Another Market-Conduct Maelstrom Brewing

Using qualified-plan dollars to buy life insurance and annuities is likely to create regulator and consumer backlash, once producers' true motivation is exposed.

by Anthony Steuer and Barry Vokes

The life insurance industry has a long and mostly honorable tradition of serving the public, but the past 10 years have been challenging from a public-relations standpoint. After the rash of class-action lawsuits over sales of policies with so-called "vanishing premiums," the industry does not need another public-relations disaster. But there could be one looming-namely, the use of qualified retirement plan dollars to buy life insurance.

Qualified retirement plans are designed to encourage employees to save money now, so they will have enough to sustain them when they are no longer working. Employer contributions are deductible for the employer and tax deferred for employees, within certain limits. The money that employees authorize their employers to divert into these savings plans--called elective deferral contributions-are tax deferred. Earnings on these monies also are tax deferred. Participants pay income tax when they receive distributions from their plans.

Simply stated, a qualified plan is a tax-favored accumulation vehicle. Permanent (cash value) life insurance also can be used as an accumulation vehicle. In these cases, premiums are paid with after-tax dollars, and the death benefit is income-tax free.

Where the Money Is

Paying life-insurance and annuity premiums with qualified-plan dollars is controversial. Why put an accumulation vehicle that enjoys tax-deferred treatment inside a plan that, by definition, is tax deferred? Life insurance and annuities are relatively expensive, in part because the vast majority of them are sold by agents on commission. This leaves producers open to allegations that their sales pitches may be aimed more at filling their own wallets, rather than helping customers choose their best investment tool.

When asked why he targeted banks, bank robber Willie Sutton, as the legend goes, replied, "because that's where the money is." Miners headed to California in 1849 because they heard that gold was there. Some producers recommend paying life-insurance and annuity premiums with qualified-plan dollars, in part, because the plans are a ready source of otherwise scarce premium dollars.

Selling life insurance is a tough but financially rewarding job for the producers who master the art and climb to the top of their field. Selling annuities is easier, but the temptation is there to sell high-commission life policies. The truth is, commission payouts are life and annuity producers' bread and butter. The fact that this business is highly commission-driven draws the attention of regulators who are increasingly focused on market conduct.

The Debate Emerges

The plaintiffs' bar already has noticed that life insurance and annuities are being sold within qualified plans. Complaints have been filed and cases are pending. There will probably be more.

To understand why, a good starting place to look is 403(b) plans, which are tax-deferred retirement plans for employees of schools and other nonprofit organizations. These plans are also known as tax-sheltered annuities, even though the term includes mutual funds and "incidental" life insurance. The rules for selling life insurance inside a 403(b) plan are fairly loose. A participant can use up to 50% of the aggregate contributions made to a 403(b) plan to purchase whole life insurance. In the case of universal life insurance, only 25% of the aggregate contributions can be used to purchase a policy.

Consider, for example, that a tax-sheltered annuity participant has accumulated $100,000. Now suppose a producer persuades the participant to use $49,000 to pay for a whole life insurance policy. The result: Life insurance sales charges and other expenses eat up a lot of participant dollars, which otherwise could be growing toward a retirement nest egg. There is no question that this sale earned the producer a nice commission. But there are arguments in favor of such a purchase:

- The life insurance is purchased with pretax dollars.
- The life insurance provides a self-completing financial and/or estate plan.
- The participant may keep the policy after retirement (by paying income tax on the cash value).
- Premiums can be paid from previously accumulated contributions.
- If no longer needed, the life insurance cash value can be transferred to an annuity contract.
- The participant can borrow the cash value subject to Internal Revenue Service Code Sec. 72(p) rules.
- The life insurance company calculates the annual cost of insurance that must be included in the participant's taxable income. This amount is based on so-called "P.S. 58" one-year term rates described in Revenue Ruling 55-747, 1955-2 CB 228.
- The arguments against buying life insurance with qualified-plan dollars go like this:
- It's more of a commission-driven than a needs-oriented sale.
- The mortality charges introduce an additional cost element when compared with an annuity or mutual fund. (Annuities on which the surrender charge is waived upon death contain a mortality element, but it is small enough to ignore for our purposes.)
- It is an attempt to fill a permanent need with temporary coverage. The life insurance policy must be distributed by the plan at retirement and income tax paid on it, or it must be converted to an annuity payout or surrendered.
- Income tax must be paid each year on the current cost of the "incidental" life insurance element.
- It uses up the participant's 403(b) contribution limit-called the exclusion allowance.
- All other things being equal, a lot less money will be accumulated when life insurance is used as the accumulation vehicle.

Part of the Plan

Qualified plans, including employee stock-ownership plans, can offer life insurance to plan participants as long as the U.S. Treasury's "incidental benefit" rule is met. That is, the life insurance must be secondary to the plan's mission of providing retirement income. In general, the incidental rule is satisfied if the cost of the life insurance is less than 25% of the cost of benefits under the plan. In addition to the 25% rule, another test applies: The initial amount of life insurance protection cannot exceed 100 times the monthly annuity payable upon retirement. The so-called "100 to 1" test does not limit the death benefit, but instead it provides a safe harbor for plan trustees.

On or before retirement, the plan must surrender the life insurance and use the cash value to provide retirement benefits or distribute the policy to the participant. In general, the cash value of the life insurance policy must be included as taxable income in the year the distribution is made. A better measure of the value of the life insurance policy, however, may be the policy reserve maintained by the life insurance company.

The Annuity Option

Only recently have annuities inside qualified retirement plans become controversial. In some cases, annuities are the traditional funding vehicle. For example, two of the three permissible investment vehicles for most 403(b) participants are annuities-fixed annuities, variable annuities and mutual funds. The controversy focuses on variable annuities, which typically have considerably higher expense charges than mutual funds.

Again, the argument centers on funding a tax-deferred plan with a high-expense investment vehicle-a variable annuity. This is a fair concern, since there are several alternative investment vehicles that have lower expense charges than variable annuities.

Solving this problem is theoretically easy: If you must fund a qualified plan with variable annuities, make sure the cost is comparable to the mutual fund alternative. Several companies offer low-cost variable annuities, but they don't pay any agent commission. Therein lies the problem: We have come full circle back to the fact that this is a commission-driven business. Logically, variable-annuity sales should be a tiny fraction of what they are. A fee-only financial adviser usually will recommend a variable annuity only when the client has maximized qualified pension plan and individual retirement account contributions-and has cash left to invest. Quite simply, the public does not seek out variable annuities; agents sell them to the public. The same is true of life insurance.

Buyer Beware

Producers often urge affluent clients to allocate some of their qualified retirement funds to life insurance and annuity contracts. The sales pitch inevitably stresses the tax benefits of purchasing these products within a qualified plan. But keep in mind that most tax professionals will say that letting tax considerations drive the decision-making process is a bad idea. It always seems to come back to haunt you.

Including life insurance inside a qualified plan is fraught with complexity. Absent careful planning, the ability to avoid estate taxes and some income taxes on the death benefit will be lost. The combined

effect could mean loss of 70% to 80% of the death benefit and/or the accumulated value.

Then there is the Employee Retirement Income Security Act of 1974, which must be considered when life insurance or annuities are included in a qualified plan. The U.S. Department of Labor oversees ERISA. The Department of Labor has contended that funding death benefits in qualified plans with permanent life insurance is a breach of fiduciary duty. To date, the majority of cases involving the Department of Labor have dealt with highly abusive practices in plans covering large numbers of employees. Sooner or later, the department will focus its attention on smaller plans, too.

The life insurance industry has a big public-relations job ahead. It cannot fall back on the ancient standard of caveat emptor-let the buyer beware. The industry must pro-actively set market-conduct standards and enforce them rigorously.

The Insurance Marketplace Standards Association is an important step in the right direction. Mandatory commission disclosure at the point of sale would be helpful in exposing commission-driven products. As experience in the United Kingdom demonstrates, mandatory commission disclosure need not put agents out of business. In the mid-1990s, British financial-services regulators began requiring life companies to reveal expenses, commissions, lapse rates and surrender values to consumers at the point of sale. This transparency led to a more professional sales force and improved persistency. It also demonstrated that consumers don't mind if agents receive commissions, but they will object to big commission numbers.

It's not always inappropriate to employ life insurance inside qualified plans, but many of these sales are inappropriate. In the right situation, with good legal and tax advice and a competent insurance adviser, it can all work out just fine.

That, unfortunately, describes a small percentage of such sales, but word is getting out. Two well-known life insurers recently acknowledged that they no longer allow the use of their life insurance products inside qualified plans. The wisdom of that decision will become apparent as yet another round of class-action litigation rocks the industry in the foreseeable future.

Anthony Steuer is a California-based life insurance analyst, who specializes in life and disability insurance products. Barry Vokes is a financial adviser in Texas. He is an independent assessor for the Insurance Marketplace Standards Association.

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