

Taxation at Fair Market Value of any Life Insurance that is Transferred from a Tax Qualified Plan to an Employee

Friday the 13th Guidance Viewed Favorably At Lafayette Life

The pension industry has been waiting for some time for guidance from the IRS on abusive practices regarding 412(i) plans. The fact that the IRS acted on Friday, February 13 may sound ominous, but we at Lafayette Life believe this guidance supports the approach we have consistently taken to 412(i) administration and bodes well for our continued place as a leader in the 412(i) industry.

The guidance itself took the form of proposed amendments to regulations, two Revenue Rulings and one Revenue Procedure. Listed below are what we believe to be the primary issues addressed by this guidance.

In some instances life insurance policies were being purchased by participants at values below the true fair market value of the policy. This allowed the ownership of the policy to be changed to the participant at a functionally reduced cost.

There are two problems with this scenario. First, a plan must have a “triggering event” before a distribution can take place. Second, if the distribution was a taxable event, the participant was not paying their fair share of taxes since the distribution was below the true fair market value.

Excess Participant Benefits

The IRS addressed the issue of life insurance in excess of the participant benefit provided for in the plan. Essentially, some plans were funded with life insurance above the statutory limits or the amount required based on the plan itself. This excess life insurance provided an increased deduction, but frequently funded for levels greater than the amounts that could be distributed.

In instances of the purchase of life insurance that funds a death benefit greater than the amount provided for under the terms of the plan, the entire premium is no longer deductible in the current year. In addition, this would be a “listed transaction” for tax-shelter reporting.

Discrimination in Favor of Highly Compensated Employees when Funding with Life Insurance Contracts

This area of the guidance dealt with two issues:

- highly compensated employees purchasing life insurance contracts prior to a distributable event
- non-highly compensated employees failing to receive the same opportunities to purchase life insurance as that of highly compensated employees

The first issue revolves around the “triggering event” issue. Without an event permitting a distribution as defined in the plan document (i.e. termination of employment, retirement, death, disability) there can be no distribution of a participant’s vested balance. A change in investment policy could allow for a change in funding vehicles, however, which could result in the opportunity for *all* participants to purchase life insurance used to that point to fund the plan. This is consistent with both the new guidance and our long-standing procedures.

What does all this mean to Lafayette Life?

We are happy to say that we see these issues having no impact on our products or services. We

believe the guidance reinforced the procedures and practices we established here at Lafayette Life nearly two decades ago. We have always been committed to doing pensions in general – and 412(i) plans in particular - the “right way,” and we see this guidance as justification of our efforts.

References

News Release 2004-21
Revenue Ruling 2004-20
Revenue Ruling 2004-21
Revenue Procedure 2004-16
Proposed amendments to Regulations 1.79-1,
1.83.3, and 1.402(a)-1

This article is general in nature and is not to be construed as legal or tax advice. For application of these concepts to an individual situation, an independent legal or tax advisor should be consulted.

