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Special Uses of Life Insurance in Pension Plans
Winning strategies revealed.
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Many highly compensated employees have successfully accumulated large sums in their qualified pension plans. As these executives approach retirement, a few begin to realize the following circumstances may apply to their situations:

- They may not need the qualified plan assets for their retirement to support their lifestyles;
- Distributions from the plan will be subject to income taxation at the executive's marginal rate that may not be any lower and in some cases potentially higher income tax rates than at the time of contribution;
- They have life insurance needs for estate planning purposes and would like to purchase such insurance now while they are still insurable. They would like to utilize plan assets to pay for all or a substantial portion of the cost of such insurance using funds they have already accumulated in their qualified plan;
- They do not want estate and income taxes to erode up to 70 percent to 75 percent of their plan's value at death

Life Insurance in a Pension Plan

One of the uses of life insurance in a pension plan is to provide substantial estate tax liquidity through the purchase of permanent life insurance in addition to enabling participants to pass qualified plan assets from the gross estate of the participant in a tax efficient manner.

Steps to Make the Strategy Work

- Employer either establishes or amends an existing Profit Sharing Plan to enable the plan to purchase life insurance.
- Participant may transfer other existing qualified plan assets (i.e. 401(k), IRA Rollover, Money Purchase Plan) into the Profit Sharing Plan.
- The Profit-Sharing Plan purchases a permanent life insurance policy on either the Participant's life or the Participant and their spouse.
- The Profit-Sharing Plan pays the annual premium of the life insurance policy.

For each year the policy is inside the *plan*, the *participant* is taxed on the amount of the annual economic benefit. The *participant* reports the annual economic benefit on the *participant*'s tax return. The Participant gifts "other" assets to an Irrevocable Life Insurance Trust (ILIT) utilizing Lifetime Credit if available.

In the future the *participant* may wish to change the asset allocation of their participant directed investment program within the Plan, thereby triggering the need to remove the contract from the plan's asset mix. The policy may either be "distributed" or "purchased" from the *plan* by either the *participant* or a third party entity (i.e. ILIT) to change the asset allocation. The sale of the policy in this situation should be structured with the advice of counsel to qualify as an exemption under PTE 92-6.

Transfer for Value Rules

The transfer of a life insurance policy to someone other than the insured in exchange for valuable consideration is called a transfer-for-value. A transfer-for-value subjects the life insurance proceeds in excess of the transferee's basis to income tax. The sale of a life insurance policy to someone other than the insured (i.e. ILIT) may be a

transfer-for-value. In order to avoid the adverse tax consequences of a transfer-for-value transaction, an exception must be found.

The purchase of the policy by the ILIT (drafted as a grantor trust) may be considered a transfer to the insured and therefore qualify as an exception to the transfer-for-value rule (Swanson, Jr. v Commissioner, 518 F.2d 59 (8th Cir. 1975)). In PLR 2002280191, the IRS ruled that a transfer of a life insurance policy from one grantor trust to another for adequate consideration would not be subject to the transfer-for-value rules and as a result, the death benefit proceeds would not be subject to income taxation.

Incidental Benefit Limits

Qualified plan documents must allow for the purchase of life insurance and the death benefit to be incidental to the plan's primary purpose of providing retirement benefits. There are different tests designed as safe harbors to determine whether the insurance provides an incidental benefit. The coverage must pass the appropriate test each year that contributions are made. As an alternative to the safe harbor tests, the Profit Sharing Plan may utilize "seasoned money" (Rev. Rul. 68-24) to purchase amounts of insurance greater than the safe harbors allow. "Seasoned money" is comprised of Plan funds that are eligible for withdrawal by the participant. Employer contributions may be available after two years and the balance of the account may be withdrawn after five years. For an IRA and qualified plan assets rolled over into the *plan*, the two- and five-year time requirements can be fulfilled through proper drafting to be determined by "tacking" on the time the funds were in the previous plan. Voluntary contributions are another potential source of funds.

Policy Valuation

Participants who purchase the policy from their qualified plan must be comfortable in making the determination of the appropriate valuation of the policy. If the IRS determines that a different value is appropriate, additional taxes and penalties may occur. According to PTE 92-6, the plan must receive as payment an amount at least equal to the amount the plan would have received if the policy were surrendered (i.e. cash surrender value).

Under Treasury Regulation §1.402(a) –1(a)(2), property distributed from a qualified plan will generally be taken into account at its fair market value. Treasury Regulation §1.402(a) –1(a)(2) states that for a life insurance contract, "the entire cash value of such contract at the time of the distribution must be included in the distributee's income." However, there is not a clear indication of the term "entire cash value". Some commentators believe that this value may be based on the tax reserves, interpolated terminal reserve, the accumulation value, replacement cost, premiums paid or some other amount.

Rev. Proc. 2005-25 provides guidance on how to determine the fair market value of a life insurance contract, retirement income contract, endowment contract or other contract providing life insurance protection for purposes of applying the rules of §§ 79, 83 and 402 of the IRC. This revenue procedure applies to distributions, sales and other transfers made on or after February 13, 2004.

Basic Plan Requirements

- The plan must be established for the benefit of employees or their beneficiaries.
- Plan assets cannot be used other than for the exclusive benefit of the employees or their beneficiaries.
- The Plan must be non-discriminatory, meet vesting requirements and provide for distributions that satisfy the minimum distribution requirements.
- Plan must allow for in-service distributions.
- Plan should allow participant-directed investing, permit the purchase of life insurance and if applicable, survivorship (joint-life) insurance.

Conclusion

This is one of the strategies utilizing life insurance that may enable plan participants to put pension assets to work to accomplish life insurance and estate planning needs in a tax efficient manner while transferring significant wealth to their intended beneficiaries.

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