



Fully Insured 412(e)(3) Plans

This Issue Snapshot discusses requirements applicable to fully insured plans under IRC Section 412(e)(3). The IRS issued guidance in 2004 and 2005 to stop abuses involving the use of certain specially designed life insurance policies in retirement plans. See Rev. Rul. 2004-20, Rev. Rul. 2004-21 and Rev. Proc. 2005-25. This guidance is discussed as part of the analysis. The issues from the guidance also form the basis of some of the issue indicators or audit tips.

IRC Section and Treas. Regulation

- IRC Section 72(m)(3)(B)
- IRC Section 402
- IRC Section 404(a)(1)(E)
- IRC Section 411(b)(1)(F)
- IRC Section 412(e)(2)
- IRC Section 412(e)(3)
- IRC Section 6707A
- Treas. Reg. Section 1.72-16(b)
- Treas. Reg. Section 1.83-3
- Treas. Reg. Section 1.401(a)(4)-3(b)(5)
- Treas. Reg. Section 1.401-1(b)(1)(i)
- Treas. Reg. Section 1.402(a)-1
- Treas. Reg. Section 1.410(b)-3(a)(2)(iv)
- Treas. Reg. Section 1.412(i)-1

Resources (Court Cases, Chief Counsel Advice, Revenue Rulings, Internal Resources)

- Rev. Rul. 60-83
- Rev. Rul. 74-307
- Rev. Rul. 2004-20
- Rev. Rul. 2004-21
- Rev. Proc. 2005-25
- Notice 2002-8
- IRM Section 7.12.1.15

Analysis

Before the Pension Protection Act of 2006 (PPA '06), these plans were known as "412(i) plans" and were established pursuant to the rules of IRC Section 412(i). The former IRC Section 412(i) provisions were retained under PPA '06 but were relocated to IRC Section 412(e)(3), effective for plan years beginning after December 31, 2007. Regulations were not updated after the enactment of PPA '06 and remain in Treas. Reg. Section 1.412(i)-1.

IRC Section 412(e)(3) plans are exempt from the minimum funding rules of IRC Section 412 pursuant to IRC Section 412(e)(2)(B).

IRC Section 412(e)(3) Requirements:

To qualify as an IRC Section 412(e)(3) defined benefit plan, a plan must also satisfy the following requirements:

- Plans must be funded exclusively by the purchase of a combination of annuities and life insurance contracts or individual annuities,
- Plan contracts must provide for level annual premium payments to be paid extending not later than the retirement age for each individual participating in the plan, and commencing with the date the individual became a participant in the plan (or, in the case of an increase in benefits, commencing at the time such increase becomes effective),
- Benefits provided by the plan are equal to the benefits provided under each contract at normal retirement age under the plan and are guaranteed by an insurance carrier (licensed under the laws of a state to do business with the plan) to the extent premiums have been paid,
- Premiums payable under such contracts for the plan year, and all prior plan years, have been paid before lapse or there is reinstatement of the policy,
- No rights under such contracts have been subject to a security interest at any time during the plan year, and
- No policy loans are outstanding at any time during the plan year

Section 412(e)(3) further states that "a plan funded exclusively by the purchase of group insurance contracts which is determined under regulations prescribed by the Secretary to have the same characteristics" as those described above is to be treated as a fully insured plan

Incidental Death Benefit Rule:

The amount of a participant's death benefit under a qualified pension plan must be incidental to the primary purpose of providing retirement benefits. See Rev. Rul. 74-307 and Treas. Reg. Section 1.401-1(b)(1)(i). However, a plan can hold life insurance in an amount that exceeds the incidental death benefit as long as the participant's death benefit under the plan doesn't exceed the incidental death benefit (and the insurance proceeds in excess of the death benefit under the plan are instead used in future years to pay premiums for other participants). See Rev. Rul. 2004-20.

Taxation Rules Relating to Life Insurance:

- **Participant's Cost of Life Insurance:** For life insurance coverage provided to a participant under the plan (but not to any portion of coverage maintained by the plan and not provided as a life insurance benefit to the participant), any deductible contribution, including income of the trust which is used to purchase life insurance protection, is includible in the gross income of the participant for the taxable year. IRC Section 72(m)(3)(B). Treas. Reg. Section 1.72-16(b). Participants must annually recognize the portion of the premium paid for the current year's insurance coverage, reporting the economic benefit as taxable income. The amount reported as income is equivalent to the premium paid on a term life insurance policy for 1 year for the face value of the plan policy.

The cost of current life insurance protection is determined using the premium rate table for life insurance in Notice 2002-8. It is currently referred to as "Table 2001", and was formerly the "PS-58 Cost." A plan may use the rates in Notice 2002-8, or actual premium rates available on term insurance, if less (subject to the conditions in Notice 2002-8). When calculated for a participant, the plan administrator issues the participant a Form 1099-R to include in gross income for the year. The participant's account receives a basis for the cost and the participant is not taxed again on this basis when the insurance contract is distributed to the participant or when life insurance proceeds are distributed to the beneficiary.

- **Transfer of Life Insurance to a Participant:** Any life insurance contract transferred from an employer or a tax-qualified plan to a participant must be taxed at its full "fair market value". The policy cash value and all other rights under such contract (and any supplemental agreements) are included in determining the fair market value of the contract. IRC Section 402(a) and Treas. Reg. Section 1.402(a)-1(a)(1)(iii). *Rev. Proc. 2005-25* provides a safe harbor means to calculate the fair market value of life insurance contracts.
- **Deduction issues:** Under IRC Section 404(a)(1), premiums required for death benefits funded through life insurance are considered part of the current cost of maintaining the plan. Rev. Rul. 2004-20 clarifies that there is no current deduction for the premium attributable to the cost of insurance in excess of the participant's death benefit under the plan. The remainder must be carried over pursuant to the rules of IRC Section 404(a)(1)(E) to be treated as contributions under the rules of IRC Section 404(a)(1)(E) in later years and deductible when the employer contributions are less than the maximum deductible limit (e.g., in years in which excess death benefits under the insurance contract for the participant are used to satisfy the employer's obligation to pay future premiums on other participants).

Any contributions determined to be nondeductible per Rev. Rul. 2004-20 are subject to the 10% excise tax under IRC Section 4972, pyramided each year until the excess is eliminated, unless an election under IRC Section 4972(c)(7) applies.

If the employer deducts amounts used to pay premiums on a life insurance contract with a death benefit that exceeds the participant's death benefit under the plan by more than \$100,000, the arrangement is a "listed transaction". Treas. Reg. Sections 1.6011-4(b)(2), 301.6111-2(b)(2), 301.6112-1(b)(2), and Rev. Rul. 2004-20.

Non-Discrimination:

The right to purchase insurance contracts from a retirement plan must be available to all of the participants in the plan in a nondiscriminatory manner in accordance with IRC Section 401(a)(4) and Treas. Reg. Section 1.401(a)(4)-1. It is discriminatory if, for example, the plan permits highly compensated employees, prior to distribution of retirement benefits, to purchase those life insurance contracts prior to distribution, if any rights under the plan for nonhighly compensated employees to purchase life insurance contracts from the plan prior to distribution of retirement benefits are not of inherently equal or greater value than the purchase rights of highly compensated employees. See Rev. Rul. 2004-21.

Exemption from Accrual Rules:

If a plan is funded exclusively by insurance contracts and the plan satisfies the provisions of IRC Section 412(e)(3), then the plan does not have to demonstrate that its method of accrual satisfies one of the three options provided for in IRC section 411(b)(1). IRC Section 411(b)(1)(F).

Design-based Safe Harbor Plan:

A fully insured plan under IRC Section 412(e)(3) is a design-based safe harbor plan if the requirements under Treas. Reg. Section 1.401(a)(4)-3(b)(5) are satisfied.

Employee Benefiting:

An employee is treated as benefiting under IRC Section 412(e)(3) for a plan year if a premium is paid on behalf of that employee for that plan year. Treas. Reg. Section 1.410(b)-3(a)(2)(iv).

Issue Indicators or Audit Tips

When reviewing the plan provisions, the agent should:

- Determine if the plan provisions comply with IRC Section 412(e)(3).
- Determine if the benefit formula is nondiscriminatory under IRC Section 401(a)(4).
- Determine if the plan benefits equal the benefits under each contract at the plan's normal retirement age. Rev. Rul. 2004-20.
- Determine if the accrual formula meets the special accrual provisions set forth in IRC Section 411(b)(1)(F).
- Determine if the plan is a design-based safe harbor plan that meets the requirements under Treas. Reg. Section 1.401(a)(4)-3(b)(5).
- Determine if the plan meets the eligibility/coverage requirements under IRC Section 410.

When reviewing the insurance policies, the agent should:

- Verify that any premium amounts applied to current insurance protection are included in that participant's income. See Treas. Reg. 1.72-16(b) and Notice 2002-8 regarding P.S. 58 costs and Table 2001 costs.
- Determine if all insurance and annuity contracts are effective and adopted timely for the plan year(s) under examination.
- Determine if all insurance and annuity contracts are in compliance with IRC Section 412(e)(3) (i.e., providing for level annual premiums, all premium payments have been made timely, no policy loans are outstanding at any time during the plan year, etc.).
- Determine if all benefits, rights and features in all insurance and annuity contracts are offered on a non-discriminatory basis under IRC Section 401(a)(4) and Treas. Reg. Section 1.401(a)(4)-1.
- Determine if the total face amounts of all contracts purchased on the participant's life exceed the death benefit under the plan. If so, the premium related to the excess face amount is non-deductible under IRC Section 404. Rev. Rul. 2004-20.
- Determine if the life insurance provided to each participant under the plan is incidental to the primary purpose of providing retirement benefits. Treas. Reg. Section 1.401-1(b)(1)(i). Rev. Rulings 60-83, 74-307.
- Determine if any life insurance contract transferred to a participant is taxed at its full fair market value (taking into account the policy cash value and all other rights under the contract, including any supplemental agreements thereto and whether or not guaranteed). IRC Section 402(a). Treas. Reg. Section 1.402(a)-1(a)(1)(iii). Rev. Proc. 2005-25.