Life Insurance In Qualified Plans

For business owners, it's sometimes a good idea—but sometimes not. Know the trade-offs

Most people would like some life insurance. Problem is, no one really wants to pay for it. So, since the beginning of time, life insurance professionals have sought creative sources to pay for premiums, the brass ring being to find money that is not currently needed and use it to purchase a policy. If tax leverage can be achieved at the same time: jackpot!

Many turn to qualified plans to purchase their life insurance. This is particularly true for private business owners. And, naturally, one of their primary considerations with a plan's initial design is how it will benefit them as participants.

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Buying life insurance in a qualified plan offers asset protection and significant tax benefits. (See "Income Tax Benefits," p. 48.) And, because the plan assets are usually not needed until retirement, at first blush, it seems that a qualified plan might be an ideal vehicle for purchasing life insurance. That can be—but is not always—the case. Advisors must be aware of the negatives and positives of placing life insurance in a qualified plan so they can decide when it's the best option for a particular client. (See "Concerns," p. 50.)

First, it's important to know how much life insurance can a qualified plan have. The rules differ depending on whether we're talking about a defined-contribution plan or a defined-benefit plan, the type of policy

used, how old the plan is and how long the employee has been a plan participant.

The Treasury regulations specify that the plan document must allow for life insurance and the death benefits must be considered "incidental" to the primary purpose of providing retirement benefits.[1] For example, in defined-contribution plans using whole life insurance, the premium must be less than 50 percent of the employer's contribution. If any other type of policy is used, up to 25 percent of the employer 's contribution can be used to purchase the insurance premium.[2] With a defined-benefit plan, the incidental benefit rule is satisfied in one alternative, if the insurance death benefit does not exceed 100 times the projected monthly pension.[3]

But "incidental" doesn't seem that strictly construed, because in some situations more than 50 percent of the plan assets may be used to purchase life insurance. For example, in a defined-benefit plan the "74-307 test" derived from Revenue Ruling 74-307 may be used. It is actuarially calculated, but generally allows for a larger percentage. In fact, if the participant has accumulated assets in a profit-sharing plan for at least five years, then the incidental rules do not apply and the entire account can be used to pay for insurance premiums.[4]

INCOME TAX

The fact that life insurance premiums in a qualified plan are tax-deductible is very compelling for business owners who are in a high tax bracket or whose premiums are more expensive because of health issues or risky pastimes. The plan participant pays taxes annually on what is deemed to be the pure life insurance protection. That number is simply the cash surrender value subtracted from the amount of the death benefit. So if a $1 million policy accumulated $200,000 of cash value, the amount subject to taxation would be $800,000.

In most cases, the Internal Revenue Service's Table 2001 is applied to the pure protection amount to determine the actual amount of taxable income.[5] Although Table 2001 increases as the insured ages, it's a good deal until around age 70. As a point of reference, these costs would generate $1,224 of taxable income on a 45-year-old and $16,496 on a 70-year-old on $800,000 of pure protection. The good news is that unless the business entity is unincorporated and the participant is an "owner-employee,"[6] these accumulations are considered to be cost basis and can be recovered if the policy is distributed to the participant later. The cost basis is lost and cannot be recovered if the policy lapses or is surrendered at the plan level.

Under Internal Revenue Code Section 101(a), when the participant dies, the pure insurance protection amount is paid out income tax-free to the beneficiaries. However, the amount of the policy's cash surrender value is treated as a taxable retirement plan distribution. The beneficiaries are entitled to deduct the participant's basis in the policy from this amount—unless the participant was an "owner-employee."[7]

In 2007, defined-contribution plans have a maximum per participant contribution limit of $45,000. Because life insurance is just one of the investment allocations in the plan, the participant has to consider whether tax-deferred returns on a different investment would yield overall higher returns than spending those dollars in the plan on premiums to purchase life insurance. Although most policies placed in qualified plans build cash values, mortality costs and expenses will cut into the returns. On the other hand, placing life insurance in a defined-benefit plan will actually increase the total cost needed to fund future benefits and hence increase the tax deduction. The older the participant, the greater the increase. For instance, the deductible contribution for a 45-year-old would be about $40,000 without insurance and about $47,000 with insurance. For a 65-year-old, it would be about $200,000 without insurance and $275,000 with insurance.

SECTION 412(I) PLANS

An IRC Section 412(i) plan is a defined-benefit plan that is funded solely by annuity and life products. Instead of the general funding requirement tests of a traditional defined-benefit plan, the insurance contract guarantees are used for the funding assumptions. These low funding assumptions allow higher contributions in the initial years than a traditional defined-benefit plan. Although there is no diversification or investment flexibility, there also is no market

Business owners in high tax brackets like the fact that life insurance premiums in qualified plans are tax deductible.

risk, because the retirement benefits are guaranteed.

A 412(i) plan may be attractive to the small business owner who needs large tax deductions. The real point to consider is the trade-off between deductions and rate of return. In a 412(i) plan, the overall rate of return will be lower because of the insurance company's low interest rates as well as the mortality costs of the life insurance. The lump-sum amount that needs to be achieved at retirement in order to generate the target benefit is the same with either type of defined-benefit plan. It just takes more tax-deductible dollars to get there with a 412(i) plan. The client needs to measure what the potential gain or loss would be if he had taken the excess 412(i) contribution net of taxes and invested it outside of the plan.[8]

ESTATE TAX

Life insurance proceeds in a qualified plan are includible in the participant's estate.[9] Depending on the amount of the death benefit and the value of the participant's other assets, the estate tax could be onerous and negate the benefit of deductible premiums. The wealthier the participant, the more important it is to get the insurance out of the plan before death. Moreover, the Table 2001 annual taxable costs start increasing significantly at older ages making the continuation of the insurance in the plan less attractive.

If the insured no longer wants the insurance, he can cash in the policy. Upon notice of surrender, the insurance company will pay the cash surrender value to the plan and the employee can roll this value along with the other accumulated assets into an individual retirement account (IRA.) But, by surrendering the policy in the plan, the employee loses his income tax basis in the policy and cannot apply it to any cash distributions from the plan or IRA.

If a participant wants to retain the life insurance outside of the retirement plan, a roll out is the best solution. If the requirements are met under Prohibited Transaction Exemption 92-6 (PTE 92-6), the policy can be either distributed to the participant or sold to the participant for the fair market value (FMV.)

The IRS addressed the value of a life insurance policy when it is removed from a qualified plan with final regulations issued in August of 2005. Previously, the FMV typically was considered to be the cash surrender value. Because many policy designs include surrender charges for a period of time, which reduce the cash values at surrender, there was an opportunity for valuation game-playing. In other words, an insured plan participant could enjoy the benefits of tax-deductible life insurance premiums paid by the business and later distribute or buy the policy from the plan at a discount.

For policy sales or distributions from a qualified plan made after Feb. 12, 2004, the "policy cash value and all other rights under such contract (including any supplemental agreements thereto and whether or not guaranteed) are included in determining fair market value."[10] The IRS also provided a safe harbor formula in Revenue Procedure 2005-25. Particularly for the wealthy participant with concerns about estate tax, these new regulations significantly reduce the advantages of purchasing insurance in a qualified plan. The arbitrage of lower taxable cash values has been eliminated.

If the life insurance policy is distributed and not sold to the participant, the policy's FMV minus the amount of his basis will be gross income to him in that year. One advantage of life insurance outside of a qualified plan is the tax deferral on the cash values. That benefit is eliminated if the insured participant takes the policy as a taxable distribution. Conversely, purchasing the policy from the plan preserves the deferral in the policy.

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INCOME TAX BENEFITS

Here's a summary of the positives to purchasing life insurance through a qualified benefit plan

When deciding whether a client who is the owner of a privately held business should purchase his life insurance through his company's qualified plan, keep in mind that:

- Premiums are tax-deductible to the business.
- A participant with a higher premium because of a health rating has no greater reportable annual taxable income than a healthier participant, because Table 2001 is used to calculate the amount on the pure insurance protection regardless of any rating.
- Larger total deductible contributions are available to the business if life insurance is part of a defined-benefit plan.
- Upon distribution to a participant, the accumulated annual tax payments can often be applied as basis.
- At the participant's death, the accumulated annual tax payments often can be applied as basis to the taxable cash surrender amount.
- The pure insurance protection is received income tax-free by the beneficiaries.

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plan would require the participant to pay the plan for the policy's FMV. The policy still will be estate-taxable, unless ownership rights are transferred. Transferring the policy to a life insurance trust or another beneficiary as a gift would trigger the three-year rule, meaning the proceeds would not be removed from the estate until three years after the gift was made.[11] The three-year rule could be avoided providing the policy is sold to a trust or beneficiaries. The transfer-for-value rules,[12] which create an income-taxable death benefit, can be avoided if the policy is sold to a partnership in which the insured is a partner[13] or to a grantor trust.[14] The long and short of it is that there are solutions for getting the insurance out of the estate. Living long enough and planning in advance are key.

Some professionals have used a technique called "subtrust planning" to attempt estate-tax exclusion. The subtrust is a trust established by the employer to hold a life insurance policy on the participant's life, and a trustee is selected irrevocably. In 2006, an unpublished Technical Advice Memorandum (TAM) concluded that a subtrust feature caused disqualification of a defined-benefit plan.[15] It's unclear whether this TAM means that all subtrust arrangements are suspect or that better drafting could have overridden this ruling. Determine a client's risk tolerance before pursuing subtrust planning, as plan disqualification could result in disallowance of all the employer's deductions and possibly lead to current taxation of plan participants.

SECOND-TO-DIE POLICIES

For clients who are married, second-to-die policies—which insure two lives and pay when the second policyholder dies—may be a viable option. These policies are often purchased to provide liquidity to pay the estate tax, which is not usually due until the second spouse dies. Qualified plans may purchase these policies, as long as the plan document provides for it. The participant is taxed annually using Table 38 in most cases, which is a table adjusted for joint lives.

There are numerous details to finalize in an attempt to keep the insurance proceeds out of such an estate. An irrevocable life insurance trust must be established. The spouse must sign a consent form waiving the pre-retirement survivor annuity. The participant must execute a beneficiary designation directing the trustee to transfer ownership of the policy to the irrevocable trust if the participant dies first. The cash value is includible in the deceased participant's estate, along with the balance of the plan.

Depending on policy design and performance, it's possible that ongoing premium payments will be required

after the first death. Carefully evaluate whether, if the participant dies first, the surviving spouse will have the ability and desire to pay those premiums.

If the spouse dies first, the participant must remove the policy from the plan and transfer it to the trust in the same manner as with a single-life policy. Under age 59 1/2, a 10 percent penalty applies to early distribution in addition to the income taxes. In this scenario, a sale rather than a distribution is advisable. If the participant lives too short a time to make the appropriate distributions and transfers, the entire proceeds will be estate-taxable.

There is one caveat to a sale of a survivorship policy: PTE 92-6 exempts the plan's sale of a life insurance policy from the prohibited transaction rules provided that the sale is made to the participant or beneficiary. If the policy needs to be rolled out while both spouses are living, the spouse is neither a participant nor a beneficiary. But if the participant alone purchases the policy, this may be considered only partly a sale to the insured for purposes of the transfer-for-value rule because the policy covers both spouses.

BUY-SELL PLANNING

One strategy that helps business partners provide buy-sell funding at death involves using life insurance in a profit-sharing plan. The plan document must permit the purchase of insurance. It also must allow for self-directed accounts and must provide that proceeds on the insured's death may pass to the participant whose account paid for the insurance. The participant purchases the insurance on the partner and is the ultimate beneficiary of the policy. The pure insurance protection is received free of income tax by the surviving partner to purchase the stock from the deceased partner's estate.

The buy-sell agreement should specifically identify the policies and indicate that only the pure insurance protection is to be used for the stock purchase. To mitigate additional income tax consequences, any additional payment requirements can be made in the form of installments from assets outside the plan. The partners may be able to purchase the insurance on their lives directly from the other's account under PTE 92-6), if neither partner dies before retirement or the surviving partner wants to continue his insurance.

Tax-deductible premiums for a business owner have obvious advantages. Even when a client knows he needs insurance, he never likes paying for it. The qualified plan provides the accessible cash for premium payments and enables the business owner to increase his deductible contribution if he has a defined-benefit plan. Purchasing the insurance from the plan before the Table 2001 costs get too high results in a capital transfer. The insured is taking money from outside the plan and putting it inside the plan along with the retirement assets and rolling it all into an IRA for further tax-deferrals.

The competing consideration is for the business owner who wants to minimize his estate taxes. Since policy valuations using depressed cash values as the FMV for policy transfers is no longer a viable strategy, the business owner has to consider if it's better to purchase insurance in an irrevocable trust from the outset. Asking the right questions and understanding the trade-offs will enable the advisor to determine if the client's qualified plan is the best funding source for his life insurance. ❙

CONCERNS

Know the drawbacks

There are some real drawbacks to buying life insurance through a qualified plan:

- Life insurance is estate taxable if left in the qualified plan.
- Avoidance of transfer-for-value and prohibited transactions must be accomplished when purchasing the policy from the plan and transferring ownership.
- The fair market value of the policy must be ascertained to avoid severe tax consequences.
- Qualified plan documents must permit life insurance and should be coordinated with the overall estate plan.
- The participant must live long enough to carry out the planning.

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Endnotes

1. Treasury Regulations Section 1.401-1(b)(1)(i).
2. Revenue Ruling 66-143, 1966-1 C.B. 79.
3. Rev. Rul. 60-83, 1960-1 C.B.; Rev. Rul. 68-453, 1968-2 C.B. 163.
4. Rev. Rul 68-24, 1968-1 C.B. 150.
5. Notice 20002-8, 2002-4 I.R.B. 398.
6. Sole proprietor of unincorporated business, or a partner who owns more than 10 percent of either the capital interest or the profits interest in the partnership. Internal Revenue Code Section 401(c)(3); Treas. Regs. Section 1.72-16(b)(4)
7. Treas. Regs. Section 1.72-16(c)(3)m, Ex. 1; Rev. Rul. 63-76, 1963-1 C.B. 23.
8. There have been abusive transactions with IRC Section 412(i) plans that go beyond the scope of this article. However, these abuses have been addressed by the Internal Revenue Service in Rev. Ruls. 2004-20, 2004-21 and Revenue Procedures 2004-16 and 2005-25.
9. IRC Section 2042.
10. *See* Treas. Regs. 1.402(a)-1(a)(1)(iii), Aug. 29, 2005, as amended, and Rev. Proc. 2005-25, 2205-17 I.R.B., which provides a safe harbor formula.
11. IRC Section 2035(a).
12. IRC Section 101(a)(2).
13. IRC Section 101(a)(2)(B), Private Letter Ruling 2001-20007
14. IRC Sections 671 to 677, Rev. Rul. 85-13, 1985-C.B. 184 and PLRs 2005-14001, 2005-14002 and 2002-47006.
15. The basis for this conclusion is that a subtrust feature, in the particular facts and circumstances, (1) violates the exclusive benefit rule of Section 401(a); (2) violates the joint and survivor annuity requirement of IRC Sections 401(a)(11) and 417; and (3) creates a prohibited assignment or alienation.