

What Tax Issues Must I Understand Regarding Life Insurance In Retirement Plans?

Adding life insurance to a retirement plan is a time-honored strategy for a Plan to provide enhanced survivor benefits on a tax-favored basis. However, before a “qualified” life insurance policy is considered, you should first be familiar with some general compliance and tax issues:

1. The Plan Documents must permit the purchase of life insurance.
2. Unless, in the case of some profit sharing plans, a Plan has “seasoned” money, the amount of premium allocable to life insurance must satisfy the “incidental benefit test.”
3. Generally, life insurance death proceeds are includable in an insured’s estate for estate tax purposes.
4. Life insurance coverage cannot continue inside the Plan after the participant’s termination of service.
5. The cost of life insurance protection (commonly referred to as the “economic benefit cost or Table 2001 cost” and formerly referred to as the “PS 58 cost”) provided under the Plan must be included in the employee’s gross income for the tax year in which deductible employer contributions or trust income is used to purchase life insurance protection.
6. Life insurance death proceeds in excess of the cash values just prior to death are received income tax-free by the beneficiary. The remainder, less the economic benefit costs of the life insurance protection previously taxed to the employee, is income taxable. However, if the deceased was an owner-employee, there is no credit for the economic benefit cost because these amounts were not previously taxed to the owner-employee.

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