

Leimberg's Think About It

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#390

PENSION-OWNED LIFE INSURANCE: THE SEARCH FOR TAX LEVERAGE

INTRODUCTION

Business owners seek to maximize the effectiveness of their employee benefits. From the employer's perspective, the perfect employee benefit

1. Has high perceived value—from both the employer's and employee's perspectives—relative to cost,
2. Allows the business owner to discriminate in favor of a select group,
3. Gives the employer a tax deduction,
4. Allows the employee to exclude the employer contribution to cost from his income, and
5. Yields a tax-free benefit to the employee at a critical time.

Individual life insurance performs well when measured against the first and fifth goals in the list. However, those of us in the life insurance business struggle with maximizing the other three goals. Getting a tax deduction for the business's premium contribution, excluding the premium from the employee's income, and allowing the employer to discriminate in favor of the company's majority owner is the life insurance holy grail.

Life insurance owned by the business does not create an income tax deduction for the company. Section 264 of the Internal Revenue Code states

No deduction shall be allowed for ... premiums on any life insurance policy, or endowment or annuity contract, if the taxpayer is directly or indirectly a beneficiary under the policy or contract.

Determined life professionals have tried various ways to generate income tax leverage for life insurance premiums. For example, charitable reverse split dollar (CRSD) was marketed several years ago with the following highlights:

- A business's premium for life insurance coverage would be income tax deductible.
- The employee/owner would not have to include the premium paid by the business in his taxable income.
- The company could be completely selective on who it chose to include.
- The employee/owner could use the insurance policy to provide for his or her own retirement income on a tax-advantaged basis.

The charity involved in the plan would receive some benefit in the event of the owner/employee's death.

IRS Notice 2002-59 effectively ended all reverse split dollar configurations, including CRSD. Professionals have also looked to Section 419(e), Section 419A (f) and 501(c) (9) for authority to create discriminatory, tax-advantaged plans for a select group of employees. The IRS has effectively shut down those avenues by identifying most such plans as listed transactions. The failure of more aggressive plans to pass tax muster has made professionals revisit and embrace more traditional implementations.

For example, these days the executive bonus plan is getting more looks. Under a bonus arrangement,

- The employer pays the employee a reasonable amount of extra compensation,
- The employer takes a tax deduction for the bonus, and
- The employee includes the bonus in his taxable income.

On the plus side, the company sponsoring the plan gets a tax deduction, and discrimination in favor of key employees is allowed.

Bonus plans are usually not that attractive for the business owner because the business's paid premium is personally taxable. In particular, if the business has just one owner, a bonus plan for his or her benefit generates no real income tax leverage.

So what's left?

If a closely-held company's pension plan can own insurance on the life of an owner, it seems like an attractive strategy. The pension plan can pay for the needed insurance with pre-tax money, and the death benefits are available to support the family needs of the participant.

The purpose of this article is to review the use of pension owned life insurance, where it fits, the rules that must be followed and its drawbacks.

THE RULES

Before a client can have his pension plan purchase insurance coverage on his life, the client's business must have a pension plan. Some may consider implementing a pension plan just to support the desired insurance. However, that's not a course for everyone, because the normal pension qualification rules apply:

- All eligible employees must be included
- The plan cannot discriminate in favor of certain employees
- Related businesses must be aggregated together
- A plan document must be implemented and kept up-to-date
- Other strict administrative requirements must be observed

In addition to the normal pension rules, the plan document itself must deal with the details of when and how insurance may be purchased on the plan participants.

The bottom line is that it's expensive to implement a pension plan. While there may be circumstances where it makes sense to start a plan in conjunction with life insurance, those circumstances would be the exception rather than the rule.

General Rules on Pension Money Used to Pay for Life Insurance

Employer contributions to a qualified plan, including amounts used to purchase life insurance, are generally deductible if the amount of life insurance purchased is "incidental" to the plan.

A qualified retirement plan, from the government's perspective, should provide retirement benefits. But it may also provide for the payment of death benefits as long as those benefits are "incidental." Life insurance can be used to provide an incidental death benefit to participants in a qualified retirement plan.

The Service considers any non-retirement benefit in a qualified plan to be incidental so long as the cost of that benefit is less than 25% of the total cost of the plan. Since this standard is difficult to apply, the IRS has developed two practical tests for life insurance in a qualified plan.

If the amount of insurance meets either of the following tests, it is considered incidental:

1. The participant's insured death benefit is no more than 100 times the expected monthly normal retirement age benefit, or
2. The aggregate premiums for any insured death benefit is less than the following percentages of the overall cost to provide plan benefits for that participant:
 - a. 25% for term or universal life insurance

- b. 50% for whole life or variable life insurance

Defined Benefit, Defined Contribution and Profit Sharing Plans

Defined benefit plans have typically used the first test with respect to incidental benefits, while profit sharing plans and defined contribution plans have generally used the second. However, any type of plan can use either limit.

A profit sharing plan may allow for extra contributions to be made to plan-owned life insurance. If the plan provides that life insurance can only be purchased with funds that have been on deposit for two years or more, there is no limit as to how much can be used to purchase life insurance.

Section 412(i)

In recent years, some life companies and producers have focused on marketing 412 (i) pension plans. These plans allow annuities and life contracts to be used to fund the pension benefits.

A 412(i) Plan is one that provides for a fixed monthly pension benefit at a specific retirement age. The benefit must be funded with either

- an annuity, or
- a combination of an annuity and a life insurance contract.

Each of these contracts must have level premiums that will guarantee the specified pension benefit.

Section 412(i) permits the insurance company to determine its guaranteed interest rate that generates the retirement benefit. The insurance company usually sets this rate to be very low—as low as 3% or less. That means the deductible contributions in early years can be much higher than those for more traditional defined benefit plans, while still guaranteeing the retirement payout. That fact can favor older 100% owners of a closely-held business.

The IRS has expressed its dislike for low interest rate guaranteed life and annuity contracts funding 412(i) plans. The Service has stated its position that such contracts may be valued too low, and that a fair valuation would disallow some claimed deductions for the 412(i) contributions into those contracts. See Revenue Ruling 2004-20.

In the absence of firm regulations from the Service, a conservative implementation of 412 (i) should have life and annuity contracts that

- pay a reasonably high guaranteed interest rate for the life and annuity contracts funding the plan,
- are structured with reasonable surrender periods, and do not have any other “springing

- cash value” features, and
- limit the death benefit amount at risk of its life contracts.

Section 412(i) plans often use life insurance as part of their funding. Because of the special 412(i) rules, the amount of pension money used for life insurance may be higher than for other pension plans. However, because the funding of each participant’s pension account uses the same guaranteed issue life products, performance of the life product for a healthy insured is typically not as good as for a fully underwritten individual product.

SEPs

Under a Simplified Employee Pension (SEP), the employer makes regular contributions to each employee’s IRA. Contributions under a SEP are deductible by the employer, and not included in the employee’s income. The amount that can be contributed to a highly compensated employee’s SEP is much greater than the individual might contribute on a deductible basis to his or her own IRA.

While SEPs are popular for closely-held businesses for their simplicity, they cannot be used in conjunction with life insurance. SEP contributions are made into the participants’ IRA accounts, and IRAs are not permitted to own life insurance. See Code Section 408(a)(3).

Economic Benefit Value

The premium used by the participant’s pension account to pay for a life policy is pre-tax, but the transaction is not completely tax free to the participant. The employee must recognize taxable income equal to the economic benefit value of the life insurance.

The calculation of taxable benefit is calculated on the amount at risk—that is, the difference between the policy’s cash value and its death benefit. The amount at risk is taxed annually to the participant at the lower of

- the IRS Table 2001 cost, or
- the life insurance company’s actual rates for individual one-year term policies available to all standard risks.

If the policy in question is a survivorship contract, as long as both insureds are still alive, the imputed income is less than under a single life contract.

THE ISSUES

Setup and Ongoing Administration

To conform to nondiscrimination rules, pension-owned insurance coverage should be provided for all plan participants under a nondiscriminatory formula. For example, the amount of life

insurance for each employee might be specified as ten times the expected annual retirement benefit under the plan.

The insurance coverage can be conditioned on taking a medical exam if this does not result in discrimination in favor of highly compensated employees. For example, if the plan's insurance formula provides insurance of ten times the annual benefit for standard risks, the insurance provided for a "rated" employee might be only five times the annual benefit.

In general, the pension trustee may make sensible investment choices about whether permanent or term insurance is appropriate for a particular participant. It is unclear whether the plan can offer life insurance at all if one or more of the participants cannot qualify for coverage.

In addition to the expense and hassle of including all participants in the life insurance aspect of the plan, the pension-owned policy is less flexible than similar personal coverage. For example, cash flow can be generated from a non-MEC personal policy on a tax-free basis through withdrawals up to basis and loans. Any distributions from a pension-owned policy to the insured, if they are permitted by the plan, are taxable pension distributions. The taxable distributions are also potentially subject to the 10% penalty tax, if the participant is younger than 59 ½.

Unwinding —Income Tax Consequences

At retirement, the participant may want to terminate his interest in the qualified plan. Likewise, it may be smart to undo the pension-owned life policy.

Pension rules prohibit members of a family controlling 50% or more of the ownership of a business from buying a life insurance policy from the pension plan. However, Prohibited Transaction Exemption (PTE) 92-6 permits such an employee to purchase life insurance from the pension plan if the plan would have otherwise disposed of the policy.

Under PTE 92-6, as amended, the purchase price for the policy is its fair market value. The IRS released Revenue Procedure 2005-25 saying the value of a life insurance contract sold or otherwise distributed from a qualified plan is the greater of its *interpolated terminal reserve* and its so-called *PERC value*.

Interpolated terminal reserve is the amount that the insurance company sets aside to fulfill its obligations under the policy. In general, the interpolated reserve value of a life insurance contract is similar to its surrender value.

The calculation of the PERC value is a relatively new idea. The Service set a safe harbor formula for determining the policy's PERC value based on the aggregate of:

1. aggregate premiums paid; plus
2. any dividends, earnings or interest credited with respect to those premiums; minus

3. any distributions made; and minus
4. reasonable mortality charges and reasonable expense charges.

After purchasing the policy from the plan for its value, the participant would be free to re-configure policy ownership and beneficiary designation to meet his planning needs. Of course, such re-configuration might have gift or other tax implications that would need to be managed.

If the insured passes away prior to retirement, the policy's death benefit would be paid to the insured's designated beneficiary. The income taxation of an insured death benefit paid to the participant's beneficiary is as follows:

1. The death benefit less any cash value is income tax free to a participant's beneficiary.
2. The total of all economic benefit costs paid by the participant can be recovered tax free from the cash value part of the death benefit.
3. The remainder of the distribution is taxed as a qualified plan distribution.

Estate Tax Issues

Qualified plan death benefits are included in a decedent's estate for federal estate tax purposes. However, proponents of the "pension subtrust" technique believe it is possible to exclude the insured portion of the death benefit by eliminating the participant's lifetime ownership rights in the pension-owned life insurance policy.

The pension subtrust strategy has had some popularity for the past twenty years or so. Here's how the strategy is usually implemented:

- The pension plan document is amended to allow the creation of an irrevocable life insurance subtrust to receive the proceeds from the insurance on plan participants.
- The subtrust creates a mechanism for and names a "special trustee" which holds all incidents of ownership.
- For all practical purposes, the subtrust acts like an irrevocable life insurance trust—where the beneficiaries of the subtrust would usually be the participant's children.

The objective of the subtrust is to eliminate the proceeds of the insurance from the taxable estate by removing all of the participant's incidents of ownership from the pension-owned policy. And, because pension plan money is used, the participant gets an indirect income tax deduction for the premium.

In 2007, the IRS issued an unpublished Technical Advice Memorandum (TAM) which, in our opinion, has effectively killed the subtrust technique. The subtrust considered in the memorandum caused the pension plan to be disqualified because it

1. Violated the requirement that the plan be for the exclusive benefit of the participant and his family,

2. Violated defined benefit plan rules regarding joint and survivor annuities, and
3. Created a prohibited alienation of benefits.

Disqualifying the pension plan as a whole was a severe penalty for implementing the subtrust.

Some may argue that since the TAM does not have the same force as a court opinion, that the subtrust technique is still viable. In light of the logic of the TAM, subtrusts seem to be highly risky at best.

CONCLUSION

Pension-owned life insurance is a relatively safe way for a business owner to obtain needed life insurance coverage using pre-tax money. However, it's not a fit for every situation.

Having the pension plan pay for coverage is worth considering where

- The coverage is needed for family income replacement,
- Estate tax inclusion is a less important consideration,
- The employer has already implemented a pension plan that allows for the purchase of life insurance, or
- The amount of coverage needed is high, and a profit sharing plan is already in place.

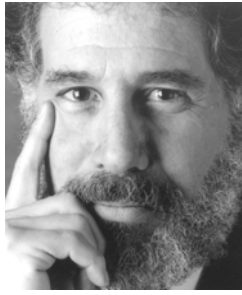
While using pre-tax money for needed coverage is helpful,

- There are relatively high costs of setup and implementation, especially if the pension plan does not yet exist or allow for the purchase of life insurance,
- The participant must recognize the economic benefit value of the death benefit as taxable income, and
- The cost of unwinding the coverage can be high.

For those instances where pension-owned life insurance is not a fit, business owners should consider bonus arrangements, collateral assignment non-equity split dollar, supplemental executive retirement arrangements, or the simple purchase of needed insurance with personal money as alternatives.

In the right situation, pension-owned life insurance is a good bet. Where aggressive planners and clients have been greedy about making it do too much, the IRS has imposed a high penalty.

The moral? Don't make pension-owned life insurance do too much.



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