

# Issuing life insurance inside qualified retirement plans

Principal® will underwrite life insurance in qualified retirement plans under very limited circumstances as discussed below.

## Overview

- (1) **Special rules for life insurance in qualified plans:** The purchase of life insurance inside a qualified plan is subject to special rules and regulations. The parties involved (particularly plan fiduciaries and their professional advisors) must understand these rules and regulations prior to the purchase of coverage. Violation of qualified plan rules may cause the plan to become disqualified.

In general, a plan fiduciary under the Employee Retirement Income Security Act (ERISA) is any person or entity (1) exercising any discretionary authority or control in the management of the plan or disposition of plan assets; (2) that can or does render investment advice for a fee; or (3) with any discretionary authority or control in administering the plan. Depending upon the functions performed, plan fiduciaries may include the employer (as plan sponsor), plan trustees, plan administrators with discretionary authority, and/or investment managers. A fiduciary is also anyone identified as such in the plan document.

*A plan administrator fiduciary should not be confused with a non-fiduciary “third party administrator” providing non-discretionary administrative services, including record keeping services.*

- (2) **Life insurance request review by Principal:** Business and Advanced Solutions and/or Business Market Administration (Benefits and Solutions segment) will review requests for life insurance coverage inside qualified plans for employees, including owner-employees.
- Minimum policy size should be \$750,000 face amount or \$10,000 annual premium
  - For multiple policies in the same qualified plan, the average size of all policies should be at least \$750,000 face amount or \$10,000 annual premium.
  - Our Alternate Surrender Value Rider (ASVR) for Principal Indexed Universal Life Accumulation II<sup>SM</sup> is not available for life insurance in qualified plans.
  - A Life Insurance in Qualified Plan Submission Checklist (DD 849Q) available online or through Business Market Administration is required to be completed as part of the life insurance application process.

- (3) **Principal as administrative service provider:** If Principal is providing plan-level administrative services through Retirement and Income Solutions, life insurance (regardless of size) is generally not permitted as a plan asset if Principal is to continue providing administrative services.
- (4) **412(e)(3) qualified plan funding:** The individual insurance products (including life insurance) of Principal are not available to fund insured defined benefit plans as permitted under Internal Revenue Code (IRC) Section 412(e)(3) (formerly IRC Section 412(i)).
- (5) **Risky concepts:** Principal will not offer life insurance coverage to fund concepts we consider inherently unsound or risky from a tax or legal standpoint. We feel that life insurance issued to an irrevocable life insurance sub-trust inside a qualified plan would fall within this risky classification.

## Additional details

- (6) **Plan document:** The qualified plan document must be adopted or amended prior to the purchase of coverage to allow the purchase of life insurance inside the qualified plan, generally as a participant-directed investment in a plan that allows participants to direct investments.

*Plan fiduciaries are responsible for determining if survivorship and/or single life insurance coverage is permitted in the qualified plan. If coverage is permitted as a participant-directed investment, the plan participant, in consultation with his/her attorney, tax advisor, or financial professional, must determine if life insurance inside the qualified plan is appropriate for his or her situation. Coverage amounts should be reasonable based on the long-term insurance protection needs of the plan participant.*

- (7) **Fiduciary responsibility:** Fiduciary liability issues under ERISA may arise in case of plan fiduciaries using their own discretion to invest general plan assets in life insurance without proper due diligence.

*Plan fiduciaries are responsible for using their own discretion to determine if life insurance products are prudent investments and if the death benefit amounts are reasonable, based on the long-term insurance protection needs of the plan participants.*

- (8) **Compensation disclosure:** On February 3, 2012, the Department of Labor released its final regulation relating to service provider disclosures under Section 408(b)(2) of ERISA. Under the final rule, a covered service provider (CSP) must describe to the responsible fiduciary of a qualified plan the services to be provided to the plan and all direct and indirect compensation to be received for such service by the CSP. The effective date of the final regulation was July 1, 2012.

*If Principal insurance products are purchased by a qualified plan, Principal will provide information to the plan trustee on compensation paid to the insurance agent or broker on*

*such insurance sale. Principal will require a plan fiduciary to acknowledge receipt of such written disclosure form. The insurance agent or broker will also be required to sign the disclosure form. This form is provided to the plan fiduciary as part of the policy application packet.*

*The information provided is designed to help the plan fiduciary assess reasonableness of total compensation, identify potential conflicts of interest, and satisfy reporting and disclosure requirements under Title I of ERISA.*

*Neither Principal Life nor Principal National Life is considered to be a CSP under the final rule. The disclosure form is being provided as a service to the selling representative in their capacity as a CSP.*

- (9) DOL definition of investment-advisor fiduciary:** In 1975, the Department of Labor (DOL), under 29 Code of Federal Regulations (CFR) 2510.3-21(c), provided a five-part test for determining who is an investment-advisor fiduciary under an ERISA qualified retirement plan. Under this test, an investment-advisor fiduciary is a person who
- (1) “renders advice... or makes recommendation(s) as to the advisability of investing in, purchasing, or selling securities or other property;”
  - (2) “on a regular basis;”
  - (3) “pursuant to a mutual agreement...between such person and the plan”
  - (4) the advice “serves as a primary basis for investment decisions with respect to plan assets;” and
  - (5) the advice is “individualized...based on the particular needs of the plan.”

On April 6, 2016, the DOL released its final Fiduciary Rule (2016 Fiduciary Rule) redefining who is to be considered a fiduciary under an ERISA qualified retirement plan or Individual Retirement Account (IRA) as a result of giving investment advice to a plan or its participants or beneficiaries.<sup>1</sup> However, on March 15, 2018, the U.S. Court of Appeals for the 5th Circuit ruled that the 2016 Fiduciary Rule was invalidly promulgated. This court ruling was not appealed by the DOL; therefore, on June 21, 2018, the 5th Circuit issued a formal mandate to vacate the DOL’s 2016 Fiduciary Rule in total.

With the vacating of the 2016 Fiduciary Rule, the five-part test discussed in the first paragraph above again determines fiduciary status of an investment advisor under an ERISA qualified retirement plan.

An investment-advisor fiduciary, like other fiduciaries to qualified plans, is subject to duties and liabilities outlined in ERISA and the IRC. A fiduciary must act prudently and with undivided loyalty to the plan and its participants and beneficiaries and is prohibited from engaging in certain specified “prohibited transactions,” including a prohibition from receiving consideration for the investment-advice fiduciary’s personal benefit from any party dealing with the plan in connection with a transaction involving plan assets. In the

absence of additional guidance, this would include the sale of a life policy to the plan if the investment advice fiduciary receives commissions or other compensation on the sale.

On December 18, 2020, the DOL adopted Prohibited Transaction Exemption (PTE) 2020-02, which permits an investment-advisor fiduciary to receive commissions or other compensation as a result of providing investment advice if certain conditions are met. (PTE 2020-02 replaced the temporary enforcement policy adopted by the DOL in Field Assistance Bulletin 2018-02.)

Conditions that must be met include:

- meeting a best interest standard,
- meeting a reasonable compensation standard,
- a requirement to make no materially misleading statements about recommended investment transactions and other relevant matters,
- disclosure requirements,
- adoption of policies and procedures designed to ensure compliance with such Impartial Conduct Standards, and
- a retrospective annual review.

On January 4, 2023, the DOL published its regulatory agenda, which includes amending the fiduciary advice rule to propose a new fiduciary definition, and proposed amendments to existing prohibited transaction exemptions. The DOL's Employee Benefits Security Administration (EBSA) has indicated that it plans to release the anticipated Notice of Proposed Rulemaking in August, 2023.

**(10) Security Exchange Commission Regulation Best Interest (Reg BI):** Under Reg BI, all securities recommendations must be in the retail customer's best interest. This best interest standard is comprehensive and will be satisfied only if the parties comply with four component obligations:

- Care,
- Disclosure,
- Conflict of Interest, and
- Compliance.

The compliance date for Reg BI was June 30, 2020. Variable life insurance and variable universal life insurance are considered securities for purposes of Reg BI.

**(11) Future Regulatory Guidance:** Federal regulatory agencies review existing rules from time to time and may well propose new rules and/or modify existing rules. The date of the last update of this guide is found at the end of the guide (prior to Exhibit A). Several states are considering or have implemented client "best interest" standards for the sale of financial products (including life insurance).

*The sale of a life policy inside a qualified retirement plan should include a full, documented*

*review with the client of the advantages and disadvantages of life insurance in the qualified plan and a determination that life insurance in the qualified plan is in the best interest of the plan participant.*

- (12) Incidental limits – defined contribution:** The payment of life insurance premiums by the plan administrator is subject to “incidental” limits allowing up to 25% of employer contributions (including employee salary reductions if the plan has a 401(k) feature) to a defined contribution plan to be used for term or universal life premiums, or up to 49.9% for whole life coverage on an aggregate basis. There are IRS rulings<sup>2</sup> suggesting that premiums paid from accumulations that have been inside a plan participant’s account for at least two years may be used without limit to pay life insurance premiums, or that account accumulations may be used if the plan participant has been participating in the plan for at least five years. There is uncertainty among experts as to the interpretation of these rulings.

*Plan fiduciaries are responsible for monitoring such limits and ensuring that premium amounts remain within the incidental limits on an aggregate basis. Plan fiduciaries are also responsible for determining whether the affected participant is subject to the two-year rule or the five-year rule.*

- (13) Incidental limits – defined benefit:** The 25%/49.9% incidental limits discussed above for defined contribution plans also apply to defined benefit plans, as discussed in Revenue Ruling 74-307. Incidental limits may also be met if the pre-retirement death benefit doesn’t exceed 100 times the participant’s anticipated monthly retirement benefit. This test is customarily applied to defined benefit plans but can be applied to defined contribution plans as well.<sup>3</sup>

*Plan fiduciaries are responsible for monitoring incidental limits regardless of the method of calculation.*

- (14) Retirement of plan participant:** Under IRS rules, life insurance is generally required to be distributed to the plan participant outside of the plan or converted into cash or other investments inside the plan no later than the employee’s retirement as provided under the plan document. The plan participant or other third party may also buy the policy for its fair market value prior to retirement. These rules must be discussed with the plan participant and his or her attorney, tax advisor or financial professional prior to the application for life insurance. A proper plan to remove the life insurance from the qualified plan is critical to the success of the overall concept of life insurance inside a qualified plan.

*Plan fiduciaries are responsible for plan compliance with all IRS rules, including the rules listed above. The plan participant and his/her professional advisors are responsible for an exit strategy for the life insurance. Exhibit A lists several possible options.*

**(15) Policy fair market value:** Final regulations under IRC Section 402(a) address issues associated with valuing life insurance policies transferred from qualified plans to plan participants or beneficiaries. Fair market value includes policy cash value and all other rights under the policy (including any supplemental agreements thereto, and whether or not guaranteed). These regulations took effect August 29, 2005. Revenue Procedure 2005-25 provides safe harbor guidance for policy fair market value, and is applicable to all covered distributions, sales or transfers made on or after February 13, 2004. Under the safe harbor, fair market value may be the greater of: (1) the interpolated terminal reserve and any unearned premiums, plus a pro rata portion of a reasonable estimate of dividends expected to be paid for that policy year, or (2) the “PERC amount” reduced by the applicable “Average Surrender Factor.” “PERC” stands for premiums, earnings, and reasonable charges. For many policies, the PERC amount will equal the policy cash value without reduction for surrender charges. The definition of PERC varies slightly between non variable and variable contracts.

*The plan administrator will generally have the duty to properly tax report any distributions from a qualified plan, including the distribution of a life insurance policy. Upon request, Principal will provide policy information on policies from Principal as of a specified date, including policy cash value without reduction for surrender charge and the applicable “Average Surrender Factor” as calculated by Principal based on our understanding of Revenue Procedure 2005-25.*

**(16) Annual plan participant taxable income:** Generally, the cost of the pure life insurance protection of a life insurance policy inside a qualified plan (as measured by the economic benefit costs<sup>4</sup>) is includible in the gross income of the participant each year. The economic benefit costs are generally low compared to the entire premium for single life coverage and very low for survivorship coverage during the lives of both insureds. The cumulative economic benefit costs included in the gross income of the plan participant over the years may count as policy cost basis if the policy is eventually distributed to an employee plan participant. Economic benefit costs do not constitute cost basis for a policy distributed to certain self-employed individuals (including sole proprietors and partners of a partnership who own more than 10% of either the capital interest or profit interest of the partnership).<sup>5</sup>The pure life insurance protection amount is generally equal to policy death benefit minus policy cash value.

*The plan administrator will generally have the duty to tax report annual economic benefit costs. Upon request, Business Market Administration will provide annual economic benefit cost information to the plan administrator.*

**(17) Life insurance death benefit taxation:** The pure life insurance protection portion of a life insurance death benefit will generally be income tax free to the beneficiary, assuming the plan participant has properly recognized taxable income on the annual economic benefit costs. The participant’s investment in the contract may also be recovered income tax free by the beneficiary. Any death benefit balance in excess of these amounts would generally

be considered taxable income to the beneficiary if the insured dies with the policy inside the qualified plan.

*The plan administrator will generally have the duty to tax report any taxable amount distributed to a plan beneficiary. Upon request, Business Market Administration will provide the cumulative economic benefit costs and cash value as of the date of death of the insured to the plan administrator.*

- (18) Form 5500 – Schedule A:** Information on life insurance in a qualified plan should be provided on Schedule A-Insurance Information on the appropriate Form 5500- Annual Return/Report of Employee Benefit Plan filing.

*The plan administrator will generally have the duty to properly complete and file Form 5500 and appropriate schedules. Upon request, Principal will provide Schedule A information to the plan administrator.*

- (19) Important plan administration issues:** Life insurance inside a qualified plan is a plan asset that needs to be properly administered by the plan administrator. If there is a change in plan administrator, the new plan administrator must be aware of life insurance coverage owned by the plan trust and commit to proper administration. If a qualified plan is terminated with a distribution of plan assets, life insurance must be included in such distribution. If a plan participant has requested a distribution of his or her qualified plan account balance, any life insurance in his or her account should be included in such distribution. A life policy is not eligible to be rolled over to an IRA.

## Exit strategies

*An exit strategy of the policy from the qualified plan should also be discussed (with the policy transferred out of the qualified plan no later than the retirement of the plan participant from employment with the employer sponsoring the plan). These considerations would be supplemental to any regulatory requirements from applicable federal or state administrative agencies. The following are among the possible exit strategies for life insurance in a qualified retirement plan:*

1. If the plan participant is eligible to receive a plan distribution, the life policy may be distributed by the plan trustee to the plan participant. The fair market value of the life policy minus the plan participant's investment in the contract will be taxable income to the employee.

Possible advantages:

- (A) The life insurance coverage will continue, subject to the terms of the life policy.
- (B) Any investment in the contract in the policy will reduce taxable income.

Possible disadvantages:

- (A) There will be taxable income reported to the plan participant.
- (B) There will be mandatory 20% income tax withholding of the taxable amount. This may involve (i) additional funds from the qualified plan being withheld, (ii) a partial withdrawal from the life insurance policy being distributed, or (iii) a payment by the participant to the employer, to cover the withholding requirement.

(C) Unless ownership of the policy is subsequently transferred to another person or entity outside the estate of the plan participant (with the plan participant/ insured living three years from the date of the transfer in case of a gift), the life insurance death benefit will be included in the estate of the plan participant for federal estate tax purposes.

2. If permitted by the plan and in compliance with Prohibited Transaction Exemption (PTE) 92-6 (as amended), the life policy may be purchased by the plan participant for its fair market value.

Possible advantages:

- (A) The life insurance coverage will continue, subject to the terms of the life policy.
- (B) There is no taxable income to the plan participant.
- (C) There is no income tax withholding to the plan participant.

Possible disadvantages:

- (A) Depending upon the fair market value of the policy, the plan participant may need substantial “out of pocket” funds to purchase the policy. Note that the price of the policy is not reduced to reflect the participant’s investment in the contract
- (B) Unless ownership of the policy is subsequently transferred to another person or entity outside the estate of the insured (with the insured living three years from the date of the transfer in case of gift), the life insurance death benefit would be included in the estate of the insured/plan participant for federal estate tax purposes.

3. If permitted by the plan and in compliance with Prohibited Transaction Exemption (PTE) 92-6 (as amended), the policy may be purchased by an irrevocable life insurance trust (drafted to include grantor trust provisions) for its fair market value.

Possible advantages:

- (A) The life insurance coverage will continue subject to the terms of the life policy.
- (B) There is no taxable income to the plan participant.
- (C) There is no income tax withholding to the plan participant.

Possible disadvantages:

- (A) Depending upon the fair market value of the policy, the plan participant may need to gift substantial “out of pocket” funds to the trust to purchase the policy. Note that the price of the policy is not reduced to reflect the participant’s investment in the contract.
- (B) The trust would need to be drafted as a grantor trust for income tax purposes to avoid “transfer for value” problems under Internal Revenue Code section 101(a)(2).

## Conclusions

For the right situation, life insurance from Principal inside a qualified plan may meet a plan participant’s needs. However, the above requirements must be strictly complied with to avoid potential problems. Professional advisors working with plan participants – as well as plan administrators and trustees and their professional advisors – must be well-versed in the special tax law and other requirements of life insurance inside qualified plans. Principal is responsible only for the administrative services related to the life insurance policy specifically stated.



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- <sup>1</sup> Under the expanded definition (no longer applicable as discussed above), a person would generally be an investment-advice fiduciary if the person receives a fee or other compensation (to include commissions) for providing investment advice to a retirement plan (or IRA) investor to include sales/investment advice on a single sales transaction. The DOL also provided several prohibited transaction exemptions to be used in conjunction with the expanded definition of investment advisor fiduciary.
- <sup>2</sup> Revenue Rulings 60-83 and 61-164 provide that insurance purchased with funds that have accumulated in a participant's account in a profit sharing plan for at least the minimum deferral period of two years may be used without limit to pay insurance premium without disqualifying the plan if the plan document is properly drafted. The IRS reasoned that the costs associated with current benefits such as life insurance protection are permissible distributions from the plan. Revenue Ruling 71-295 supports this position as well. Under Revenue Ruling 68-24, profit sharing plan documents may also be drafted to allow a withdrawal by the plan participant of his or her entire account balance after five years of participation in the plan. Revenue Ruling 94-76 states that this so-called "seasoned money" status holds following the transfer of assets to another plan.
- <sup>3</sup> Rev. Rul. 60-83, 1960-1 CB 157. Additional compliance tests may be available for satisfying the incidental benefit test.
- <sup>4</sup> "Economic benefit costs" refer to the amounts includable to the employee as income under IRC Sec. 72(m)(3)(B) (and regulations thereunder), as a result of the plan providing life insurance protection to the employee's beneficiary or trust. This amount is calculated based on the employee's age and the amount of death benefit provided, using either Table 2001 or the insurer's lower published term premium rates for products regularly sold. IRC Sec. 72(m)(3)(B); Notice 2002-8, 2002-1 CB 398; Treas. Reg. §1.72-16(b). This amount was previously referred to as the "P.S. 58 cost."
- <sup>5</sup> IRC Secs. 72(m)(6), 401(c)(3).



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