Life insurance in a qualified plan

A case study

Purchasing life insurance through a qualified plan can make good financial sense.

The problem

Often, clients are interested in getting the greatest amount of benefit for the least amount of cost. When considering the purchase of life insurance in a qualified plan, often times, rollout and exit strategy discussions will delay the process. This usually occurs because of concerns over inclusion of the death benefit proceeds in the insured's taxable estate.

A possible approach

Aside from estate tax and planning issues, an immediate benefit of purchasing life insurance in a qualified plan is that premiums will not create a current, personal or out-of-pocket cost outlay.

Meet Roy

- Age 50.
- Plans to remain in his business until age 65.
- Would like to have life insurance coverage beyond age 65, and therefore, intends to purchase a permanent life insurance policy.
- 35% marginal income tax bracket.
- Qualifies for $56,000 maximum contribution to the plan in all years.[1]

Important considerations

- Not all clients have estate tax issues.
- If the estate tax rates are reduced and the equivalent exemptions are increased, estate taxes will become even less of a concern.
- In many cases, the income tax savings are noteworthy.

A closer look at Roy's new policy[2]

Name	An indexed universal life insurance policy
Annual premium	$6,621 (Note: Under the incidental benefit rules for qualified plans, Roy is limited to 25% of the annual contribution to pay annual life insurance premiums.)
Total cost	$99,315 ($6,621 x 15 years)
Death benefit	$500,000 (based on Roy's age using unisex preferred non-smoker rates)

Economic considerations

Roy's decision to purchase life insurance in a qualified plan may have some impact on the following:

1

Taxes

When a pension plan purchases life insurance, a plan participant is taxed on the economic benefit calculated, under the current rules, by using IRS Table 2001 rates or a company's published qualifying annual term rates.[3] In this case, Equitable Financial's alternative term rates are used.

- $431 economic benefit to Roy for first year.
- $151 out-of-pocket costs for taxes in the 35% tax bracket.
- $9,472 cumulative economic benefit costs over the 15 years until retirement. (Note: economic benefit rates increase with age.)
- $3,315 cumulative taxes at a 35% tax rate.
- $9,472 represents Roy's basis in the life insurance contract, since the business is a C-Corporation. This will be important when addressing the taxable amount from the plan upon distribution of the policy to Roy.[4]

2

The lost opportunity cost for pension investments

If the maximum contribution of $56,000/year* was invested at a hypothetical earnings rate of 5%, the pension account would hold $1,268,820 at the end of 15 years.[5] When life insurance is purchased, the amount available for investment is reduced by the premium amount.

- At the 5% hypothetical annual growth, the reduced amount, $49,379, would grow to $1,118,804.
- The policy cash value is $101,884.[2]
- Total combined value is equal to $1,220,688.

The difference between the two account values, without insurance and with insurance, is $48,132. The net difference is $31,286 after adjusting the difference for income taxes. In this example, $31,286 represents the net investment loss attributed to purchasing life insurance within the qualified plan.

Lost opportunity costs — profit-sharing account value

Without life insurance	$1,268,820
With life insurance	-$1,220,688
Gross difference	$48,132
Net difference	$31,286

3

Cost upon distribution

Assuming the policy will be distributed from the plan when Roy retires, he will have to include, for tax purposes, the policy value less his basis. Because Roy is an owner of a C-Corporation (which is not a pass-through entity), he will be entitled to a credit for his basis upon distribution (the economic benefit that he's paid taxes on over the years).[6]

Applying the IRS Safe Harbor guidelines found in Revenue Procedure 2005-25, the FMV or PERC value at age 65 is $101,884. Roy's basis is equal to his cumulative economic benefit cost, $9,472.[6] His taxable distribution is $92,412 ($101,884-$9,472). In a 35% tax bracket, his tax will be $32,344 ($92,412 x 35%).

Cost upon distribution

Policy FMV at age 65	$101,884
Less the economic benefit costs	$9,472
Less the economic benefit costs	$92,412
Income tax to be paid (35% bracket)	$32,344

*Maximum plan contribution in 2019.

4 The result

Under this comparison, the difference is $32,370 in favor of purchasing life insurance inside the profit-sharing plan. This represents a 33% savings in Roy's situation. 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.

Each case will be different, and the variables can change. In addition to the possibility of providing a larger death benefit for the same premium and reducing out-of-pocket costs during working years, purchasing life insurance in a qualified plan can make good financial sense for your clients.

The client should consult with their tax attorney prior to implementing this strategy.

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 economic benefit	$3,315	$0
Reduced accumulation	$31,286	$0
Tax when policy is distributed	$32,344	$0
Total cost	**$66,945**	**$ 99,315**

Important note

The policy cash value at age 65 is $101,884 and premiums paid were $99,315.[2] The policy cash value is greater than premiums paid at this point. So, even when the value of the policy is greater than cumulative premiums paid, 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.

For more information, please call the Life Insurance Sales Desk or visit us at equitableLIFT.com.

1 IRC 415(c); 2019 Annual Limit, IRS Notice 2016-62.

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

3 See IRS Notice 2002-8.

4 In contrast, an owner employee/self-employed does not develop basis — IRC §72(m)(2); Treasury Reg §1.72-16 (b)(4). The term owner employee as applied here appears to include sole proprietors, partners, possibly members of LLCs, but not shareholders — IRC §401(c)(3).

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

6 At the time of distribution of a life insurance policy, an owner employee/self-employed is not entitled to deduct taxable economic benefit from policy value — IRC §72(m)(2); Treasury Reg §1.72-16 (b)(4). See the Economic Considerations section for a discussion of economic benefit costs.

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.

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