

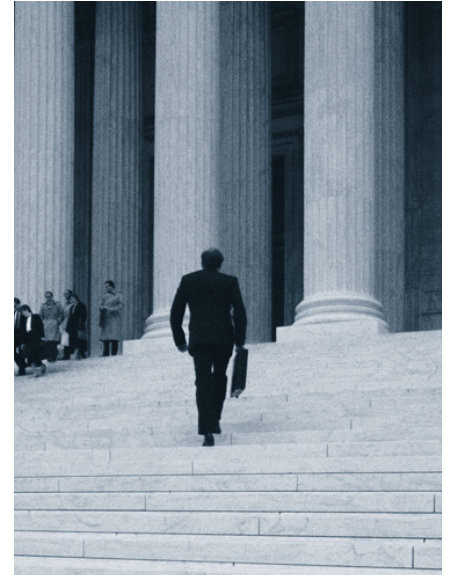
## IRS Releases Final Regulations on Life Insurance Distributions



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### Markets:

- Qualified Retirement Plans
- Split Dollar Life
- Section 79 DBO Plans

The phone call from Washington that Larry Raymond received was disturbing, if not quite unexpected. “Larry, the IRS is about to announce new regulatory guidance that will completely shut down 412(i) defined benefit plans!” As chairman of the Association of Advanced Life Underwriters (AALU) Pension Committee at that time, Larry knew that he had to get his team involved, and quickly. As president of Retirement Funding Corp., a third-party pension administration and consulting firm, he was quite well-versed as to why the IRS was proposing such drastic action.

### The IRS Concern . . .

The IRS was keenly aware that a handful of life insurance companies and consulting firms had created a new breed of life insurance policies whose essential design elements could be used to circumvent taxation when used in a retirement plan. Although 412(i) has been in the Code since ERISA '74, it had been somewhat dormant until recent favorable changes in pension limits and aggregation rules made defined benefit plans attractive to small businesses once again.

These abusive new plans worked like this: a 412(i) plan was adopted by an employer, ostensibly to fund a retirement benefit at normal retirement age. Because 412(i) plans use an *insurance contract* exception to the funding limits of IRC 412, the firm that adopts this type of defined benefit plan is *required* to contribute (and deduct) the amount the life insurance company calculates to guarantee the

promised benefit. Thus, if the insurance contracts used to fund the plan had very low *cash values*, enormous contributions may be required for the plan benefit.

Better yet, if these policies used to fund the 412(i) plan were distributed or sold for this artificially low cash value, current taxation would be minimal or non-existent. Once outside the retirement plan, these policies might quickly grow in value as surrender charges disappeared (or were exchanged for policies with significant values). Tax-free income could then be taken via policy loans. The result was:

1. take big tax deductions today,
2. pay a modest price to roll-out or sell the life insurance policy,
3. receive tax-free income at retirement!

(continued)

## The Real Problem . . .

The AALU exercised its considerable influence and quickly arranged a meeting with IRS and Treasury officials in Washington to discuss its concerns. During a series of long (and aggravating) meetings, the AALU found that the IRS was really concerned about qualified life insurance policies in general, not just those found in 412(i) plans. The AALU reasoned that 412(i) plans have been properly sold and administered for decades. If the IRS wanted to solve these perceived abuses, it needed to fix a problem of its own making.

IRC sections 402(a), 79 and 83 were different sections of the Code that govern the taxation of life insurance contracts in qualified plans, welfare benefit plans and employer-employee transfers, respectively. Unfortunately, each Code section offered conflicting guidance as to how to value life insurance for distributions, sales or gifts. This confusion was heightened by a series of Revenue Rulings and IRS Notices over the decades that further muddied the waters, rather than providing clarity. To fix the problem, the IRS needed to amend the Code and give better guidance as to what the fair market value of life insurance policies actually should be.

## Initial Actions

On February 14, 2004, the IRS proposed amendments to IRC 401(a), 79 and 83 to clearly specify that *fair market value* was to be the measure for taxation of policy distributions. A new Revenue Procedure (2004-16) was offered to provide a *safe harbor* definition that could be relied upon by the taxpayer. Generally, the safe harbor defined the policy accumulation value (without benefit of surrender charges) as the fair market value. The IRS reasoned that if surrender value was to be used, the policy must actually be surrendered. It then invited comment, and the AALU and life insurance industry provided lots!

The initial safe harbor did not reflect that the policy's accumulated value could be affected by loans, withdrawals or dividends. The guidance also did not prove helpful for determining the fair market value of traditional whole life insurance policies (used in most valid 412(i) plans) and was, therefore, not very useful in solving the initial intent. The AALU suggested what they termed "PERC" be considered. PERC is an acronym that reflects the:

- Premiums paid, plus
- Earnings, less
- Reasonable Charges and expenses.

Finally, the AALU lobbied for the IRS to consider that the policy may actually be surrendered before the surrender charges expire, and thus, a portion of these charges should be reflected in its value. Larry was delighted to learn that the IRS listened and formally adopted PERC in the new guidance!

## Updated Safe Harbor

On April 8, 2005, the IRS published Rev. Proc. 2005-25 to provide a new safe harbor definition of fair market value that takes into consideration the comments that AALU and others made. The new guidance adopted the proposed PERC definition and adjusts this value for a portion of current and future surrender charges. It also solved the problems regarding loans, prior distributions, dividends and traditional whole life concerns. We now have effective guidance that you and your clients can rely on to determine the fair market value for qualified life insurance as well as split dollar and welfare benefit plan rollouts.

Without getting overly technical, the new safe harbor restores the time-honored "interpolated terminal reserve" definition commonly used for gift purposes since the 1950s. This reserve value is adjusted for dividends, prior distributions and unearned premiums.

The new guidance essentially states that the fair market value is the **greater** of the adjusted interpolated terminal reserve or the PERC amount adjusted to reflect the *un-weighted average* of the policy's surrender charges over the next 10 years as long as any one year's surrender charge index is not greater than 30 percent.

## New Final Regulation

While Larry and I were preparing for Security Mutual's Advanced Marketing Seminar, the IRS published final regulations under IRC 402(a), 79 and 83. These new regulations were very similar to the proposed regulations in that they specified that fair market value shall be the measure for taxation of distributions and sales of qualified life insurance policies. However, the final regulation addressed a final issue that commentators (including the AALU) had brought up.

Prohibited Transaction Exemption 92-6 specifies that qualified life insurance policies may be sold at *cash surrender value*. This is unchanged. However, if the fair market value exceeds the cash surrender value, the participant will be taxed on the difference. Importantly, the final regulation states that sales for less than fair market value (although allowable) are considered distributions from the plan. Because only certain profit sharing and 401(k) plans can allow for in-service distributions, the sale of a policy for less than fair market value may disqualify the plan!

Larry commented that this added surprise in the regulations appears to be directed at some 412(i) plans that promoted the purchase of large life insurance policies and suggested that these policies be sold before the values emerged (typically within the first five years). However, because this was a change to practice, policies sold for below fair market value (FMV) prior to September 23, 2005 were grandfathered and are not considered plan distributions. However, the difference between the sale price and the FMV is still taxable to the participant.

## Effect on 412(i) Plans


Security Mutual Life welcomes this new guidance because it is very consistent with our marketing and sales of qualified life insurance in general, and 412(i) plans in particular. Our current qualified whole life insurance policy (Pension Customizer 4+) was designed so that the policy cash value equals the adjusted interpolated terminal reserve (ITR) in all years. Thus, it is ideal for funding part of a 412(i) plan where the policy values equal the plan's accrued benefit.

*"This design allows these policies to have more favorable premiums and long-term values."*

Some whole life policies have lower initial policy values than their adjusted ITR. For example, the Customizer V series' cash value is lower than the adjusted ITR for most ages and amounts in the first 10 policy years. This design allows these policies to have more favorable premiums and long-term values. These *suppressed* cash value policies may not work well in 412(i) plans because there may be a disconnect between the policy's fair market value and the value of the accrued benefit. This potential mismatch has forced some insurance companies to withdraw products or withdraw completely from the 412(i) market in recent months.

*Exhibits 1 and 2* compare and contrast our two whole life policies' fair market value as it related to the adjusted ITR. We've added a column that reflects one additional tax advantage that qualified plans may afford. Because the policy is acquired with pre-tax dollars, should a qualified life insurance policy that is sold or distributed in the early years have a higher acquisition cost, the difference between the total premiums paid and its fair market value would provide added tax leverage to your client.

Exhibit 1				
PENSION CUSTOMIZER 4+		Age 45, SNS \$500,000 Face		
Year	Net Premiums	Adjusted ITR	Cash Value	Q-Life Advantage
1	\$ 9,570	\$ 0	\$ 0	\$ 9,570
2	9,570	7,375	7,375	11,765
3	9,570	14,980	14,980	13,730
4	9,570	22,805	22,805	15,475
5	9,570	30,920	30,920	16,930
6	9,510	39,435	39,435	17,925
7	9,280	48,185	48,185	18,455
8	9,040	57,255	57,255	18,425
9	8,695	66,545	66,545	17,380
10	8,325	76,065	76,065	16,635
	<b>\$ 92,700</b>			

Exhibit 2				
CUSTOMIZER 		Age 45, SNS \$500,000 Face		
Year	Net Premiums	Adjusted ITR	Cash Value	Q-Life Advantage
1	\$ 9,635	\$ 0	\$ 0	\$ 9,365
2	9,635	7,670	1,125	11,600
3	9,635	15,570	9,125	13,335
4	9,635	23,705	17,365	14,835
5	9,635	32,140	25,905	16,035
6	9,570	40,925	35,825	16,820
7	9,395	50,005	46,085	17,135
8	9,155	59,395	56,720	16,900
9	8,815	69,035	67,660	16,075
10	8,440	78,925	78,925	14,625
	<b>\$ 93,550</b>			

## Universal Life Planning

At Security Mutual, our universal life insurance policies generally have a lower policy reserve than the PERC value. Thus, to determine the fair market value, you need to take the accumulated value, reduce it by any outstanding loans and then adjust it by the average surrender charge index as defined in the Revenue Ruling.

*Exhibit 3* shows the value of a unisex Security Premier UL policy acquired within a qualified plan with pre-tax dollars. Note that the adjusted ITR is lower than the accumulated value in all years. Also note that the accumulated value may now be reduced by the average surrender charge index, which is significant in the early years of the policy. Again, because the fair market value may be lower than the acquisition cost in the early years, the purchaser of the qualified life policy may enjoy an added tax advantage upon distribution or sale of the policy.


## Conclusion

Life insurance remains the ideal financial instrument to provide tax-favored monies to beneficiaries when needed most. Clients who have life insurance needs may continue to turn to retirement plans, split dollar or welfare benefit plans to obtain the coverage they need. They now have some assurance in the tax treatment of this purchase. The previous lack of surety had caused some advisors and planners to avoid using these plans to meet life insurance needs. The uncertainty has been removed.

The life insurance industry and professional associations including the AALU have been your active voice in making sure that the IRS and Treasury respect reasonable sales of policies inside bonafide plans. The Association for Advanced Life Underwriting (AALU) is an organization whose mission is to provide not only education for its members who

practice in the areas of advanced life insurance planning, but also to monitor, develop and present legislation and regulation to serve all insurance practitioners. If you would like to know more about the organization or consider joining, please visit the AALU website at [AALU.org](http://AALU.org).

Security Mutual Life and our wholly-owned pension subsidiary, Security Administrators, Inc. (SAI), continue to remain at the forefront of providing qualified life insurance, retirement plans, education and service. Let us know how we can help you and your clients achieve business, family and estate security using specialty retirement plans, like 412(i). We look forward to being of service.

<b>Exhibit 3</b>						
		<b>Age 45, SNS, \$500,000 Face \$5,715 Target Px.</b>				
<b>Year</b>	<b>Adjusted ITR</b>	<b>Surrender Value</b>	<b>Accumulated Value</b>	<b>10 Year Index</b>	<b>FMV</b>	<b>Q-Life Advantage</b>
1	\$ 0	\$ 0	\$ 4,379	.73	\$ 3,197	\$ 2,518
2	3,901	200	8,685	.78	6,774	4,656
3	7,802	4,826	12,979	.82	10,643	6,502
4	11,821	9,602	17,413	.86	14,975	7,885
5	16,050	14,627	22,082	.89	19,653	8,922
6	20,345	19,685	26,770	.92	24,628	9,662
7	24,992	24,992	31,695	.94	29,793	10,212
8	30,575	30,575	36,880	.96	35,405	10,315
9	36,452	36,452	42,344	.97	41,074	10,361
10	42,641	42,641	48,105	.98	47,143	10,007

