

Part II

Section 401.--Qualified pension, profit-sharing, and stock bonus plans
26 CFR 1.401(a)(4)-4: Nondiscriminatory availability of benefits, rights, and features

Rev. Rul. 2004-21

ISSUE

Does a plan that is funded, in whole or in part, with life insurance contracts satisfy the requirements of §401(a)(4) of the Internal Revenue Code prohibiting discrimination in favor of highly compensated employees where: (1) highly compensated employees are permitted, prior to distribution of retirement benefits, to purchase life insurance contracts from the plan at cash surrender value; and (2) any rights under the plan for nonhighly compensated employees to purchase life insurance contracts from the plan prior to distribution of retirement benefits are not of inherently equal or greater value than the purchase rights of highly compensated employees?

FACTS

Employer M maintains Plan A, a retirement plan that is intended to be a qualified plan under §401(a). Plan A provides an incidental death benefit within the meaning of §1.401-1(b)(1)(i) of the Income Tax Regulations for each participant, and holds a life insurance contract on the life of each participant to fund that incidental death benefit. Before distributions to a participant under Plan A commence, each participant is offered the opportunity to purchase the life insurance contract under which the participant is insured from Plan A for its cash surrender value. It is assumed for purposes of this revenue ruling that Prohibited Transaction Exemption 92-6, 57 FR 5189 (February 12, 1992) applies to the purchase of a life insurance contract from Plan A and, thus, a participant's purchase of a life insurance contract from Plan A is not a prohibited transaction under § 4975. Employer M has nonhighly compensated employees that are not excludable employees within the meaning of §1.410(b)-6, and the features of the life insurance contracts covering the lives of highly compensated employees are different than the features of the life insurance contracts covering the lives of nonhighly compensated employees. In addition, because of these differences in the features of the contracts, the rights that the nonhighly compensated employees have to purchase the life insurance contracts under which they are insured from Plan A are not of inherently equal or greater value than the rights that highly compensated employees have to purchase the life insurance contracts under which they are insured.

LAW AND ANALYSIS

Section 401(a)(4) provides that, under a qualified retirement plan, contributions or benefits provided under the plan must not discriminate in favor of highly compensated employees. Section 410(b) provides minimum coverage requirements that are designed to ensure that a qualified plan provides sufficient benefits to a large enough proportion of participants who are nonhighly compensated employees.

Section 1.401(a)(4)-1(b)(3) provides that a plan satisfies the requirements of §401(a)(4) only if all benefits, rights and features provided under the plan are made available under the plan in a nondiscriminatory manner. Under §1.401(a)(4)-4(a), benefits, rights and features (i.e., optional forms of benefit, ancillary benefits, and other rights or features) are made available under the plan in a nondiscriminatory manner only if each benefit, right or feature satisfies the current availability requirement of §1.401(a)(4)-4(b) and the effective availability requirement of §1.401(a)(4)-4(c). In general, a benefit, right or feature satisfies the current availability requirement of §1.401(a)(4)-4(b) for a plan year if the group of employees to whom the benefit, right or feature is currently available during the plan year satisfies §410(b) (without regard to the average benefit percentage test of § 1.410(b)-5).

An other right or feature is any right or feature applicable to employees under the plan (other than a benefit formula, an optional form of benefit, or an ancillary benefit) that can be expected to have meaningful value. Under § 1.401(a)(4)-4(e)(3)(i), a distinct other right or feature exists if a right or feature is not available on substantially the same terms as another right or feature. Under § 1.401(a)(4)-4(e)(3)(iii)(C), the right to a particular form of investment, including, for example, a particular class or type of employer securities (taking into account, in determining whether different forms of investment exist, any differences in conversion, dividend, voting, liquidation preference, or other rights conferred under the security) is a distinct other right or feature. Similarly, differences in insurance contracts (e.g., differences in cash value growth terms or different exchange features) that may be purchased from a plan can create distinct other rights or features even if the terms under which the contracts are purchased from the plan are the same.

Under § 1.401(a)(4)-4(d)(4), an optional form of benefit, ancillary benefit, or other right or feature is permitted to be aggregated with another optional form of benefit, ancillary benefit, or other right or feature if one of the two is, in all cases, of inherently equal or greater value than the other, and the optional form of benefit, ancillary benefit, or other right or feature that is of inherently equal or greater value separately satisfies the current availability requirement of § 1.401(a)(4)-4(b) and the effective availability requirement of § 1.401(a)(4)-4(c). For this purpose, one benefit, right, or feature is of inherently equal or greater value than another benefit, right, or feature only if, at any time and under any conditions, it is impossible for any employee to receive a smaller amount or a less valuable right under the first benefit, right, or feature than under the second benefit, right, or feature.

To the extent the purchase from Plan A of a life insurance contract by a highly compensated employee is a distribution alternative with respect to benefits described in § 411(d)(6)(A), such a purchase right is an optional form of benefit under Plan A. Even in situations in which this purchase right is not an optional form of benefit, this purchase right is an other right or feature. The purchase rights for the highly compensated employees are distinct optional forms of benefit or other rights or features from the purchase rights for nonhighly compensated employees because of differences in the life insurance contracts (analogous to a conversion right applicable to a security). This purchase right for highly compensated employees does not satisfy the current availability requirement of § 1.401(a)(4)-4(b) because the right to purchase the contracts of a type available to the highly compensated employees is not available to any nonhighly compensated employees, and therefore is not available to a group that satisfies the requirements of § 410(b). Moreover, under the facts presented, this purchase right of highly compensated employees cannot satisfy the requirements of § 1.401(a)(4)-4 through aggregation with any other optional form of benefit, ancillary benefit, or other right or feature (such as the purchase right for nonhighly compensated employees) because no other optional form of benefit, ancillary benefit, or other right or feature under the plan that would enable the aggregated benefits to be available to a group that satisfies the requirements of § 410(b) is of inherently equal or greater value. Thus, Plan A fails to satisfy the nondiscrimination requirements of § 401(a)(4).

HOLDING

A plan that is funded, in whole or in part, with life insurance contracts does not satisfy the requirements of § 401(a)(4) prohibiting discrimination in favor of highly compensated employees where: (1) the plan permits highly compensated employees, prior to distribution of retirement benefits, to purchase those life insurance contracts prior to distribution; and (2) any rights under the plan for nonhighly compensated employees to purchase life insurance contracts from the plan prior to distribution of retirement benefits are not of inherently equal or greater value than the purchase rights of highly compensated employees.

DRAFTING INFORMATION

The principal authors of this revenue ruling are Larry Isaacs of 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 ruling, contact the Employee Plans taxpayer assistance telephone service between the hours of 8:00 a.m. and 6:30 p.m. Eastern Time, Monday through Friday, by calling (877) 829-5500 (a toll-free number). Mr. Isaacs may be reached at (202) 283-9710, and Ms. Marshall may be reached at (202) 622-6090 (not toll-free numbers).