



Looking for premium dollars?

Advanced Markets

Life insurance in a qualified plan
producer guide



EQUITABLE

Introduction

Are your clients optimizing their pretax dollars? This guide can help you demonstrate the notable benefits of purchasing life insurance in a qualified plan.

It is likely that your small business owner clients have significant insurance needs. These clients may know they are underinsured, but may be unsure how to purchase additional coverage due to cash flow issues. In these situations, pretax retirement plan dollars can be an ideal source of the life insurance premium dollars needed to help protect assets, businesses, spouses and families.

Please be advised that this document is not intended as legal or tax advice. Accordingly, any tax information provided in this document is not intended or written to be used, and cannot be used, by any taxpayer for the purpose of avoiding penalties that may be imposed on the taxpayer. The tax information was written to support the promotion or marketing of the transaction(s) or matter(s) addressed, and you should ask your clients to seek advice based on their particular circumstances from an independent tax advisor.

In this guide

You will learn the many benefits of purchasing life insurance with pretax dollars, key technical issues and how plan assets may be distributed while seeking maximum tax benefits.

Important note

As this sales approach could be applied in connection with either the sale of a product to fund an ERISA-qualified plan, or distributions from retirement accounts (as defined by the Department of Labor's (DOL) Fiduciary Duty Rule), it may be subject to, or otherwise fall within the context of that rule. Accordingly, you must ensure that any action you take pursuant to this sales approach fully comports with all aspects of the DOL's rule, as determined and approved by your firm's legal, compliance and supervisory policies, procedures and protocols. This discussion does not constitute direct or indirect advice toward, or recommendation for, any particular product or of the appropriateness of any particular investment-related option. Each client's unique needs, goals and circumstances require individualized attention.

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Target market any business entity

The inclusion of life insurance in a qualified plan may provide benefits to the owner(s), as well as other plan participants, of virtually any form of business entity — sole proprietorship, partnership, S-Corporation, C-Corporation or LLC — provided one or more of the owners have a significant need for life insurance. Of course, if a qualified plan offers life insurance, all plan participants can elect to utilize it.

It may be especially advantageous for business owners who meet any one or more of the following criteria:

- **Are the sole owner of a service business** — These businesses typically have no market value upon the retirement or death of the owner, so the qualified plan, including life insurance, can provide the liquidity and exit strategy that would otherwise be found only in an insured buy-sell arrangement.
- **Age 50 or older** — Because they are likely more sensitive to their life insurance needs, not because the use of life insurance is any less advantageous for younger business owners.
- **Can influence employee retirement plan decisions** — The decision to include life insurance will likely be made by the majority owner(s) of the business.
- **Face estate tax and planning issues**

Business owners who, in addition to meeting the criteria, have considerable assets in IRAs, rollover IRAs or other qualified plans may benefit the most, as they may be able to use these assets to fund a significant portion or perhaps even the entirety of their life insurance needs.

Benefits of purchasing life insurance in a qualified plan

Above all, qualified plans are designed to accumulate assets for retirement. In certain circumstances, purchasing life insurance within a qualified plan (when the plan permits) is an excellent way for your clients to save money, while protecting their beneficiaries and assets, using pretax dollars.

Asset protection

Your clients' reasons for purchasing life insurance will vary. Life insurance can meet the unique needs of your individual and business clients. Below are some of the reasons your clients may choose to put coverage in place. For plan participants looking to a qualified retirement plan to accumulate assets for themselves and their spouses, life insurance can provide a means of self-completing the plan in the event of the premature death of the plan participant. Life insurance purchased in a qualified plan provides a prudent degree of security for a non-working family partner, helping to ensure their retirement income needs will be met.

1

Estate preservation

Although qualified retirement plans are among the most efficient asset accumulation plans available, they can be inefficient for estate transfer, since these plans:

- Are subject to estate taxes.
- Are subject to income tax as they are withdrawn or inherited.
- Provide limited options for heirs to delay (stretch out) the receipt and taxation of plan values.

Life insurance purchased within a qualified plan can provide cash to pay income and wealth transfer taxes. Also, a large portion of the death benefits received will be generally federal income tax-free.

Qualified retirement plans are among the most efficient asset accumulation plans available for both business owners and employees because:

- Contributions are deductible to the business plan sponsor.
- Accumulations are tax-deferred for the participant.
- Plan assets are generally sheltered from creditors.

2 Protect and transfer a business

Many small business owners (especially those in the service industry) such as attorneys, accountants, architects and real estate sales consultants, do not have formal plans for the continuation of their businesses at death. This presents potential negative consequences for family members, since at a business owner's death, their business enterprise is essentially worthless. Life insurance in a qualified plan may provide a viable option to replace this lost business value.

Similar to its role in a "funded buy-sell" agreement, life insurance within a qualified plan could play a vital role if a business owner/professional died prior to retirement. With proper planning, the surviving spouse and family could receive an amount equal to the business's replacement value as a life insurance death benefit.

There are two key reasons to accumulate assets in a retirement plan:

1. To use these assets during retirement.
2. To transfer some or all of these assets to the participant's beneficiaries.

3 Other advantages

Other advantages of purchasing life insurance in a qualified plan include:

- **Limited impact on personal cash flow** — Life insurance premiums are not paid directly from the clients' pockets, since profit-sharing plans are typically funded by the businesses.
- **Pretax premiums** — Premiums for life insurance policies held within qualified plans can be satisfied with pretax dollars. As a result, significant reductions in net insurance costs can be achieved. In addition, if the employer and employee are the same, the impact can be even greater, since qualified plan dollars are tax-deductible for the employer and tax-deferred for the employee.
- **Potentially tax-free death benefit** — For life insurance within a qualified plan, the portion of the death benefit in excess of the policy's cash surrender value is received income tax-free.
- **Employee not taxed on substandard premium** — When a qualified plan owns life insurance, the participant does not directly pay premiums. However, the election of a life insurance benefit is a current plan benefit and is treated somewhat similarly to employer-provided group life insurance. Government Table 2001 is normally used to determine the taxable value of this current protection provided by the qualified plan; however, it is possible to use the insurer's one-year term rate if it is lower.¹ Equitable does publish an "alternative" rate schedule. This table bases the taxable cost of insurance on a "standard risk". Employees are not taxed on extra charges associated with rated, tobacco-user or otherwise substandard risks.
- **Portability** — At employment termination, the policy can be transferred to another qualified plan (if the plan will accept life insurance), distributed to the employee, or purchased by the employee's Irrevocable Life Insurance Trust (ILIT).
- **Protecting a non-working spouse** — Life insurance can provide a means of self-completing a retirement plan in the event of the premature death of the plan participant.
- **Protecting an estate** — Life insurance can protect beneficiaries against estate shrinkage.

Many small business owners do not have formal plans for their businesses to be continued at their deaths. This presents potential negative consequences for family members, since at a business owner's death, his or her business enterprise may be essentially worthless. Life insurance in a qualified plan may provide a viable option to replace this lost business value. Similar to its role in a "funded buy-sell" agreement, life insurance within a qualified plan could play a vital role if a business owner/professional died prior to retirement.

¹ Currently, taxpayers are generally allowed to use the insurer's published 1-year term rates available to all standard risks, including tobacco users, if the company regularly sells term insurance at those rates. See Notice 2002-8, 2002-1 CB 398. Equitable does publish alternative 1-year term rates.

Plan taxation

Although plan participants do not contribute directly toward the life insurance premium, the election of a life insurance benefit is deemed a current plan benefit and is taxed currently to the employee participant, similar in approach to employer-provided group life insurance.² This annual taxable value is known as the economic benefit (EB).

Permanent life insurance

For permanent life insurance purchases, the annual taxable value to the plan participant, of this current protection, may be calculated using either of the two methods below, preferably the one that produces the least taxable amount.

- **Government Table 2001 rates** — Published IRS rates used to measure the taxable EB received by employees from the pure insurance protection provided by split-dollar life insurance plans and qualified retirement plans.
- **Published 1-year term rates** — If a company has published terms rates that are available to all standard risks who apply for term insurance, those rates may be able to be applied.³ Equitable does publish an “alternative” rate schedule.

Term life insurance

For term life insurance purchases, the annual taxable value to the plan participant, of this current protection, will generally be the premium paid. An argument could be made, however, that the same approach taken for permanent life insurance could be applied.

Survivorship life insurance

For survivorship life insurance purchases in a profit-sharing plan, a formula is applied to the Government Table 2001 rates for both insureds. This formula approach is used until the death of the first insured, at which point the single life rates are applied. For a comparison, see the relative rates below.

On a comparative basis, the rates for a survivorship life policy are significantly less than those for a single life policy

EB on a single life per \$1,000		EB on a survivorship policy per \$1,000	
Age	Government Table 2001	Age	Survivorship rate based on Government Table 2001
50	\$2.30	50/50	\$0.01
60	\$6.51	60/60	\$0.04
70	\$20.62	70/70	\$0.42

² An “owner employee” does not report any COI on life insurance owned by a plan for his or her benefit. That individual, however, cannot deduct the portion of any contribution to a plan that represents COI of such insurance, and the aggregate COI is not excludable from income when the contract is distributed — Regs 1.401 (K)-1 (d)(6)(ii). Other conditions may also apply in order for an insurer’s 1-year term rate to be deemed appropriate for these purposes. These conditions include: (1) the policy is available at such rates to all standard risks; and (2) the insurer regularly sells term insurance at those rates to individuals who apply for term coverage through the insurer’s normal distribution channels. See IRS Notice 2002-8. Unlike group term life, there is no exclusion for the EB of up to \$50,000 of coverage. Group term life generally looks to Government Table 2001 for valuing the EB of coverage.

³ Equitable does make alternative term rates available for single life policies. A copy of the Equitable alternative rate schedule can be ordered from our website or your internal wholesaler. Cat. #144707.

Case study:

calculating the annual taxable economic benefit

Purchasing permanent life insurance in a qualified plan

Meet Carl



- Age 50.
- Has a \$1,000,000 universal life policy set up under Death Benefit Option B.
- In a 35% tax bracket.

What is the current out-of-pocket cost to Carl? What is the value of the current coverage? That value is determined based on the pure death benefit amount (death benefit less cash value) and applying Government Table 2001 rates based on the insured's age. Remember, if a company has a qualifying published 1-year term rate that is regularly sold to individuals and available to all standard risks, including tobacco users, and meets other Notice 2002-8 requirements, it may be possible to use that rate instead of the Government Table 2001 rate.

Plan participant's advantage

When purchasing permanent life insurance in a qualified plan, plan participants essentially pay tax on a term insurance cost rather than on the actual permanent life insurance premium. The rates applied are on a "standard risk." Extra charges associated with rated, tobacco-user or other substandard risks are not taxable to the employee.

Comparison of Government Table 2001 rates to sample premium charges for male, age 50, for \$1,000,000

	Government Table 2001	Equitable's alternative rates ⁴	Annual renewable term	20-year level premium term
Male Table C Non-Tobacco User	\$2,300	\$890	\$3,327	\$5,795
Male Standard Tobacco User	\$2,300	\$890	\$4,386	\$9,095
Male Table C Tobacco User	\$2,300	\$890	\$9,326	\$19,295

⁴ Assumes alternative rate is available for product selected.

The incidental death benefits guidelines

The purpose of a qualified plan

First and foremost, the purpose of a qualified plan is to provide participants with retirement income. If the IRS determines that the primary purpose of a qualified plan is not for retirement benefits, the plan will be disqualified and lose its tax advantage.

The purchase of life insurance must be secondary or “incidental” to the retirement goals of the plan. Qualified plans “may provide for the payment of incidental death benefits through insurance or otherwise.” See Reg 1.401-1(b)(1)(i). These rules are called the “incidental death benefit rules.” An employer may take a current income tax deduction for contributions to a retirement plan to the extent it provides only an incidental death benefit. Restrictions on the purchase of life insurance are not found in the Internal Revenue Code or regulations. Instead, guidelines have been developed through a series of revenue rulings. Different guidelines exist for the type of insurance being purchased (term, whole life, universal life) and the type of qualified plan (defined benefit, defined contribution, profit-sharing).

Understanding the incidental death benefit guidelines

Defined contribution plans

Defined contribution qualified plans must adhere to the “less than... percentage tests.” Under these tests, the total premiums paid (premiums over the life of the plan) for a participant insured must at all times be less than those percentages of the employer’s contributions to the plan.

For universal life, indexed universal life, variable universal life or term insurance, the rule is modified. Death benefits will be deemed incidental if less than 25% of the total funds allocated to a participant’s account are used to purchase life insurance.

For whole life, less than 50% of the aggregate employer contributions allocated to a plan participant’s account can be applied to the purchase of life insurance.

Defined benefit plans

An additional guideline can be optionally used in defined benefit plans. This test provides that life insurance is incidental if the participant’s insured death benefit is no more than 100 times the expected monthly benefit payable if the insured retires at normal retirement age (Rev. Rul. 74-307, 1974-2, CB 126, Rev. Rul. 76-353-1976-2).

Planning note: Although either test — the percentage of contributions test or the “100 times rule” — can be used with defined benefit plans, many plan designers suggest reliance on the percentage test. In many cases, the amount of insurance that can be purchased will be larger using the percentage test. In addition, when the percentage test is used, at the death of an active plan participant, both the insurance benefit and the accrued vested plan benefit would be available for payout as a plan death benefit. However, if the “100 times rule” is used, the accumulation funds remain within the plan, and only the life insurance death benefit would be paid out to the participant’s plan beneficiary.

Profit-sharing plans can provide additional funding opportunities

Although profit-sharing plans are defined contribution plans, they provide greater insurance funding flexibility than other defined contribution plans. In addition to using current contributions, profit-sharing plans also have special rules that apply to plan assets that have been in the plan for an extended period. These funds are often referred to as “Seasoned Money.”

Defining seasoned money

If the plan allows, 100% of employer contributions that have remained in the qualified plan for 2 years or more can be applied to purchase life insurance (not earnings, just contributions) — Rev. Rul. 54-231, 1954 CB 150, Rev. Rul. 60-83, 1960-1 CB157.

The 2- and 5-year rules

In addition, if (or once) the employee plan participant has been in the plan for 5 years or longer, then 100% of the participant’s total account can be applied to purchase life insurance (current contributions, prior contributions and earnings).

The reason this seasoned money can be used for life insurance (if the plan allows) is that profit-sharing rules allow the participant to withdraw these funds from the plan after the 2- and 5-year time frames. Since they are available for withdrawal, they are also available to purchase life insurance. All other forms of qualified plans require a “qualifying event” before a participant can withdraw funds from the plan. (Termination of the plan, termination of employment or retirement and disability are other events that allow for withdrawal of funds from a qualified plan.) If the plan document does not provide for the 2-year and 5-year rules, then it’s the 50% and 25% incidental rules discussed previously that apply.

The availability of seasoned money can unleash a tremendous cash resource to help plan participants address their personal and family life insurance needs.⁵

⁵ Although there is no limit on the amount of life insurance that can be purchased with plan contributions accumulated in a profit-sharing plan for 2 years or longer, a question that has cropped up periodically is whether premium amounts in excess of that allowed by the “incidental rules” should be treated as a “taxable distribution.” The IRS has never issued an official statement on this point. However, the authors of *The Pension Answer Book*, Aspen Publishing, have suggested that the IRS had a proposed letter on this point but withdrew it. It appears that on one occasion, in 2000, in a public forum, an IRS representative had suggested that the “excess” premium should be treated as a taxable distribution. The more common approach taken today has been to limit income to the reportable EB. Plan sponsors intending to use “seasoned” funds should consult with their tax advisors.

Using IRA assets to purchase life insurance (seeded money)

Life insurance cannot be purchased within an IRA. However, IRA money can be rolled into a profit-sharing plan. This presents an opportunity to make IRA funds available for the purchase of needed life insurance.

The ability to use seeded money, funds that are transferred into the profit-sharing plan from IRAs and other existing qualified plans adds an element of planning flexibility to a profit-sharing plan that is not available with other qualified plans. This opens up a funding and cash flow source for individuals, especially professionals and small business owners whose estate plans require significant amounts of permanent life insurance with sizeable premium requirements.

Use of voluntary employee plan contributions

If the qualified plan allows for voluntary employee contributions, 100% of funds contributed by an employee can also be applied to the purchase of life insurance as soon as the funds are contributed.

Taxes due at death

At death, usually all funds paid out from a qualified plan are subject to ordinary income tax. In contrast, at death, life insurance benefits paid are received income tax-free with life insurance owned outside a qualified plan.⁶ When a participant dies with life insurance in his or her qualified plan, the life insurance death benefit in excess of cash value (the pure amount at risk) is received free of federal income taxes by the beneficiaries (IRC§72(m)(3)(c) [Treas. Reg 1.72-16(c)(4)]).

The cash value portion is treated similarly to a regular qualified plan asset. The beneficiaries are taxed on the policy's cash value, but they get to offset the taxable amount by the cumulative value of the previously taxed EB amounts [IRC§72(m)(2)]. (Not the tax paid, the amount that was taxable.)

Along with other qualified plan values, life insurance death benefits may also be subject to estate taxes. Generally, it will depend on the size of the overall taxable estate, the availability of credits and exemptions, and the beneficiary. The fact that the death proceeds may be included in the taxable estate is an estate plan design consideration. If the life insurance benefit is paid to a surviving spouse, it may avoid estate taxes.⁷ It may be best to take the policy out of the plan when it becomes economically feasible. See page 14 for more information.

Case study: understanding the tax implications



Meet John

- At death, he has life insurance held in a qualified plan.
- He purchased a \$1,000,000 UL policy through his qualified plan. It is still in the qualified plan when he dies at age 55.
- The life insurance cash value at the date of death is \$100,000.
- Government Table 2001/EB amount taxed to him over the life of the plan is \$10,000.

When the \$1,000,000 death benefit is paid to the beneficiaries, \$900,000 is received tax-free as a life insurance death benefit.

Of the remaining \$100,000, \$90,000 is taxable. This represents the policy cash value, minus the \$10,000 cumulative EB taxed to John for the insurance protection over the life of the plan.⁸

The \$1,000,000 death benefit is also included in John's estate and may be subject to estate taxes as well.⁹ If these taxes are an issue, if possible, the life insurance should be removed from the profit-sharing plan prior to death. See page 14 for more information.

⁶ IRC 101(a)(1).

⁷ IRC 2056.

⁸ An "owner employee" does not report any COI on life insurance owned by a plan for his or her benefit. That individual, however, cannot deduct the portion of any contribution to a plan that represents COI of such insurance, and the aggregate COI is not excludable from income when the contract is distributed — Regs §1.401 (K)-1 (d)(6)(ii).

⁹ In the subsequent calculation of income taxes, a credit is available for a portion of estate taxes attributed to "income in respect to a decedent."

Retirement and life insurance

What happens?

Most plans provide that when a participant retires, the trustee must convert the policy into cash or make a distribution of the policy to the participant.

Your clients' options

1

Terminate the life insurance policy and reinvest the cash value.

2

Distribute the policy in kind to the plan participant.

3

Sell the policy to the plan participant or to a trust created by the plan participant.

Distribution in kind will trigger income taxation on the value in the policy in the year of distribution. Both distribution and sale will raise the issue of valuation. See page 19 for more information.

When life insurance in a qualified plan is purchased in conjunction with a broader estate plan, removal of the policy from the qualified plan should occur prior to retirement. Usually, the policy will be withdrawn from the plan at a time deemed to provide maximum tax and cost advantage for the estate owner. The issues of valuation, purchase or distribution can significantly affect the value added by purchasing life insurance in a qualified plan.

Exit strategies:

removing life insurance from a qualified plan prior to retirement

Planning for tax-efficient wealth transfer

Life insurance that remains in a qualified plan at a participant's death and is payable to a beneficiary other than the participant's spouse (for example, to a trust) is subject to estate taxes in addition to income taxes. Therefore, in many situations, it may be appropriate for the policy to be removed from the qualified plan as soon as economically feasible. The proper timing may be related to several factors, including: the purpose of the insurance, the cost and tax leverage provided by the overall strategy, and the client's cash flow situation.

The best time to remove a policy from the qualified plan may also depend on the level of premiums the client is willing to pay to maintain the policy outside the qualified plan.

Options for removing life insurance from a qualified plan prior to retirement:

- Distribute the policy from the plan to the participant.
- Sell the policy to the participant.
- Sell the policy to the plan participant's grantor trust.
- Liquidate the life insurance policy for cash.

Removing a policy from a qualified plan in a shorter time frame will generally result in:



Less tax at removal (or lower purchase price if purchased from the qualified plan).¹⁰



Higher outlays to maintain coverage thereafter.

Removing a policy from a qualified plan later (near or at retirement) will generally result in:



Greater tax at removal (or greater sales price if the policy is being purchased from the plan).



Lower outlays to maintain coverage thereafter. The policy may even have sufficient value to not only cover the tax, but also may have enough value to reduce or even eliminate ongoing premium payments to maintain a substantial portion of the coverage thereafter.

¹⁰ However, if the client is less than age 59½, a premature distribution penalty tax equal to 10% of a deemed distribution would apply, possibly increasing the tax liability compared to a later distribution at a potentially higher FMV. Cost of removal will be based in part on the actual performance and cash value accumulation of the policy. The duration statements are based upon generalization that additional years of premium payments and time for cash value accumulation may produce higher values.

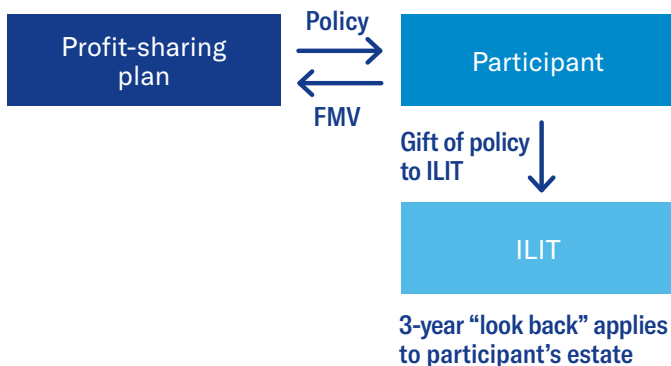
Exit strategy 1

Distribute the policy from the plan

Distributing the policy to a plan participant may be a viable option; however, there are several issues to consider. Planning considerations include:

- The plan must allow for in-service distributions or another triggering event must occur.¹¹
- Distribution prior to age 59½ may subject the withdrawal to a premature distribution penalty.
- The participant will have to pay the income tax on the FMV of the policy.¹²
- The insurance proceeds will be subject to estate tax issues.
- If the plan is to transfer the policy to an ILIT, it will not ensure estate tax exclusion if death occurs within 3 years of the transfer.
- Also, transfer of the policy to an ILIT may result in gift tax issues.

Distributing the policy from the plan



¹¹ A profit-sharing plan may allow for in-service withdrawals, which are usually available after a number of years of participation in the plan or when the participant reaches a specified age. Termination of the plan, termination of employment or retirement are other common triggering events that would allow for a distribution of the policy. Upon certain triggering events, such as plan termination, the participant's retirement plan would require the trustee to consider some action with regard to the policy: termination (liquidation), distribution or sale.

¹² If the policy is distributed to the participant, he or she must include in gross income (in the year received) the FMV of the policy [IRC 402(a)]. The FMV of the policy must be determined, and the value will be subject to income tax as a qualified plan distribution. There may be a penalty for a premature distribution from the plan if the participant is less than age 59½ at the time of distribution of the policy, unless one of the exceptions to IRC 72(t) is met.

Case study:

life insurance is distributed from a qualified plan

Understanding the tax implications

Meet Bob



- Age 50.
- He has a universal life policy in his profit-sharing plan, with a significant death benefit.
- Based on information provided by the insurance carrier, Bob's accountant has advised him that the FMV of the policy is about \$500,000.

If the life insurance policy were distributed from the qualified plan to Bob.

- Bob would be taxed on the FMV of the policy (\$500,000).
- Since Bob is under age 59½, he would also face a premature withdrawal penalty (10% on \$500,000).

Once the life insurance policy is distributed to Bob, he may transfer the policy to an ILIT to avoid inclusion in his estate at his death.

- Transfer to his ILIT brings into play the estate tax inclusion rule. If he should die within 3 years of the transfer of the policy to the trust, the death benefit would be included in his estate [IRC 2035(a)].

Transfer to the ILIT also creates a gift tax issue. The annual gift tax exclusion of \$17,000 (2023) per donee is available for present interest gifts. And the lifetime gift exemption currently covers lifetime gifts of up to \$12,920,000 in 2023. Note: Bob's wife could join in the gift as well, which would raise the gift tax exclusion. She could also use some or all of her lifetime gift exemption.

Exit strategy 2

Sell the policy to the participant

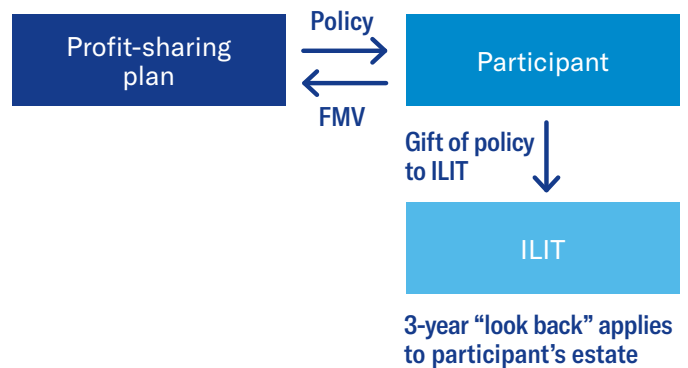
If the participant has sufficient liquid assets, an alternative would be to remove the life insurance from the qualified plan by sale.

- A sale and purchase leaves an amount equal to the FMV of the policy in the qualified plan (paid by the plan participant), which is allocated to the participant and continues to grow income tax-deferred.
- Sale to the insured is an exception to the “transfer for value” rule under §101(a)(2)(B).
- Since a sale does not trigger a taxable event, it avoids current income taxes.
- A sale avoids the issue of the 10% premature withdrawal penalty.
- The transaction would have to comply with the “prohibited transaction” guidelines.¹³

With a purchase and sale, estate planning flexibility remains. A transfer to an ILIT can follow the sale of the policy to the insured. As with a distribution, if the policy is gifted to the ILIT, the 3-year rule for estate tax inclusion may apply to this transfer.

The primary issues to be addressed will include policy valuation, avoiding the prohibited transaction rules, and addressing estate tax inclusion and gift tax issues upon transfer of the policy.

Participant purchases the policy



¹³ Generally, purchase by a plan participant of his or her policy is an exception to prohibited transaction rules (PTE-1992-6). The conditions required would include: (1) if the policy was not purchased, it would be surrendered by the plan trustee; (2) the purchase price is at least equal to what the plan would get if he or she surrendered the policy. (There is no price reduction for employee's basis or EB costs.) See also, however, the discussion of determination of FMV discussed later in these materials, since a purchase for less than FMV can have various adverse consequences.

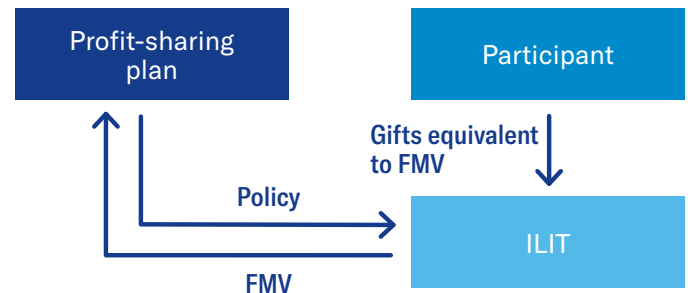
Exit strategy 3

Sell the policy to the plan participant's grantor trust

Purchase of the life insurance policy directly by an ILIT is another practical approach to removing the life insurance policy from the qualified plan.¹⁴

- A sale and purchase by the participant's grantor trust will leave an amount equal to the policy's FMV in the plan, which is allocated to the participant and continues to grow income tax-deferred.
- Properly structured, sale of the policy by the plan to the insured's grantor trust (grantor trust for income tax purposes — NOT estate tax purposes) should result in application of the "sale to the insured" exception to the "transfer for value" rule.
- If the ILIT purchases the policy instead of the insured, the 3-year rule for estate tax inclusion is avoided.
- Since a sale does not trigger a taxable event (provided the sale is for FMV), it avoids current income taxes.
- A sale avoids the 10% premature withdrawal penalty.
- Sale to an ILIT presents prohibited transaction concerns, similar to those for the participant.
- The participant will have to contribute or loan sufficient cash to the trust to allow it to pay the FMV of the policy.¹⁵
- There will be gift tax issues upon the transfer of assets to the trust.

ILIT purchases the plan



¹⁴ In general, ERISA prohibits transactions between pension plans and participants (parties in interest). However, there are exceptions for a relative, an employer and another employee, as well as for a plan participant. An ILIT created by the plan participant (insured) that is a grantor trust meets the exemption as well. Sale to a grantor trust is considered a sale to the insured and is an exception to the transfer for value issue. (Rev. Rul. 85-13, 1985-CB. 184.) In addition, the issue of transfer for value must be addressed [IRC 101(a)(2)] when an existing life insurance policy is purchased by a third party (someone other than the actual insured), the "transfer for value rule" can subject the death proceeds, in excess of basis (investment in the contract), to income tax. There are exceptions to the rule. Purchase by a grantor trust created by the participant insured meets one of the exceptions.

¹⁵ Although gift taxes are an issue, planning for a future purchase may allow the trust to be funded for the eventual purchase over a number of years. If the trust is not already funded, then transfers of cash to the trust by the participant would be deemed gifts to the trust beneficiaries. A loan to the trust may also be possible.

Determining fair market value

When removing life insurance from a qualified plan, the fair market value (FMV) of the insurance policy must be determined. The determination of the FMV of a life insurance policy is a changing dynamic. Although we may be able to provide assistance to the client's attorney and accountant, the approach and the value that are used are ultimately up to them.

Safe Harbor guidelines

Generally, tax law requires that a life insurance policy be valued at its FMV. This FMV is generally defined as the policy cash value and the value of all rights under the contract, including any supplemental agreements thereto and whether or not guaranteed. Since this definition is somewhat vague, the IRS, in Revenue Procedure 2005-25, has provided a safe harbor formula for determining the FMV of a life insurance policy in certain situations.

Note: This procedure offers a safe harbor approach, but a taxpayer is under no obligation to use this formula to determine the FMV. One is free to rely upon another method of arriving at the FMV, though he or she runs the risk of running into a challenge from the IRS.

Safe Harbor formula

The IRS will generally accept use of the safe harbor formula to establish the FMV of a policy, provided that it is interpreted in a reasonable manner that does not understate the FMV. If an insurance policy has not been in force for some time, the value of the contract is best established through the premiums paid for that contract rather than the safe harbor formula.

Under the safe harbor formula, the FMV of a life insurance policy in a qualified plan is the greater of:

Adjusted ITR

The sum of the policy's Interpolated Terminal Reserve (ITR) and any unearned premiums plus a pro rata portion of a reasonable estimate of dividends expected to be paid for that policy year based on company experience.¹⁶

Adjusted PERC Amount

The product of the PERC amount multiplied by the **Average Surrender Factor**. The PERC amount is generally equal to **Premiums** plus **Dividends** plus **Other Earnings** minus **Reasonable Charges** and **Distributions**.

¹⁶ A policy's terminal reserve is the amount of money that the life insurance company has set aside by law to guarantee the payment of policy benefits. It is determined once a year. The ITR is a mid-year estimate of the terminal reserve value determined by adding the current year's increase to the prior year's reserve. ITR is generally understood to be applicable to whole life contracts and, accordingly, has not historically been used for variable universal life or universal life contracts.

The terms below are defined as follows:

Premiums The premiums paid from the date of issue of the life insurance policy through the valuation date without reduction for dividends that offset those premiums.

Dividends For participating policies, the dividends applied to purchase paid-up insurance prior to the valuation date. For variable policies, the dividends applied to increase the value of the contract prior to the valuation date (including dividends used to purchase paid-up insurance).

Other earnings Amounts credited (or otherwise made available) to the policyholder with respect to premiums, including interest and similar income items (whether credited or made available under the contract or to some other account), but not including participating policy dividends used to offset premiums and dividends used to purchase paid-up insurance. For variable policies, all adjustments (whether credited or made available under the contract or to some other account) that reflect the investment return and the market value of segregated asset accounts.

Reasonable charges Explicit or implicit reasonable mortality charges and reasonable charges (other than mortality charges), but only if those charges are actually charged on or before the valuation date and those charges are not expected to be refunded, rebated or otherwise reversed at a later date.

Distributions Any distribution (including distributions of dividends and dividends held on account), withdrawals, or partial surrenders taken prior to the valuation date.

Average Surrender Factor For all valuations other than valuations applicable to distributions and sales of life insurance policies from qualified plans, the Average Surrender Factor is 1. For distributions or sales from qualified plans, the Average Surrender Factor is the unweighted average of the **Applicable Surrender Factor** over the 10 years beginning with the policy year of the distribution or sale (i.e., a projected value). For this purpose, the applicable surrender factor for a policy year is equal to the greater of (1) .70 and (2) the following fraction (determined as of the first day of the policy year):

$$\frac{\text{Projected cash surrender value}^{17}}{\text{Projected (or actual) PERC amount}}$$

Projected (or actual) PERC amount

The applicable surrender factor is 1 for a year in which there is no surrender charge. In addition, a surrender charge can be taken into account only if:

- A. Contractually specified at issuance.
- B. Expressed in the form of non-increasing percentages or amounts.
- C. Cannot be waived or otherwise avoided.
- D. Created for purposes of the transfer or distribution.

¹⁷ The projected cash surrender value is the projected amount of cash that would be available if the policy were surrendered on the first day of the policy year (or, in the case of the policy year of the distribution or sale of the life insurance policy, the amount of cash that was actually available on the first day of that policy year).

Case study:

remove life insurance from a qualified plan

Calculating FMV

Meet Brian



- Brian is a 50-year-old successful small business owner.
- He has a profit-sharing plan with \$600,000 of cash.
- He needs \$4,000,000 of life insurance for estate liquidity.
- The qualified plan allows for the purchase of life insurance as a funding program.
- He decides to purchase \$4,000,000 of permanent life insurance through his profit-sharing plan.
- Brian has health issues and is rated Table C.
- The premium is \$77,415 per year.
- The policy purchased is a unisex universal life policy from Equitable.

Summary

- PERC value: \$268,772
- Total premiums years 1–5: \$387,075
- Amount taxed year 5: \$268,772
- Decrease in amount taxed: \$118,303
- Credit for imputed income: \$19,395

FMV calculation after 5 years

Assume that the plan distributes the policy to Brian after 5 years. To determine the taxes Brian must pay on the distribution, we first must determine the FMV of the policy. As described above, under the Safe Harbor formula, the FMV is the greater of Adjusted ITR and Adjusted PERC Amount.

The Adjusted PERC Amount (the PERC amount multiplied by the Average Surrender Factor) is determined to be \$268,772. For this purpose, the Average Surrender Factor was calculated by projecting the PERC amount and cash surrender value for the 10 years beginning with the year of distribution using non-guaranteed values assuming current charges. The earnings assumptions were based on the policy's current crediting rate. Assume that this amount — \$268,772 — is greater than the Adjusted ITR.

Assume that the IRS accepts this valuation and does not argue that it understates the FMV of the contract.¹⁸ By paying total premiums of \$387,075 of pretax money over the 5-year period, Brian was able to receive the policy with \$4,000,000 in death benefits in exchange for paying tax on \$268,772. In a 35% tax bracket the tax would be \$94,070. This represents a difference of \$293,005 between the premiums paid and a tax payable upon distribution of the policy. Brian was also taxed on the EB costs over the 5 years, around \$19,395.

FMV calculation after 10 years

Now assume Brian leaves the policy in the profit-sharing plan for 10 years.

In year 10, the Adjusted PERC value is \$658,968. Again assuming the IRS accepts this valuation, Brian will recognize this amount as income when the policy is distributed from the profit-sharing plan to him in year 10. Up to this point, the plan has paid \$774,150 of pretax premiums. Brian was also taxed on the EB costs over the 10 years, around \$42,198.

Brian would have paid premiums of \$774,150 with after-tax money over the first 10 years for the insurance outside of the plan. Inside the plan, Brian:

- Pays \$774,150 of premiums with pretax money.
- Pays taxes of \$14,769 on the cumulative EB costs (which total about \$42,198 over the 10 years).
- Pays \$215,869 in taxes (assuming a 35% tax rate) to take possession of the insurance policy in year 10.

At Brian's death, the life insurance policy will provide \$4,000,000 of income tax-free liquidity. Properly arranged in an ILIT, the insurance proceeds can be estate tax-free as well.

Summary

- PERC value:
\$658,968
- Total premiums years 1-10:
\$774,150
- Amount taxed year 10:
\$658,968
- Decrease in amount taxed:
\$115,182
- Credit for imputed income:
\$42,198

¹⁸ For example, the IRS could potentially argue that the policy has not been in force for a sufficient period of time to avoid using premiums paid to value the contract.

Sales idea:

funding a cross-purpose buy-sell plan

Life insurance can offer a relatively inexpensive mechanism by which business owners can fund a business continuation plan. By paying an annual life insurance premium, a business and/or business owner can potentially leverage their dollars with a life insurance death benefit. By contrast, if business owners wait until death to address their business continuation plans, the cost can be significantly higher. In the proper circumstances, life insurance to fund a cross-purchase buy-sell agreement may be able to be purchased through a profit-sharing plan using a participant's plan account.

Benefits of using a profit-sharing plan to fund a buy-sell arrangement

Corporations that pay life insurance premiums for the purpose of funding a buy-sell agreement generally do not get a federal income tax deduction. On the other hand, corporate contributions to a qualified profit-sharing plan are federal income tax-deductible.¹⁹

A key attraction in using qualified plan dollars to fund a life insurance policy designed to assist a client's buy-sell plan is that it allows deductible dollars to serve a dual purpose. Where a business operates a profit-sharing plan, it is reasonable to assume that it makes annual plan contributions. Because these dollars are already built into a business's cash flow, in many business owners' minds there is no additional expenditure when allocating profit-sharing contributions in a plan to fund life insurance premiums.

It is also important to note that in many cases, business owners may be years away from retirement. As such, they may view retirement plan funds as "dormant" assets. If the plan is correctly set up, a business owner may be allowed to use these funds to address current business and personal needs.

The amount of new money contributed to a profit-sharing plan that can be applied toward life insurance premiums is limited.

For more information on these limits, refer to page 8.

¹⁹ Two private-letter rulings have been issued approving this technique (8108110 and 8426090). Private-letter rulings are applicable only to the taxpayers who requested them; however, they do give an indication of the general thinking of the Internal Revenue Service. The rulings did not address: (1) whether the policy on the life of another was a permissible investment; or (2) the impact of the proposed transaction on the qualified status of the plan. Those issues were not within the scope of their ruling authority.

How profit-sharing plans can be used to fund cross-purchase buy-sell plans

Under this approach, a closely held business owner or professional practice client establishes a defined contribution profit-sharing plan or amends an existing profit-sharing plan with language that allows for:

- 1 The purchase of life insurance.
- 2 In-service distributions.

Typically, profit-sharing plans allow for the purchase of life insurance on plan participant(s) and family member(s). It may be necessary to amend the profit-sharing plan to allow plan participants to purchase insurance on lives other than their own in which they have an insurable interest. With a properly established plan, business owners can purchase policies on co-owners' lives within their individual profit-sharing accounts. A portion of the annual tax-deductible profit-sharing plan contribution can be used to purchase this life insurance coverage.

If there is a death, the death proceeds will be paid into the survivor's profit-sharing account. These funds can be distributed and used to buy out the deceased's business interest. This is where the second amendment, allowing for in-service distributions, comes into play.

With this arrangement, the survivor can honor his or her buy-sell plan commitment by purchasing the deceased's business stake from his or her estate or family. Keep in mind that any cross-purchase arrangement or profit-sharing plan put together by your client should always involve the services of qualified legal, tax and ERISA counsel as to the client's particular situation.

Other issues to consider

Unisex rates

The life insurance policies selected should offer a unisex rate. The 1985 Norris decision indicated that using sex-distinct policies in qualified plans discriminated in favor of females, and mandated that a blended or unisex rate must be used with life policies in defined contribution qualified plans.

Use of survivorship policies and insureds other than plan participant

Survivorship life insurance can probably be purchased (there are no official rulings) as well as single life policies. Also, in some cases, life insurance on lives other than the plan participants themselves may be a viable planning option in a qualified plan. In a profit-sharing plan, life insurance can be purchased on the participant's spouse, child or a business partner.

Does it make financial sense?

Case study: purchasing life insurance in a qualified plan

Understanding the additional costs

Leaving estate tax and planning issues aside, consider the economics of purchasing life insurance inside a qualified plan versus purchasing life insurance outside a plan. For this review, we will apply a number of the discussion points addressed earlier in this guide. To see how this works, we will compare approaches for our client, Roy Perkins.

Meet Roy



- Roy is 50 years old and plans to remain in his business until age 65.
- He needs \$500,000 of life insurance and will purchase the maximum amount he can through his profit-sharing plan.
- He would like to have life insurance coverage beyond age 65, and therefore intends to purchase a permanent life insurance policy.

For our comparison, we will consider that the maximum contribution into a profit-sharing plan for all years is \$56,000 and Roy qualifies for this maximum contribution.

Since we are considering purchasing a universal life contract, we are limited to 25% of the annual contribution, or up to \$14,000 per year. The premium for \$500,000 at Roy's age with a unisex rate is \$6,433, so Roy can purchase the full \$500,000 in his profit-sharing plan.²⁰

If Roy purchased the same amount of insurance outside the plan, it would cost \$6,621 using male, preferred non-tobacco rates. (Note the higher premium purchased outside the qualified plan with male rates.)

Summary:

- Age 50
- 35% marginal tax bracket
- Contribution: \$6,433 x 15 years
- \$6,433 x 15 years = \$96,495
- \$500,000 QP life insurance death benefit

²⁰ The policy premium and death benefit amounts used for this example are intended only to help demonstrate the planning concept discussed and not to promote any specific product. The rates are broadly representative of rates that would apply for a policy this type and size for insureds of good health and ages noted in the example. To determine how this approach would work for your clients, individual illustrations should be prepared or requested for your review. If different rates are used, there might be significantly different results.

If Roy has the plan purchase the policy, the premium will not represent the total cost. Three other factors will affect the cost:

- 1 Tax on the EB over the 15-year period until retirement.
- 2 Lost opportunity cost for pension investments.
- 3 Cost when the policy is distributed by the plan at retirement (in 15 years).

1 Tax on the EB

When a pension plan purchases life insurance, the plan participant is taxed on the EB calculated using the Government Table 2001 rates or a company's published 1-year term rates. For this review, we used the 1-year term rates.

- The EB rate in the first year is \$441.
- Roy is in a 35% tax bracket; therefore, his out-of-pocket cost for taxes will be \$154.35.
- Over the next 15 years until Roy's retirement, the cumulative EB is projected to be \$9,401.
- The cumulative tax paid on EB over the 15-year period would only be \$3,290.

Since the business is a C-Corporation, the amount taxed, \$9,401, represents Roy's basis in the life insurance contract. This will be important when we address the taxable amount that occurs when the plan distributes the policy to Roy.

Summary:

First year

- Premium: \$6,433
- EB: \$441
- Tax on EB: \$154.35

After 15 years

- Cumulative EB: \$9,401
- Cumulative Tax on EB: \$3,290

2 Lost opportunity cost for pension investments

We have assumed that contributions to the plan for Roy would be \$56,000 per year. If the full amount were contributed each year and invested at an earnings rate of 5%, the pension account would hold \$1,268,820 at the end of 15 years.²¹

- When life insurance is purchased, the amount available for investment is reduced by the premium amount each year.
- The reduced annual contribution to be invested, \$49,567, invested at 5% each year, would grow to \$1,123,064.
- The profit-sharing account would have the policy cash value of \$98,748.
- The combined value would be \$1,221,812.

Lost opportunity costs

Profit-sharing account value

Without life insurance	With life insurance	Gross difference	Net difference
\$1,268,820	\$1,221,812	\$47,008	\$30,555

The difference between the two account values, without insurance and with insurance, is \$47,008. The net difference is \$30,555 after adjusting the difference for income taxes. In this example, \$30,555 represents the net investment loss attributed to purchasing life insurance within the qualified plan.

3 Cost when the policy is distributed by the plan at retirement (in 15 years)

For this comparison, we are assuming that the policy will be distributed from the plan when Roy retires at age 65. If it is, he will have to pay tax on the policy FMV less his “cost basis.” If Roy is an employee of the business or if he is a business owner, as long as the business is not a “pass through entity,” the EB costs represent his basis upon distribution.

- The policy FMV at age 65 is \$98,748.
- Roy’s basis is equal to his cumulative EB cost, \$9,401.
- \$89,347 (\$98,748–\$9,401) is taxable upon distribution of the policy from the plan.
- In the 35% tax bracket, the tax will be \$31,271 (\$89,347 x 35%).²¹

Cost upon distribution

- Policy FMV at age 65: \$98,748
- Less the economic benefit costs: \$9,401
- Net taxable amount upon distribution: \$89,347
- Income tax to be paid (35% bracket): \$31,271

²¹ This example shows a 5% fixed interest rate. Earnings rates will vary depending on the performance of available investments and interest rate availability.

Cost summary

We will summarize our case study by totaling the identified costs associated with purchasing insurance inside a qualified plan versus the cost of purchasing the policy outside the plan:

- Under this comparison, the difference is \$30,555 in favor of purchasing life insurance inside the plan. The cost is 34% less when the life insurance is purchased inside a qualified plan. As an additional benefit to Roy, when the insurance is purchased inside the plan, his disposable income goes up by the amount that would have been directed toward the annual premium, \$6,621.
- For the policy purchased inside the qualified plan, the cash value at age 65 is \$98,748, and premiums paid are \$96,495. The policy cash value is greater than premiums paid at this point. This example demonstrates that using a qualified plan to purchase life insurance can make good financial sense even in situations where the policy's cash value is greater than the cumulative premiums paid (which can increase a policy's FMV). In these scenarios, even without an early withdrawal of the policy from a qualified plan, the economics can still favor the purchase of life insurance in a qualified plan.

Purchasing life insurance within a qualified plan versus outside a plan		
Life insurance	In plan	Out of plan
Initial death benefit	\$500,000	\$500,000
Out of pocket for premium	\$0	\$99,315
Tax on EB	\$3,290	\$0
Reduced accumulation	\$30,555	\$0
Tax when policy is distributed	\$31,271	\$0
Total cost	\$65,116	\$99,315

Getting started

The use of a qualified plan to assist in the purchase of life insurance necessary to address personal insurance needs is a special technique that will not be available or appropriate for all clients. Look for clients who fit the life insurance in qualified plans prospect profile on page 3. Discuss their current pretax elections with them. These clients may be surprised to learn that using tax-deferred assets to purchase life insurance in a qualified plan is a viable option.

**For more information, visit
equitableLIFT.com.**

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