The Economic Benefit Cost of Life Insurance in a Qualified Retirement Plan

Buying life insurance with qualified retirement plan assets is great way to pay premiums using pre-tax dollars. However, there is a small portion of the current life insurance protection that needs to be included in the employee's/insured's gross income each year in order for the insured's beneficiary(ies) to receive the "pure death benefit" tax free. This cost, formerly known as P.S. 58 costs, is currently known as the economic benefit cost of life insurance since the P.S. 58 Table for calculating that cost was replaced by Table 2001.

Generally, a qualified plan participant does not have to include in their gross income contributions made on his or her behalf by an employer into a qualified retirement plan until benefits are actually distributed. However, there is an exception to this rule when contributions are used, in part, to purchase life insurance protection on the life of the participant that would be payable to the participant's beneficiary(ies). This is known as the economic benefit cost of life insurance.

Pursuant to Treasury Regulation 1.72-16, under a qualified plan or trust, if amounts allowed as a deduction or earnings of the trust are used to purchase life insurance, the cost of the life insurance protection will be included in the gross income of the participant. Therefore, each year the cost of life insurance protection provided under a qualified retirement plan must be included in the employee's gross income.

Including this cost in gross income enables the "pure amount at risk" to pass to the participant's beneficiary(ies) tax-free. The "pure amount at risk" is defined as the face amount of the policy minus the cash value that has accumulated in the policy. For example, the pure amount at risk for a life policy with a face amount of $1,000,000 and cash value of $200,000 is $800,000 ($1,000,000 - $200,000). This means that if the economic benefit cost is included in the participant's gross income each year and that participant dies, $800,000 will be paid to their beneficiary(ies) tax-free.

Additionally, since the cash value of the policy is subject to ordinary income tax at the time of distribution, all amounts included in the participant's gross income, become part of the participant's cost basis or investment in the contract and may be subtracted from the taxable amount due at that time. In the previous example where there is $200,000 in cash value accumulated in the policy, assume the participant included the economic benefit costs over the last 15 years totaling $4,000 in their gross income. This means that the taxable amount would be reduced to $196,000 ($200,000 - $4,000).

It is important to note that if a participant does not include the total cost of the life insurance protection provided under the insurance contract in the qualified plan in their gross income, the entire death benefit paid to the beneficiary(ies) will be taxable.

How is the Economic Benefit Cost Calculated?

Only the cost of the pure amount of risk is treated as a currently taxable distribution. The cost is determined by applying the one year premium term rate at the insured's age to the difference between the face amount and the cash surrender value at the end of the year.

Retirement Planning

As of March 1, 2001, the Internal Revenue Service (IRS) mandated the use of Table 2001 for use in economic benefit calculations for qualified plans, replacing the old PS 58 rates. Subsequent IRS Notices and Regulations established additional criteria in order to use alternative term products in calculating economic benefit costs for policies. Since there are several rates that may be available in determining the economic benefit, Guardian provides several rates along with the Table 2001 rates. Therefore, it is recommended that the Trustee/Administrator consult with their own tax attorney, accountant or Third Party Administrator to determine which costs would be most appropriate to include in gross income pursuant to their individual situation.

Please consult with your Guardian Financial Representative if you have any questions concerning this document.

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GEAR # 2013-0222 Expiration: 12/31/2015

Guardian Financial Representatives may call the Business Resource Center for Advanced Markets, at 1.800.871.7780, Option 3, Option 1, for additional information