

Life Insurance In A Qualified Plan

Purchasing life insurance through a qualified plan enables clients to leverage the dollars they spend on premiums and, in many cases, provides important estate planning benefits.

Purchasing the Life Insurance. The first step in implementing this strategy is to direct the qualified plan to purchase life insurance on the life of the plan participant. If a plan is currently not available then an individual as sole proprietor can establish his own profit sharing plan. The individual must have earned income that would allow him to establish the profit sharing plan. Qualified plan assets may be invested in life insurance provided that (1) the plan document specifically authorizes the purchase of life insurance on the person to be insured and (2) the life insurance death benefits are incidental to the plan's principal purpose of providing retirement benefits.

In a defined contribution plan [401(k), profit sharing, money purchase or target benefit plan] a percentage test is ordinarily applied. For whole life policies, the general rule is that total premiums must be less than 50% of cumulative employer contributions to the plan. For other policies the total premiums must be less than 25%. Defined benefit (pension) plans may provide a death benefit of up to 100 times the anticipated monthly benefit at normal retirement age.

The G&T Benefits Services Defined Contribution Plan has special language that permits exceptions to these general rules. This greatly increases the amounts that can be spent for life insurance. First, the incidental benefit rule does not apply to funds that have been in a profit sharing plan for at least two years. In addition, an employee with at least five years of plan participation in a profit sharing plan may invest all employer contributions in life insurance (including those made within the past two years).

Perhaps more importantly, the plan assets that may be used to purchase life insurance can be augmented with IRA funds. For tax years before 2001, distributions from IRAs can be rolled into qualified plans only if the assets originally came from a qualified plan and have not been commingled with regular IRA contributions. EGTRRA changed this rule. It provides that all IRA distributions made after 2001 can be rolled into a qualified plan regardless of their source. The funds rolled into the plan from the IRA may not be subject to the incidental benefit test. Taxpayers who have an IRA but are not participants in a qualified plan could still take advantage of this strategy by creating a business (e.g. consulting) and setting up a self-employed (Keogh) plan for themselves.

Favorable Tax Consequences. The qualified plan pays premiums on the policy each year and these payments are a taxable event to the plan participant. The amount subject to tax is not the amount of the premium, but only the cost of the pure insurance protection (i.e. the cost of the term component of the policy). After about five years, the policy will be distributed out to the plan participant. The amount subject to tax will be the cash surrender value of the policy as of that date, reduced by the sum of the annual tax payments made on the term cost. The policy will be structured so that its cash surrender value will be only a small percentage of the premiums paid (perhaps less than 22%). Purchasing life insurance through a qualified plan leverages the amount spent on premiums, in effect enabling the plan participant to purchase life insurance mainly with pre-tax dollars. The main reason for the discrepancy between the cash surrender value and the total amount of premiums paid is that the policy has a very high surrender charge in its early years. When the taxpayer dies and the policy proceeds are paid to his or her beneficiaries, the death benefit will not be subject to income tax.

If a life insurance policy is transferred, there would ordinarily be a taxable gift equal to the cash surrender value of the policy. If the insured keeps the policy until death, the value of the policy is included in the gross estate only if he or she had "incidents of ownership" over the policy at death or transferred incidents of ownership in the policy within three years of death. Incidents of ownership include not only outright ownership of a policy, but also certain other retained rights over the policy, like the right to change beneficiaries, to pledge the policy as collateral for a loan, or to surrender or cancel the policy.

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To avoid having the policy included in the estate, the taxpayer could transfer it to his or her children or to an irrevocable life insurance trust (ILIT) set up for their benefit. Gift tax or use of unified credit could be avoided by using annual exclusion amounts to make the transfers. While the transfer of interests would not ordinarily qualify for these exclusions because the gift is not one of a present interest, "Crummey" powers can be used to get around this problem. The proceeds of the policy will not be included in his or her estate provided the taxpayer lives at least three years after making the transfers to the children or to the ILIT.

Thus, the tax consequences are extremely favorable. The transaction can be structured so there is no gift tax, no estate tax, and a large reduction in income tax.

Note that if the taxpayer dies while the policy is still inside the qualified plan, the proceeds ordinarily would be included in his or her estate. Having the employer create a subtrust to hold the life insurance policy may keep the policy out of the estate.

Overall Estate Planning Benefit. If assets remain in the qualified plan at death, only a small percentage of these assets will be left for heirs after taxes have been paid. The full value of the plan assets will first be subject to estate tax. Then, when the participant's beneficiaries receive distributions, the payments will be subject to income tax (with a credit for the federal estate tax paid). When the qualified plan assets instead are invested in life insurance and the policy is distributed out to the participant, these tax consequences are replaced by very favorable tax consequences, as previously noted. There is a tradeoff, however. Returns inside an insurance policy may be quite low. Whether the participant's beneficiaries end up with more after taxes when plan proceeds are invested in life insurance depends largely on how long the plan participant lives, the rate of return on the plan assets, and whether alternative estate planning is done with the assets in the plan.

If a client needs life insurance and has more in qualified plans and/or IRAs than he or she expects to need during life, purchasing the insurance through a qualified plan will enable the client to get more insurance for the money spent. In many cases, purchasing insurance through a qualified plan will also leave a higher percentage of the plan and IRA assets for beneficiaries after all tax has been paid.

The G&T Benefits Defined Contribution Plan has received a favorable determination letter from the IRS dated 11/27/2001. This provides for 100% reliance on the language within the document.