

Part I

Section 404.--Deduction for Contributions of an Employer to an Employees' Trust or Annuity Plan and Compensation Under a Deferred Payment Plan

(Also, §§ 401, 412, 6011, 6111, 6112; §§ 26 CFR 1.401-1, 1.412(i)-1, 1.6011-4, 301.6111-2, 301.6112-1.)

Rev. Rul. 2004-20

ISSUES

Issue 1: Can a qualified pension plan be a plan described in § 412(i) of the Internal Revenue Code if the plan holds life insurance contracts and annuity contracts for the benefit of a participant that provide for benefits at normal retirement age in excess of the participant's benefits at normal retirement age under the terms of the plan?

Issue 2: If a qualified pension plan holds life insurance contracts providing for life insurance on a participant's life in excess of the participant's death benefit under the terms of the plan, are contributions for premiums for such excess life insurance coverage currently deductible by the employer?

FACTS

Situation 1

Employer M maintains Plan A, a defined benefit plan that is funded solely by life insurance contracts and annuities with level annual premiums for each participant commencing with the date the individual becomes a participant in the plan (or, in the case of an increase in benefits, commencing at the time the increase becomes effective) and ending with the individual's attainment of normal retirement age. Plan A is intended to be a plan described in § 412(i). The amounts that will be accumulated under the insurance contracts and annuity contracts for the benefit of a participant at normal retirement age, assuming premiums are paid and determined by applying annuity purchase rates guaranteed under the contracts, will provide for benefits in excess of the participant's benefits at normal retirement age under the terms of the plan.

Situation 2

Employer N maintains Plan B. With respect to Participant P, Plan B provides a death benefit that meets the definition of an incidental death benefit under § 1.401-1(b)(1)(i) of the Income Tax Regulations. The assets of Plan B include life insurance contracts on the life of Participant P with a face amount in excess of Participant P's death benefit under Plan B. Premiums with respect to Participant P include an annual premium for the waiver of the entire premium payment if Participant P becomes disabled. Upon the death of a covered employee, the portion of the proceeds of the life insurance contract that exceeds the death benefit payable to Participant P's beneficiary under the plan is applied to the payment of premiums under the plan with respect to other participants.

LAW AND ANALYSIS

Section 412 sets forth minimum funding requirements for qualified pension plans. Section 412(i) describes certain insurance contract plans that are exempt under §412(h)(2) from the minimum funding requirements of §412 (section 412(i) plans). Under §411(b)(1)(F), a plan that is funded exclusively by the purchase of insurance contracts and satisfies the requirements of §412(i)(2) and (3) satisfies the accrual requirements of §411(b) if an employee's accrued benefit

as of any applicable date is not less than the cash surrender value his life insurance contracts would have on that applicable date if the requirements of §412(i)(4) through (6) were satisfied.

A section 412(i) plan must be funded by the purchase of individual or group insurance contracts. Section 412(i)(2) requires contracts held by a section 412(i) plan to provide for level annual premium payments to be paid commencing with the date the individual became a participant in the plan (or, in the case of an increase in benefits, commencing at the time the increase becomes effective) and extending not later than the retirement age for each individual participating in the plan. Section 412(i)(3) requires benefits provided under a section 412(i) plan to be equal to the benefits provided under each contract at normal retirement age under the plan.

Under §1.412(i)-1(b)(2)(iii), the benefits for each participant provided under a section 412(i) plan that holds individual insurance contracts must be equal to the benefits provided under the participant's individual contracts at the participant's normal retirement age under the plan. Furthermore, under §1.412(i)-1(b)(2)(iv), the benefits provided by the plan for each individual participant must be guaranteed by the life insurance company issuing the individual contracts to the extent premiums have been paid.

Section 404(a)(1)(A)(i) provides that the amount necessary to satisfy the minimum funding requirement under §412 is deductible even if it is greater than the amount determined under §404(a)(1)(A)(ii) or (iii), whichever is applicable with respect to the plan.

The alternative limit determined under §404(a)(1)(A)(ii) is the amount necessary to provide the remaining unfunded cost of all participants' past and current service credits as a level amount, or as a level percentage of compensation, over the remaining future service of each participant. However, if the remaining unfunded cost with respect to any three individuals is more than 50 percent of all remaining unfunded cost, the amount attributable to those individuals is distributed over a period of at least five years.

The alternative limit determined under § 404(a)(1)(A)(iii) is the normal cost of the plan plus, if past service or other supplementary pension or annuity credits are provided by the plan, the amount necessary to amortize the unfunded costs attributable to those credits in equal annual payments over 10 years.

Under §1.404(a)-6(a)(2) of the Income Tax Regulations, the normal cost for any year is defined as the amount actuarially determined which would be required as a contribution by the employer in such year to maintain the plan if the plan had been in effect from the beginning of service of each then included employee and if such costs for prior years had been paid and all assumptions as to interest, mortality, time of payment, etc., had been fulfilled.

Section 1.404(a)-3(b) provides that in no event shall the limitations under § 404(a)(1) for pension or annuity plans exceed costs based on assumptions and methods that are reasonable in view of the funding medium and reasonable expectations as to the effects of mortality, interest, and other pertinent factors.

Section 1.404(a)-14 provides rules for determining the deductible limits under §404(a)(1)(A)(i), (ii), and (iii). The regulations provide in general that the limit on deductible amounts contributed for an employer's taxable year is based on the amounts determined for purposes of §412 for the applicable plan year or years.

Section 404(a)(1)(E) provides that an amount contributed to a plan that would otherwise be deductible, but that exceeds the limitations of § 404(a)(1), is deductible in future years to the extent of the difference between the amount contributed and the maximum amount deductible for each succeeding year under § 404(a)(1).

Section 4972 generally imposes a 10-percent excise tax on nondeductible contributions to a qualified plan, including nondeductible contributions carried over from preceding years.

Rev. Rul. 94-75, 1994-2 C.B. 59, discusses the tax consequences of converting a qualified defined benefit plan that is not a section 412(i) plan to a section 412(i) plan, and holds that the deductible limit under § 404(a)(1)(A)(iii) applies to a section 412(i) plan.

Rev. Rul. 55-748, 1955-2 C.B. 234, discusses the deductibility of contributions to a qualified plan that are used to pay life insurance premiums attributable to the life insurance benefits of retirement income contracts purchased with respect to employees by the trust, the proceeds of which, upon the death of an employee, are payable to the trustee and are held by the trustee for application to payment of subsequent premiums on similar contracts on behalf of other employees. Rev. Rul. 55-748 holds that the part of the employer's contribution attributable to the purchase of life insurance benefits, which, when they become payable, are applicable to the reduction of subsequent employer contributions to the plan are not considered as a cost of the pension plan for the purpose of determining the limitation on deductions under § 404(a)(1)(A), (B), and (C) of the Code (the predecessor provisions to current §§ 404(a)(1)(A)(i), (ii), and (iii)) for the year in which such contributions are paid, and cannot be deducted as such. Rev. Rul. 55-748 further provides that contributions attributable to such insurance benefits, not otherwise determined, may be determined by applying the rates provided in Rev. Rul. 55-747, 1955-2 C.B. 228, to the amounts of insurance that would revert to the trust in the event of death of the insured employee in the year for which the premiums are paid. In later years, if an employer for any reason, such as the receipt by the trustee of life insurance proceeds under a retirement income contract because of the death of an employee, which proceeds were applied to the payment of premiums on similar contracts for the benefit of other employees, contributes to the trust a sum less than the maximum deduction permitted for that year under § 404(a)(1)(A), (B), or (C), Rev. Rul. 55-748 provides that the employer may deduct in that year, in addition to this current contribution, the contributions made in prior years and not then deductible because they were attributable to that part of the retirement income contracts that would provide life insurance payable to the trustee, to the extent of the difference between his current contribution and his maximum deduction permitted under § 404(a)(1)(A), (B), or (C).

Rev. Rul. 55-747 provided a table to be used in computing the premiums to be included in the income of an employee on account of current life insurance protection provided for the employee under a life or endowment insurance contract held by an employees' trust qualified under § 401(a).

Rev. Rul. 66-110, 1966-1 C.B. 12, provided that the current published premium rates charged by an insurer for individual 1-year term life insurance available to all standard risks may be used for determining the cost of insurance in connection with individual policies issued by the same insurer and held by an employees' trust qualified under § 401(a). In addition, Rev. Rul. 66-110 extended the table of premiums set forth in Rev. Rul. 55-747 to cover additional ages.

Rev. Rul. 67-154, 1967-1 C.B. 11, amplified Rev. Rul. 66-110 and held that, where an insurer published one-year term insurance rates lower than those set forth in Rev. Rul. 55-747, but those rates were applicable only under a dividend option whereby term insurance may be purchased with dividends on existing policies and were lower than the insurer's published rates for initial insurance available to all standard risks, those rates could not be used in place of the rates set forth in Rev. Rul. 55-747 in determining the cost of insurance under a trust described in § 401(a).

Notice 2001-10, 2001-1 C.B. 459, revoked Rev. Rul. 55-747, and provided a new table (Table 2001) to be used in valuing term life insurance coverage provided to an employee. Under Notice 2001-10, taxpayers could continue to use the rates set forth in Rev. Rul. 55-747 for purposes of determining the value of current life insurance protection provided under a qualified retirement plan for taxable years ending on or before December 31, 2001. In addition, Notice

2001-10 provided generally that taxpayers could continue to determine the value of current life insurance protection by using the insurer's lower published rates available to standard risks as provided in Rev. Rul. 66-110. However, for periods after December 31, 2003, Notice 2001-10 sets forth certain additional conditions on the use of the insurer's published rates.

Notice 2002-8, 2002-1 C.B. 398, revokes Notice 2001-10. Under Notice 2002-8, Rev. Rul. 55-747 remains revoked; however, taxpayers can use the rates set forth in Rev. Rul. 55-747 for purposes of determining the value of current life insurance protection provided under a qualified retirement plan for taxable years ending on or before December 31, 2001. Notice 2002-8 republishes Table 2001 and provides that Table 2001 can be used to determine the value of current life insurance protection on a single life that is provided under a qualified plan for arrangements entered into before the effective date of future guidance. In addition, paragraph 3 of Section III of Notice 2002-8 placed conditions on the use of the insurer's lower published rates under Rev. Rul. 66-110, as amplified by Rev. Rul. 67-154, for periods after December 31, 2003, with respect to arrangements entered into after January 28, 2002.

Rev. Rul. 2003-105, 2003-40 I.R.B. 696, obsoleted Rev. Rul. 66-110 for arrangements entered into after September 17, 2003, except as provided in paragraph 3 of Section III of Notice 2002-8. Accordingly, Rev. Rul. 66-110, as amplified by Rev. Rul. 67-154, remains in effect until future guidance is issued for life insurance provided under a qualified retirement plan, subject to the conditions provided by Notice 2002-8 with respect to arrangements entered into after January 28, 2002.

Section 1.401-1(b)(1)(i) provides that a pension plan within the meaning of § 401(a) is a plan established and maintained by an employer primarily to provide systematically for the payment of definitely determinable benefits to employees over a period of years, usually for life, after retirement. A pension plan may also provide for the payment of incidental death benefits through insurance or otherwise.

Rev. Rul. 74-307, 1974-2 C.B. 126, holds that preretirement death benefits under a qualified pension plan are considered incidental death benefits within the meaning of § 1.401-1(b)(1)(i) if less than 50 percent of the employer contribution credited to each participant's account is used to purchase ordinary life insurance policies on the participant's life, or if the total death benefit before normal retirement date does not exceed the greater of (a) the proceeds of ordinary life insurance policies providing a death benefit of 100 times the anticipated monthly normal retirement benefit, or (b) the sum of (i) the reserve under the ordinary life insurance policies plus (ii) the participant's account in the auxiliary fund. See also Rev. Rul. 68-453, 1968-2 C.B. 163.

Rev. Rul. 81-162, 1981-1 C.B. 169, holds that a plan established by an employer that provides employees only such benefits as are afforded through the purchase of ordinary life insurance contracts (other than retirement income contracts), which are converted to life annuities at normal retirement age, does not constitute a pension plan within the meaning of § 401(a). Rev. Rul. 81-162 provides that the primary purpose of such a life insurance contract is to provide life insurance protection, and the reserve accumulated thereon is a result of premium payments being made on a level basis. Rev. Rul. 81-162 reasons that such reserve will provide a relatively small retirement annuity in comparison with the annuity that a retirement income contract of the same face amount will provide. Therefore, Rev. Rul. 81-162 concludes that a plan providing only for the purchase of ordinary life insurance contracts (other than retirement income contracts) is not primarily for the payment of benefits to employees over a period of years after retirement. This analysis would not apply, however, if the death benefit payable to the beneficiary under the plan were limited to an incidental death benefit, with the remaining benefit payable to the plan.

In Situation 1, Plan A is not a plan described in §412(i) because the participant's benefit under Plan A payable at normal retirement age is not equal to the amount provided at normal retirement age with respect to the contracts held on behalf of the participant, and thus, Plan A

fails to satisfy the requirements of §412(i)(3). Accordingly, Plan A is subject to the requirements of §412, with charges and credits to the funding standard account determined using the reasonable funding method selected for the plan under generally applicable rules, and using reasonable actuarial assumptions. Such reasonable funding method and such reasonable actuarial assumptions are also used to determine the deductible amount of contributions under the generally applicable rules of § 404(a). In addition, the exception from the accrual rules that applies to § 412(i) plans under § 411(b)(1)(F) does not apply to Plan A.

In Situation 2, the fact that the life insurance contracts on the life of Participant P provide for death benefits in excess of the death benefits under the plan would not cause Plan B to fail to satisfy the requirements to be a plan described in §412(i), if Plan B otherwise met those requirements. Similarly, the fact that the life insurance contracts on the life of Participant P provide for death benefits that would fail to satisfy the incidental benefit rule of § 1.401-1(b)(1)(i) if payable to Participant P's beneficiary under the plan does not cause Plan B to fail to satisfy the incidental death benefit rule of §1.401-1(b)(1)(i) because those excess death benefits under the life insurance contracts are not payable to Participant P's beneficiary under the plan. However, a portion of Employer N's contributions under Plan B is attributable to the purchase of life insurance coverage held by Plan B that is in excess of the incidental death benefit payable under Plan B. Under Rev. Rul. 55-748, the portion of Employer N's contributions that is attributable to such excess life insurance coverage does not constitute normal cost, and is not deductible as part of normal cost for the taxable year in which contributed. Rather, that portion of Employer N's contributions is used to provide a source of funds to pay future premiums (i.e., premiums on other participants) that will come due after the death of Participant P. Accordingly, the nondeductible portion of Employer N's contributions under Plan B that is paid for life insurance protection for Participant P is carried over pursuant to the rules of § 404(a)(1)(E) to be treated as contributions under the rules of § 404(a)(1)(E) in later years and deductible when the employer contributions are less than the maximum deductible limit (e.g., in years in which excess death benefits under Plan B are used to satisfy Employer N's obligation to pay future premiums on other participants). Similarly, Employer N's contributions to pay premiums for the disability waiver for Participant P do not constitute normal cost, and are not deductible as part of normal cost for the taxable year in which contributed. Rather, that portion of Employer N's contributions is used to provide a source of funds to pay future premiums that will come due after Participant P becomes disabled. Accordingly, the nondeductible portion of Employer N's contributions under Plan B that is paid for the disability waiver for Participant P is carried over pursuant to the rules of § 404(a)(1)(E) to be treated as contributions under the rules of § 404(a)(1)(E) in later years and deductible when the employer contributions are less than the maximum deductible limit (e.g., if and when Participant P becomes disabled).

In general, the premiums for excess life insurance coverage that are not currently part of normal cost under § 404(a)(1)(A) are determined in a manner consistent with total premiums under the contract (i.e., must be spread in a level manner over the premium payment period). However, if the premiums for the life insurance contracts covering a participant are level annual premiums payable beginning with the participant's participation in the plan and ending at the participant's normal retirement age, this excess amount can be determined by applying the appropriate term cost factors to the excess term coverage. Nondeductible contributions are subject to the excise tax of § 4972 as provided thereunder. In determining the amount of premiums for excess life insurance coverage, Table 2001 is applicable for taxable years ending after December 31, 2001, and the table set forth in Rev. Rul. 55-747 is used for earlier periods. In addition, the current published premium rates charged by an insurer for individual 1-year term life insurance available to all standard risks as described in Rev. Rul. 66-110, as amplified by Rev. Rul. 67-154, can be used for taxable years ending on or before December 31, 2003. For arrangements entered into on or before January 28, 2002, such current published premium rates can continue to be used for periods ending after December 31, 2003. However, for arrangements entered into after January 28, 2002, such current published premium rates can continue to be used for periods ending after December 31, 2003 only if the additional requirements of Notice 2002-8 are satisfied.

HOLDING

A qualified pension plan cannot be a section 412(i) plan if the plan holds life insurance contracts and annuity contracts for the benefit of a participant that provide for benefits at normal retirement age in excess of the participant's benefits at normal retirement age under the terms of the plan.

Employer contributions under a qualified defined benefit plan that are used to purchase life insurance coverage for a participant in excess of the participant's death benefit provided under the plan are not fully deductible when contributed, but are carried over to be treated as contributions in future years and deductible in future years when other contributions to the plan that are taken into account for the taxable year are less than the maximum amount deductible for the year pursuant to the limits of § 404.

LISTED TRANSACTIONS

Transactions that are the same as, or substantially similar to, the transaction described in Situation 2 of this revenue ruling are identified as "listed transactions" for purposes of § 1.6011-4(b)(2) of the Income Tax Regulations and §301.6111-2(b)(2) and §301.6112-1(b)(2) of the Procedure and Administration Regulations effective February 13, 2004, the date this revenue ruling was released to the public, provided that the employer has deducted amounts used to pay premiums on a life insurance contract for a participant with a death benefit under the contract that exceeds the participant's death benefit under the plan by more than \$100,000.

It should be noted that, independent of any classification as "listed transactions" for purposes of §§1.6011-4(b)(2), 301.6111-2(b)(2), and 301.6112-1(b)(2) of the regulations, arrangements that are the same as, or substantially similar to, the arrangements described in this notice may already be subject to the disclosure requirements of §6011 of the Code, the tax shelter registration requirements of §6111, or the list maintenance requirements of §6112 (§§1.6011-4, 301.6111-1T, 301.6111-2, and 301.6112-1).

Persons who are required to satisfy the registration requirement of §§6111 of the Code with respect to the arrangements described in this notice and who fail to do so may be subject to the penalty under §6707(a). Persons who are required to satisfy the listkeeping requirement of §6112 with respect to the arrangements and who fail to do so may be subject to the penalty under §6708(a). In addition, the Service may impose penalties on participants in these arrangements or substantially similar arrangements, including the accuracy-related penalty under §6662.

EFFECT ON OTHER RULINGS

Rev. Rul. 55-748 is modified and superseded.

DRAFTING INFORMATION

The principal authors of this revenue ruling are Larry Isaacs of the Employee Plans, Tax Exempt and Government Entities Division, and Linda Marshall of the Office of the Division Counsel/Associate Chief Counsel, Tax Exempt and Government Entities. For further information regarding this revenue procedure, please contact the Employee Plans= taxpayer assistance telephone service at 1-877-829-5500 (a toll-free number) between the hours of 8:00 a.m. and 6:30 p.m. Eastern Time, Monday through Friday. Mr. Isaacs may be reached at (202) 283-9888, and Ms. Marshall may be reached at (202) 622-6090 (not tollfree numbers).