair market value which exceeds the cash surrender value? Since the loan amount is keyed to the cash surrender value, any policy loan will fall short of the purchase price of the policy. In this situation, what are the alternatives?
(1) To take the loan on the policy and thereby reduce the amount (but not eliminate) the taxable distribution from the plan attributable to the life insurance (Fair market value minus Loan amount = Taxable distribution).
(2) To skip the loan entirely and just accept the taxable distribution reduced by the cost basis.
(3) To purchase the policy outright from plan, using personal funds. In a defined contribution plan, where there is no cap on the participant’s account balance, this approach will increase the value of the rollover to the IRA. In a defined benefit plan, however, this approach would be problematic. A participant’s lump sum at retirement can not exceed the actuarial value of the participant’s plan benefit. Exceeding this maximum lump sum could cause the plan to be disqualified. In addition, the distribution would be subject to excise tax and penalties.

**Purchasing the Policy and Avoiding Withholding**

Another way to affect a complete rollover, defer taxes and continue the life insurance protection would be for the plan participant to purchase the policy from the plan just prior to distribution. Special rules under Prohibited Transaction Exemption 92-6 (formerly Prohibited Transaction Exemption 77-8) allow a qualified plan to sell a life insurance contract to the insured under the policy. The insured would purchase the policy for its fair market value, allowing the trustee to roll the entire value to an IRA, thereby avoiding withholding while deferring any taxes. Again, the fair market value consideration means that this method can work well in a defined contribution plan (such as a profit sharing plan), but might be difficult if the fair market value is greater than the cash surrender value and the plan is question is a defined benefit plan. (See above.)

To retain the cost basis, the imputed income basis recovery rules require that a policy be distributed. A policy purchased in accordance with the rules of PTE 92-6 is not considered distributed, thus imputed income would not be recovered under this scenario.

**VI. CONCLUSION**

Life insurance maintains a useful place in qualified plans, providing a substantial, immediate death benefit. In select situations, it can fund business succession needs or other business needs. On the personal side, the portability of the policy makes coverage cost efficient to maintain beyond retirement or separation from service. While the economic benefit provided by permanent life insurance in a qualified plan can create modest imputed income today, it can also build significant cost basis. To preserve this basis, trustees and plan administrators can distribute plan assets free of withholding and penalty taxes, and simultaneously preserve the most attractive features of permanent life insurance, the death benefit protection and the cost basis.
Legal & Tax Trends is provided to you by a coordinated effort among the advanced markets consultants. The following individuals from the Advanced Markets Organization contribute to this publication: Thomas Barrett, Michele Beauchine, Kenneth Cymbal, John Donlon, Lori Epstein, Jeffrey Hollander, Jeffrey Jenei, Lillie Nkenchor and Barry Rabinovich. Jack LaBombard and Maryellen Mahoney also contributed to this issue. All comments or suggestions should be directed to tbarrett@metlife.com or jdonlon@metlife.com, Co-Editors.

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