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HEADLINE: Using qualified plan money to purchase life insurance

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BODY:

Headnote: Abstract: This article describes how qualified plan dollars can be used to pay insurance premiums while avoiding estate taxes on the policy's death benefit. It explains the variety of current techniques, and it also includes a discussion of a new technique, known as a Qualified Plan Insurance Partnership (QPIP), which may deserve consideration when the more traditional approaches do not adequately address a client's needs or concerns.

Over the last several years, there has been increasing interest in the use of qualified plan dollars to purchase life insurance on the life of a participant in the plan. Accessing qualified plan monies to pay insurance premiums is attractive because the retirement plan offers a source of liquid funds that are not currently being utilized by the participant. The retirement plan also provides the opportunity of using tax deductible dollars to contribute toward insurance premiums. Unfortunately, the Internal Revenue Code and the Employee Retirement Income Security Act of 1974 (ERISA) have made finding an easy and effective technique for using qualified retirement plans to fund the purchase of life insurance somewhat akin to the search for the Holy Grail.

The most significant drawback to a retirement plan owning a life insurance contract is that, absent careful planning, the ability to avoid estate taxes on the death benefit will be lost. This article discusses a number of techniques designed to avoid this drawback. It includes a discussion of techniques currently in use, and also describes a new technique that may deserve consideration when the more traditional approaches do not adequately address a client's needs or concerns.

Fundamentals

The use of a qualified retirement plan to acquire life insurance protection traditionally begins with the qualified retirement plan purchasing the insurance policy.' This raises income tax, estate tax, and ERISA issues which must be addressed.

When a qualified plan purchases insurance on the life of the participant, the participant must pay income taxes on the economic value of the death benefit protection.2 This is equal to the pure term

cost of the insurance benefit provided.3 Except for self-employed individuals, the amount included in income by the participant is considered to be his or her basis in the policy.4

The Incidental Benefit Rule

The incidental benefit rule limits the amount of life insurance which can be purchased inside a qualified plan. The rule is intended to keep the death benefits provided by the insurance policy incidental to the primary purpose of the retirement plan, namely, the provision of retirement benefits to the participant and his or her spouse.

The amount of insurance that can be purchased by a qualified plan depends on the type of plan and the kind of insurance involved. In the case of a defined benefit plan, the incidental benefit rule will be satisfied if the amount of insurance purchased does not exceed 100 times the projected monthly benefit.5

For defined contribution plans, up to 50 percent of cumulative employer contributions can be used to purchase whole life insurance, provided the plan requires the trustee, at or before the participant's retirement, to either (1) convert the policy to cash, or provide the participant retirement income without life insurance protection; or (2) distribute the policy to the employee.6 If term or interest-sensitive policies are purchased by the plan, up to 25 percent of employer contributions can be used to purchase the insurance premium.7

The incidental benefit rule does not apply to employer contributions held in a qualified plan for more than two years (commonly referred to as seasoned money).8 Likewise, if an employec has participated in the plan for at least five years, his or her entire account can be used to pay insurance premiums.9

Tax Considerations

If the participant dies with an insurance policy owned inside his or her retirement plan, the "at risk" portion will continue to be income tax free.lo In addition, the amount at risk under the policy should avoid the 15 percent excise tax on excess plan accumulations." An amount equal to the policy's cash surrender value at death and accumulated dividends will be subject to income tax,12 but up to $5,000 of this amount may also be excludable (assuming there is no other death benefit paid by or on behalf of any employer with respect to the plan participant).13

Given the repeal of former Internal Revenue Code Section 2039(c), life insurance death benefits which are payable from a qualified retirement plan will be subject to federal estate taxes if the participant possesses an incident of ownership over the policy within three years of the date of his or her death. 14 A plan participant will be considered to have an incident of ownership if he or she has the ability to do any of the following:

(1) designate the beneficiary of the policy;

(2) surrender or cancel the policy;

(3) assign the policy; or

(4) borrow against the policy.ls Accordingly, it may be necessary for the plan to dispose of its interest in the policy before the insured dies if estate taxes are to be avoided.

Valuing Insurance Policies

If a qualified plan sells a policy, the purchaser should pay at least the cash surrender value.16 If the plan distributes the policy to the participant, the policy's value for income tax purposes will be the cash surrender value, unless the fair market value of the policy is substantially higher, in which case the interpolated terminal reserve value of the policy should be used.17 Although not entirely clear, it may be that this higher value should be used in the event of a sale as well.

If, after the policy has been distributed by the plan, it is then gifted by the participant to another and it is not a paid-up policy, the interpolated terminal reserve value plus the amount of unused premium should be used for gift tax purposes, unless "because of the unusual nature of the contract such approximation is not reasonably close to full value."18 If the gifted policy is a policy on which no further premiums are owed, then the value for gift tax purposes is the amount the company would charge for a single premium contract on the same specified amount on the life of a person the same age as the insured.19

Because of the confusion and inconsistency in positions taken by the IRS with regard to the valuation of an insurance contract, the most conservative approach may be to use the highest of the cash value, terminal reserve value or the replacement cost to value the policy, if it is practical to do so.20

Avoiding Estate Taxes on a Single Life Policy Funded With Qualified Plan Dollars: The Traditional Approaches

The simplest way to use plan dollars to pay insurance premiums to fund the purchase of a single life policy is for the plan to make a direct distribution to the plan participant. The participant can use the distributions to make contributions to an insurance trust.

Of course, distributions to the participant will be subject to income tax. Nonetheless, in appropriate circumstances it can be quantifiably demonstrated that the amounts received by the participant's heirs after deducting estate, income and excise taxes will be significantly greater than would be the case if plan distributions were not used to fund the purchase of insurance by the trust. Of course, distributions to the participant should be structured so as to avoid the penalty tax on premature distributions.

The Rollout Technique

Income taxes attributable to distributions for premiums could be avoided if the qualified plan itself purchases the insurance contract on the life of the plan participant and pays the premiums directly.

In this event, estate taxes can be avoided on the insurance proceeds if the plan distributes the contract to the insured and the insured then transfers the policy to an irrevocable insurance trust. Under Prohibited Transaction Exemption 92-5, the distribution of an insurance policy from a retirement plan to the insured participant is not prohibited, provided the requirements set forth in the Exemption are met.22

Of course, an income tax will be triggered by the distribution of the policy to the participant. However, to the extent the value of the policy at the time of distribution is less than the premiums paid to date, total income taxes will have been reduced. Therefore, it may be appropriate to structure the insurance contract so that much of the costs associated with the acquisition and administration of the policy are paid early on, such as in the first five years. However, careful consideration should be given as to how this strategy will affect the valuation of the policy at the time of the rollout.23

To avoid estate taxes on an insurance policy which has been distributed from a qualified retirement plan to the plan participant, the participant must gift the policy to his or her children or an insurance trust more than three years in advance of his or her death.24 The risk of the participant dying before the three-year period expires could be covered by a term policy on his or her life.

Another option would be for the participant to sell the policy to his or her spouse, followed by a gift of the policy to the children or an insurance trust. A purchase by the participant's spouse is not a transfer-for-value since the spouse will have the same income tax basis as the participant.25 A gift of the policy by the spouse will not trigger the three-year rule since the spouse is not the insured.26 In the alternative, the plan could sell the policy to an insurance trust or the participant's children, provided the purchaser is a partner in a partnership of which the insured is also a partner. Under certain conditions, the plan may sell an insurance policy for its cash value to a relative of the insured participant if the relative is named as the beneficiary of the policy.27

The Subtrust Technique

The need to distribute an insurance policy which has been purchased by a qualified plan (and the associated drawbacks mentioned above) might be avoided if an irrevocable insurance trust (also known as a subtrust) is created inside of the retirement plan.28 The establishment of a subtrust involves the following steps:

1. First, the plan document must provide for the creation of the subtrust and must irrevocably name an independent third party as "special trustee." Successor transferees should also be named.

2. The special trustee then uses plan assets to purchase an insurance policy on the life of the plan participant.

3. The policy names the subtrust as the owner and beneficiary of the insurance contract.

4. When the insured dies, the special trustee will collect the insurance proceeds for distribution to the trust beneficiaries.

The subtrust will normally provide that insurance proceeds collected by the subtrust after the insured's death will be distributed to a beneficiary which has been selected by the special trustee. In most cases this authority is limited to selecting from a class of permitted beneficiaries. If the trustee of the subtrust designates a trust outside of the plan whose assets will not be includable in the taxable estate of the participant, then the insurance proceeds may be excluded from the insured participant's taxable estate as well. However, it must be noted that there are no published IRS rulings or court decisions which address the estate tax ramifications of the subtrust technique.29

When the subtrust technique is used in connection with a defined contribution plan, the amount contributed by the plan to the trust for the payment of insurance premiums may result in a taxable gift by the participant. A taxable gift could result because the subtrust is irrevocable and contributions to it are not gifts of a present interest. Withdrawal rights cannot make the gifts qualify as a gift of a present interest since nothing can be distributed from the qualified plan to anyone other than the participant during the participant's lifetime.30

If a retirement plan to which a subtrust is added covers both highly and nonhighly compensated employees, consideration must be given to whether the subtrust violates the nondiscrimination rules of Code Section 401 (a)(4). The possibility of discrimination exists because highly compensated employees will be more likely to utilize the subtrust technique. This potential problem can be avoided if (1) the use of a subtrust is made available to all employees, and (2) a description of the subtrust is included in the summary plan description.

The IRS could raise several arguments in an attempt to subject the death benefits payable on an insurance policy held by a subtrust to estate taxes. First, if a pre-existing policy is transferred to the subtrust, the IRS might argue that the participant indirectly retained the right to select the beneficiary of the insurance proceeds (i.e. when selecting the beneficiary, the independent trustee was acting at the direction of the plan participant).31 However, because the special trustee is obligated to exercise his or her discretion as a fiduciary in accordance with ERISA, he or she should not be deemed to be under the control of the participant.32 Nonetheless, if the subtrust is purchasing a new insurance policy it may be better for the trust itself to designate the ultimate beneficiary of the insurance proceeds, assuming the plan participant has no ability (directly or indirectly) to amend the terms of the subtrust.

Second, if a pre-existing policy is transferred by the participant to the subtrust, the IRS could argue that the participant retained a possibility of reverter with regard to the subtrust if the policy could be used to pay benefits to the participant or to his or her designated beneficiary.33 To limit this risk, the participant should irrevocably designate a survivor annuitant at the time the subtrust is created.34 Note that this issue should not arise if the subtrust purchased the policy originally.

Third, the IRS could argue that Code Section 2039(a) results in estate tax inclusion of the subtrust assets. This Code Section states:

General. - The gross estate shall include the value of an annuity or other payment receivable by any beneficiary by reason of surviving the decedent under any form of contract or agreement entered into after March 3, 1931 (other than as insurance under policies on the life of the decedent), if,

under such contract or agreement, an annuity or other payment was payable to the decedent, or the decedent possessed the right to receive such annuity or payment, either alone or in conjunction with another for his life or for any period not ascertainable without reference to his death or for any period which does not in fact end before his death. (Emphasis added.)

Thus, Section 2039(a) includes assets held by qualified retirement plans in the estate of the plan participant because the participant is entitled to receive distributions from the plan prior to his or her death. However, Section 2039(a) apparently excludes "insurance under policies on the life of decedent" from its application. Query, however, whether this reference to insurance is still relevant, given the repeal of former Code Section 2039(c), which had provided an estate tax exclusion for death benefits from an insurance policy on the life of a participant in a qualified plan when the policy had been purchased by the plan, regardless of whether the participant had any incidents of ownership in the policy.35 The IRS might argue that the repeal of Section 2039(c) results in the language quoted above being irrelevant.

In sum, there is some risk that a subtrust may not prevent estate tax inclusion, especially if an existing policy is transferred to the subtrust by the participant. Therefore, the subtrust should also be structured so that the marital deduction is available if the insurance proceeds are determined to be includable in the insured participant's estate. The marital deduction will be available with regard to assets held in the subtrust only if all of the permissible beneficiary options under the subtrust would qualify for the marital deduction. As an additional precaution, the subtrust should allow the special trustee to sell the policy to the participant or member of his or her family as described above.36

Avoiding Estate Taxes on Second-to-Die Insurance Funded With Qualified Plan Dollars

Second-to-die life insurance can be a very effective way to fund the payment of estate taxes because the unlimited marital deduction allows federal estate taxes to be deferred until the date of the surviving spouse's death.37

A profit sharing plan can purchase a second-to-die life insurance contract which insures the life of both the participant and his or her spouse.38 The purchase of second-to-die insurance inside a profit plan involves the following steps.

1. The participant establishes an irrevocable life insurance trust.

2. The profit sharing plan is amended as necessary:

a. to allow the participant to direct the investment of his or her account;

b. to allow the purchase of insurance on the life of someone other than the life of the participant;

c. to mandate the sale of the policy on the death of the participant's spouse; and

d. to provide that, in the event of a simultaneous death, the participant is presumed to survive his or her spouse.

3. A second-to-die insurance contract is purchased by the participant's profit sharing account. Special caution must be exercised to make sure that the plan permits the ownership of insurance on the life of someone other than the participant.

4. An irrevocable life insurance trust is designated as the beneficiary of that portion of the participant's account consisting of the survivorship policy.

a. The designation of the insurance trust as beneficiary can be revocable.

b. As a result, the participant still has access to the policy while held by the plan, and therefore no taxable gift is present.

c. However, the participant's spouse must consent to such a beneficiary designation.39

5. The participant's spouse is often designated as the beneficiary of the balance of the retirement plan account.

6. A bona fide partnership should be created between the participant and his or her children or the insurance trust.

If the participant dies first, the plan can transfer ownership of the policy directly to the irrevocable trust, bypassing the participant's estate. Because the plan owns the policy when the participant dies, the value of the policy at the date of death will be includable in the participant's taxable estate.40 Income taxes will also be due on the value of the policy at the time of distribution, less the trust's basis in the policy.41 Note that both of these taxes could be funded if a single life policy on the life of the participant was owned by the insurance trust.

In the event that the participant's spouse dies first, steps must be taken to eliminate the plan's ownership interest in the policy.42 This can be accomplished in a variety of ways.

The first choice would be for the policy to be distributed from the plan to the participant, followed by a contribution of the policy to an insurance trust. However, such a distribution will trigger income taxes on the distribution to the participant. Income taxes could be avoided at the time of the rollout if the plan were to sell the insurance policy to the participant. The sale of a policy owned by a retirement plan to the participant is permissible if the trustees are unable to maintain the policy under the plan.43 Accordingly, the participant should rescind his or her consent to the plan's ownership of the policy, or the plan should mandate the sale of the insurance upon the death of the participant's spouse.

Once the participant owns the policy, it can be contributed to the insurance trust. Such a transfer could, however, trigger gift taxes and also estate taxes if the participant dies within three years. Gift taxes could be reduced or eliminated by having the contribution qualify for the annual exclusion (i.e. having the trust agreement provide for Crummey44 withdrawal powers.) Application of the three-year rule could be prevented if the participant were to sell the policy to the insurance trust.45 The

transfer-for-value rules might be avoided on the sale to the trust if the trust were regarded as a grantor trust for federal income tax purposes.46 Income taxes, gift taxes, the three-year rule and the transfer-forvalue rule could also be avoided if the plan were to sell a policy to the participant's children, assuming (1) the children were the named beneficiaries of the policy and (2) the plan participant and the children were partners at the time of the sale.47

Of course, there is always a possibility that the participant and the participant's spouse will die simultaneously. To deal with this risk, the participant's estate planning documents, the beneficiary designation for the insurance policy, and the profit sharing plan should all include language which indicates that the participant is presumed to have predeceased his or her spouse in the event of a simultaneous death.

The Qualified Plan Insurance Partnership

Because of the uncertainties regarding the valuation of insurance policies which are distributed by qualified plans, the potential risks and complexity associated with the subtrust technique, and the inability of an IRA to own life insurance, some clients may be interested in an alternative approach for using plan dollars to fund the purchase of life insurance. The author suggests that a Qualified Plan Insurance Partnership (QPIP) may offer such an alternative.

With a QPIP, the retirement plan, the plan participant and an insurance trust join together to form a limited partnership in a manner which satisfies the prohibited transaction rules of ERISA and the Internal Revenue Code. The limited partnership, which should have a demonstrable business purpose, would then purchase an insurance contract on the life of the plan participant, which names the partnership as beneficiary.

With a QPIP, the plan participant and the qualified retirement plan are designated as limited partners, while the irrevocable trust is the general partner. Initially, the plan participant would make a nominal contribution to the partnership in exchange for a limited partnership interest (to make sure the partnership has an insurable interest on his or her life).48 The remaining contributions to the partnership would come from the plan and the insurance trust.

The irrevocable trust, acting through its trustee, would have sole authority to manage the partnership assets as general partner The general partner would be required by the partnership agreement to comply with all ERISA requirements pertaining to the plan's contributions to the partnership.49 As a result, the general partner would be required to manage the partnership assets as if partnership assets were held inside the plan.

Assuming the partnership invested in a policy of insurance insuring the participant's life, the following additional requirements would be imposed by the partnership agreement.

1. The partnership agreement would require that the plan, as limited partner, at all times own a majority of the partnership's capital interests and profits interests.

2. The partnership agreement would dictate how much each partner was obligated to contribute to the partnership toward the payment of insurance premiums.

3. The partnership agreement would specify how the insurance proceeds collected by the partnership would be divided among the partners upon the death of the insured.50

For example, the partnership agreement might utilize a traditional split dollar approach to divide the insurance premiums and proceeds. Specifically, each year the insurance trust would contribute to the partnership an amount equal to that portion of the insurance premium needed to provide the death benefit protection offered by the contract at the issuing company's annual renewable term rate.51 The balance of the premium would be paid by the plan. Upon the death of the insured, the general partner (the insurance trust) would receive an amount equal to the pure insurance protection afforded by the policy (i.e., the amount "at risk" under the contract).52 The balance of the insurance proceeds (the cash value) would be distributed to the retirement plan, as limited partner.53

As the following case study illustrates, if the insurance proceeds are collected by the QPIP and then distributed using the split dollar approach described above, the amount "at risk" under the contract might escape both income and estate taxation.

Dr. Dan is age 50, married and has three children. He is a participant in a profit sharing plan and has the ability to direct the investment of his account. His plan account has a balance of $680,000. In addition to his profit sharing plan, Dr. Dan has assets which would result in a gross taxable estate of approximately $2.5 million.

Dr. Dan is concerned about the estate taxes that will be payable when the survivor of he and his wife dies. He has decided to purchase an insurance contract on his life to provide his estate with needed liquidity at his death. He wishes to use amounts accumulated in his qualified retirement plan to help pay the insurance premium.

Accordingly, Dr. Dan establishes a QPIP between himself, his profit sharing plan, and an irrevocable insurance trust which he establishes. Each year the insurance trust pays that amount of the premium equal to the costs of the pure insurance protection afforded by the policy. The balance of the premium is paid by the qualified plan. (See Exhibit 1.) In addition to the insurance premium, Dr. Dan and his retirement plan contribute other assets to the partnership in order to substantiate its business purpose.54

Dr. Dan dies at age 71, before plan distributions have commenced. At that point, the insurance trust would receive an amount equal to the pure insurance protection afforded by the policy. This amount should, in the author's opinion, avoid both estate and income taxes. It could then be distributed to Dr. Dan's family, thereby offsetting the amount lost to estate taxes. The balance of the death benefit would then pass through the QPIP to the retirement plan. (See Exhibit 2.)

At any time after the participant attains age 59 1/2, the plan's limited partnership interest could be distributed to the participant without penalty.55 By this point, much of the acquisition costs of the policy would have been paid with pretax dollars. The participant could then contribute the

partnership interest he or she received to the insurance trust.56 Because the plan will not be distributing an insurance contract to the participant, but rather a limited partnership interest, the subsequent transfer of that partnership interest to the insurance trust should not trigger the three-year in-contemplation-of-death rule.57

In sum, a properly structured QPIP offers the following potential advantages.

1. It allows the plan to pay much of the expense associated with acquisition and maintenance of the policy with pretax dollars.

2. It allows the insurance trust to take advantage of the very favorable table rates in determining what it must pay to acquire term coverage.

3. It limits the amount includable in the decedent's estate to the cash value at the date of death if the participant dies before the plan's interest in the partnership is distributed.

4. It allows the trust to purchase the entire insurance contract from the partnership later for an amount which is potentially much less than the premiums that had been paid up to that point, without triggering the transfer for-value rules.

5. It avoids application of the incidental benefit rule, the three-year rule and the transfer-for-value rule.

6. It may allow an IRA to be used to fund the purchase of life insurance since the IRA will be acquiring a partnership interest rather than an insurance contract.

While a QPIP offers a number of potential advantages, the following precautions should be taken. First, the QPIP must be regarded as a partnership for tax purposes.58 This requires that the facts and circumstances support a determination that "the parties in good faith and acting with a business purpose intended to join together in the present conduct of the enterprise."59 For this reason, it is recommended that the plan and the participant contribute assets to be invested and managed by the QPIP in addition to the amounts needed to pay the insurance premiums.

Second, the insured must be only a limited partner, and the rights of the limited partners should be carefully limited in the partnership agreement, so that in no event can the insured be said to be able to exercise an incident of ownership "in connection with the other partners."60 The participant may also want to transfer his or her partnership interest to the irrevocable trust after the policy has been acquired, since an insurable interest is required only at the time the policy is acquired.

Third, the plan's investment in the partnership must not result in a violation of the prohibited transaction rules codified in ERISA Section 406 and Internal Revenue Code Section 4975(c). These provisions restrict a participant's ability to make certain investments with his or her retirement plan.

ERISA Considerations

Because the general partner (the irrevocable trust) is a fiduciary for purposes of ERISA, the trustee will be obligated to invest partnership assets in a manner which satisfies ERISA.61 However, the partnership itself should not be a "party in interest" because the participant and the irrevocable trust together would always own less than 50 percent of the partnership capital and profits interests.62 The question is therefore whether a plan's investment in a QPIP results in a transfer of plan assets for the benefit of a prohibited person in violation of Section 406(a)(1)(D) of ERISA and Section 4975(c)(1)(D) of the Internal Revenue Code. The arguments that such a violation exists might be:

1. because the family members of the plan participant are the beneficiaries of the insurance trust, the insurance trust constitutes a party-in-interest for purposes of ERISA;

2. the investment of plan assets in the partnership is a "transfer to or use of" plan assets; and

3. the plan's investment in the QPIP is being undertaken for the benefit of a party-in-interest (the beneficiaries of the irrevocable trust).

Assuming the QPIP complies with the Internal Revenue Code's partnership allocation rules,63 the investment of plan assets in the QPIP should not be deemed to confer a personal benefit on the plan participant or his or her family because the general partner's fiduciary duties to all partners would prohibit the general partner from applying or investing QPIP assets (including the plan's investment therein) in a way which would benefit one partner to the detriment of the other. So long as the trust's contributions to the partnership are commensurate with its beneficial interests in the partnership, there should not be a transfer of plan assets for the benefit of the trust beneficiary. A QPIP using the split dollar approach should comply with the fiduciary duties imposed by ERISA, since each partner will be contributing the cost of their share of the policy the partnership owns.

A recent decision of the United States Court of Appeals for the Third Circuit supports the conclusion that the investment in a QPIP utilizing a split dollar approach should not constitute a prohibited transaction for purposes of ERISA. In Reich v. Compton,64 the Department of Labor asserted that a transaction between a nonprofit corporation and a retirement plan violated ERISA Section 406(a)(1)(D) because the nonprofit corporation was the "alter ego" of a party-in-interest. Initially, the court found that, in order for a violation to exist, the following five elements must be satisfied.

1. The person or entity engaging in the transaction must be a fiduciary with respect to the plan.

2. The fiduciary must cause the plan to engage in the transaction at issue.

3. The transaction must use plan assets.

4. The use of plan assets must be for the benefit of a party-in-interest.

5. The fiduciary knows or should have known that elements (3) and (4) are satisfied.

In finding that there was not a transfer for the benefit of a party-ininterest, the court stated: "...(W)e conclude that element 4 requires proof of a subjective intent to benefit a party-in-interest."

Applying the foregoing to the QPIP transaction, it is not enough for the Department of Labor to simply assert that a plan's investment in the QPIP could benefit the beneficiaries of the insurance trust. Instead the Department must demonstrate that the plan's investment in the QPIP was done with the subjective intent of benefiting the insurance trust at the expense of the plan itself. A QPIP which uses the split dollar approach should pass this test because the insurance trust will be contributing to the partnership the cost of the mortality protection provided by the contract. Note too that the plan will benefit from increases in the cash value of the policy. Since the insurance trust will be paying the cost of the mortality risk, this return should be competitive with similar low risk investments. Investment in the QPIP would also provide the plan with the opportunity to diversify its portfolio.

Accordingly, so long as policy dividends are not used to reduce the insurance trust's share of the policy premiums, it does not appear that a QPIP will violate ERISA. If, notwithstanding the foregoing, additional caution is desired, then the QPIP could be funded with a variable life contract. Another option would be to structure the QPIP on an equity split dollar basis (i.e. so that the plan receives an amount equal to the premium it has paid plus interest). Of course, this could result in a reduction in the amount received estate tax free by the insurance trust being reduced.

While the above analysis supports the conclusion that the investment of plan assets in a QPIP does not violate either ERISA or the Internal Revenue Code provisions dealing with qualified retirement plans, neither the Department of Labor nor the Internal Revenue Service has issued a ruling which approves of it. Therefore, one must consider the possibility that the Department of Labor or the IRS could take issue with the effectiveness or validity of a QPIP. J (I/R Code No. 5400.00/4000.00)

Footnote: (I) If insurance is to be purchased inside a qualified plan, the plan document should contain language specifically allowing it. (2) Treas. Reg. 1.72-16(b).

(3) IRC 72(m)(3)(b). If the policy insures the life of the participant only, the taxable amount is measured either under the P.S. 58 table or as the yearly renewable term rate charged by the insurance company for policies issued by the same carrier and available to the same class of insured. If, on the other hand, the policy purchased by the plan is a joint and survivor policy, the rates provided under annuity mortality table 38 can be used. (4) IRC 72(m).

(5) Rev. Rul. 60-83,1960-1 C.B. 157; Rev. Rul. 68-453, 1968-2 C.B. 163. Money purchase target benefit plans will also satisfy the incidental benefit rule if this test is satisfied. Rev. Rul. 74307, 1974-2 C.B. 126.

(6) Rev. Rul. 73-501, 1973-2 C.B. 127; Rev. Rul. 54-51, 1954-1 C.B. 147, as amplified by Rev. Rul. 57-213, 1957 C.B. 157 and Rev. Rul. 60-84,1960-1 C.B. 159. (7) Rev. Rul. 66-143, 1966-1 C.B. 79. (8) Rev. Rul. 60-83, supra note 5. (9) Rev. Rul. 68-24, 1968-1 C.B. 150. The plan document should also specify if the two- or fiveyear rule exceptions (or both) are to be relied on. (10) IRC 101(a); Treas. Reg. 1.72

16(c)(2)(ii). (11) IRC 4980A.

(12) Treas. Reg. 1.72-16(c)(2)(ii); 1.7216(c)(3), Ex. 1. (13) IRC 101(b). (14) IRC 2042(2).

(15) Treas. Reg. 20.2042-l(c)(2); see also H.R. Rep. No. 2333, 77th Cong., 1st Sess. (1942), which appears to more broadly define incidents of ownership.

(16) Prohibited Transaction Exemption No. 926, 57 Fed. Reg. 5190 (Feb. 12, 1992); formerly Prohibited Transaction Exemption No. 77-8, 42 Fed. Reg. 31574 (June 21, 1977). (17) IRS Notice 89-25, 1989-1 C.B. 662. Except in the case of sole proprietors, the cost of the term protection may be subtracted from the terminal reserve value. Id. (18) Treas. Reg. 25.2512-6(a). (19) Id. at Ex. 3.

(20) Priv. Ltr. Rul. 94-13-045 (Jan. 4, 1994). (21) See IRC 72(t).

(22) Prohibited Transaction Exemption No. 925, 57 Fed. Reg. 5019 (Feb. 11, 1992), formerly Prohibited Transaction Exemption No. 77-7, 42 Fed. Reg. 31575 (June 21, 1977). (23) IRC 72(m)(3); Treas. Reg. 1.402(a)I (a)(2). When a retirement plan distributes an insurance contract it originally acquired, an amount equal to the cash value of the policy, less the participant's basis, must be included in the taxable income of the participant in the year of distribution. Note, however, if the policy is a "springing cash value policy," then the policy's interpolated terminal reserve value or replacement cost might have to be used to value the policy at the time of distribution. IRS Announcement 92-182, 199252 I.R.B. 45 (Dec. 10, 1992). (24) IRC 2042(2); 2035. (25) IRC 101(a)(2); 1041(b)(2). (26) IRC 2035(d)(2), 2042(2). (27) PTE 92-6, supra note 16. (28) See generally, Andrew Fair, Guardian Life Ins. Co. of Am., Pub. 1261, The Qualified Plan As An Estate Planning Tool - Advance Techniques Using Life Insurance (Dec. 1992). (29) In order for the subtrust technique to avoid estate taxes, the subtrust must provide that the trustee has the sole power to exercise all incidents of ownership over the policy insuring the life of the participant. Thus, the subtrust must provide that only the special trustee has the abil

ity to draw against the cash value of the policy, to borrow against the policy, to surrender or assign the policy or to designate the beneficiary of the policy. The insured participant must not indirectly control any of these rights. (30) A collateral assignment between the participant's account and the subtrust (whereby the account is repaid its premium contributions upon the participant's death) may be a way to avoid gift taxes. In this respect, the subtrust plan would be analogous to a corporate split dollar insurance program.

. (31) The marital deduction is available with regard to assets held in the subtrust only if all of the permissible beneficiary options under the subtrust would qualify for the marital deduction. Giving the trustee the authority to select a beneficiary can reduce the risk of estate taxation because the special trustee could select a beneficiary that would qualify for the marital deduction, if necessary, to avoid estate taxes. (32) Treas. Reg. 1.501(c)(9)-2(c)(3)(iii). (33) Treas. Reg. 20.2042-1(c)(3). (34) Assuming the plan does not provide otherwise, a participant may select a form of benefit

payment that includes a death benefit in the form of a survivor annuity. IRC 401 (a)(17). Accordingly, if the participant irrevocably designates a beneficiary of a survivor annuity, and the value of the annuity is measured as the cash value of this policy and payable therefrom, the participant should never have an ability to receive benefits from the policy. However, consideration must be given to whether such a designation constitutes an alienation of benefits in violation of IRC 401(a)(13).

(35) See generally, Fair, supra note 28, at 17-18. (36) See supra note 27 and accompanying text. (37) IRC 2056.

(38) A pension plan cannot be used to purchase joint and survivor life insurance, but a profit sharing plan can. See Treas. Reg. 1.401l(b)(1)(ii).

(39) IRC 401(a)(11), 417.

(40) See IRC 2518. Because the policy is distributed directly to the irrevocable trust at the participant's death, the three-year "in contemplation of death" rule would not apply when the surviving spouse dies. Furthermore, the amount of estate taxes attributable to the policy could be adjusted at the participant's death if the participant's spouse is named as the primary beneficiary of the plan's interest in the insurance policy, the insurance trust is named as the secondary beneficiary, and the designation provides that if the surviving spouse disclaims his or her beneficial interest in part or all of the policy, the amount so disc)aimed would then be transferred to the insurance trust.

(41) The burden to pay the income taxes due when the policy is distributed can be shifted to the participant's spouse by having the spouse bc the grantor of the insurance trust, and having him or her retain a power described in IRC 675. But see Priv. Ltr. Rul. 94-13-045, supra note 20. Query, also, whether the spouse would be treated as the grantor for income tax purposes with regard to amounts which were contributed to the trust by the participant's plan. (42) The policy may also need to be removed from the plan prior to the participant's death if the participant terminates his or her employment with the plan sponsor, the plan is terminated or the participant actually retires. (43) See PTE 92-6, supra note 16. (44) Crummey v. Comm'r., 397 F2d. 82 (9th Cir. 1968).

(45) IRC 101(a)(2)(B). A sale of the policy by the participant to an insurance trust should eliminate the application of the three-year rule because there will not be a transfer of the policy for less than full and adequate consideration. Moreover, the transfer-for-value rules would not be triggered by the sale if the insurance trust and the participant are partners at the time of the sale. (46) See IRC 671-677; W. Clarke Swanson Jr. v. Commissioner. 518 F.2d59 (8th Cir. 1975). Of course, the grantor must avoid possessing an incident of ownership with regard to the trust-owned policy. There are several different types of powers which can be included in a trust to retain the interest deduction for the grantor while keeping the policy proceeds from being included in the grantor's gross estate for estate tax purposes. Among the most common are: (1) a premium payment power; (2) a nonadverse trustee's sprinkling power; (3) a nonadverse trustee's power to add beneficiaries; (4) authorization for a nonadverse trustee to pay trust income to the grantor's spouse; and (5) authorization for a nonadverse trustee to pay trust income to the grantor.

(47) Under PTE 92-6, supra note 16, the plan may sell an insurance policy for its cash value to a relative of the insured participant if the relative is named as the beneficiary of the policy, provided the conditions set forth in the exemption are met. Once the children have acquired the policy, they could transfer it to an insurance trust they had created (if there is a concern about the ramifications should one of the children predecease the surviving parent). (48) Applicable state statutes should be consulted to make sure the partnership has an insurable interest on its partners. (49) The general partner will be regarded as a fiduciary of the plan under the plan asset rule. See infra text accompanying note 60. (50) A partnership agreement may provide that a partner's distributive share of a particular item of income, gain, loss, deduction or credit differs from his or her distributive share of partnership's general income and loss. However, a specific allocation may be disregarded by the IRS if it lacks substantial economic effect. IRC 704(b). (51) See in this regard Rev. Rul. 64-328, 19642 C.B. I1; Rev. Rul. 66-110, 1966-1 C.B. 12. If, in comparison, policy dividends were applied to offset premiums, then taxable income to the participant could result because the plan would indirectly be paying a portion of the cost of the pure insurance protection. If the trust contributed this portion of the premium, there should be no taxable income to the participant due because of the payment of the insurance premium by the plan. See supra note 3.

(52) For this purpose, the cash value of the contract should be determined as if all policy dividends were allowed to accumulate at interest. If proceeds collected from the insurance contract were insufficient to distribute to the plan the amount provided for above, the trust, as general partner, would be obligated to make additional contributions to the partnership to the extent necessary to offset the deficiency. (53) This arrangement should satisfy the partnership allocation rules since each partner will be receiving the economic equivalent of that portion of the insurance proceeds which were acquired with their respective contributions. (54) As mentioned previously, these contributions should be structured so that the plan owns a majority of the partnership. (55) Of course, the participant would have to pay income taxes on this distribution. It may be possible, however, to further reduce the value of the distribution by minority interest and lack of marketability discounts. See Andrew J. Willms, Drafting Tips to Obtain Maximum Tax Savings From FLPs. Taxation for Lawyers, lan.-Feb. 1996, at 196.

(56) This contribution should be able to avoid gift taxes due to the annual exclusion and unified credit (57) Compare Rev. Rul. 90-21,1990-1 C.B.172 with Rev. Rul. 82-141, 1982-2 C.B. 209. (58) If the QPIP were not treated as a partnership for tax purposes, then the QPIP may be regarded as a trust, which would result in the insured/partner having an incident of ownership in the policy owned by the QPIP, resulting in estate taxation of the insurance proceeds. See Rev. Rul. 83-147, 1983-2 C.B.153; Treas. Reg. 20.2042-1(c)(2). (59) Commissioner v. Culberson, 327 U.S. 738, 742 (1949); Torres v. Commissioner, 88 T.C. 702, 736 (1987).

(60) This is important to safeguard against a possible argument by the IRS that the insured "possesses incidents of ownership that are exercisable in connection with the other partners." See Rev. Rul. 83-147, 1983-2 C.B. 158. (61) ERISA 404(a). See also, John Hancock v. Harris Trust & Savings Bank, 114 S. Ct. 517 (1993).

(62) ERISA 3(14)(G). (63) See supra note 50.

(64) Reich v. Compton, 57 F.3d 270 (3rd Cir. 1995).

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Qualified Plan Insurance Partnerships (QPIPs)
A Life Insurance and Qualified Plan Partnership

What is a QPIP?
A Qualified Plan Insurance Partnership (QPIP) is a limited partnership that has a demonstrated business purpose and includes a qualified plan or IRA, the plan participant and an irrevocable life insurance trust (ILIT) as the partners. The limited partnership must be designed in a way that satisfies the prohibited transaction rules of ERISA and the Internal Revenue Code (IRC)[1].

How does a QPIP work?

- The plan participant and the qualified plan are the limited partners and the ILIT is the general partner. The plan will own a majority interest in the partnership[2].

- The participant makes a minimal contribution to the trust in exchange for a limited partnership interest. The ILIT manages the partnership and makes sure it complies with all ERISA guidelines.

- The limited partnership, with contributions from the ILIT and the qualified plan, purchases a life insurance policy on the plan participant. The partnership is the owner and beneficiary of the policy. Each year the ILIT will contribute to the partnership an amount equal to annual renewable term rates (ARTs) and the plan will pay the balance of the premium[3].

- At the death of the insured, the agreement will terminate and the ILIT will receive the amount "at risk" under the life insurance contract. The qualified plan will receive the balance of the insurance proceeds, usually the greater of cash value or premiums paid.

The process for establishing a QPIP:
1) The plan participant makes a minimal contribution to the partnership.
2) The ILIT and the qualified plan contribute the remaining amounts for the premium.
3) The partnership purchases a Manulife policy on the plan participant.
4) The partnership is named beneficiary of the policy.
5) The ILIT will contribute an amount each year equal to the lower of Manulife Term Rates or Table 2001 rates, for the insurance premium[4].
6) At the death of the insured, the agreement will terminate and the plan will receive the greater the premium paid or policy cash values.
7) The ILIT will receive the balance of the insurance proceeds.

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[1] See Prohibited Transaction Exemption (PTE) 92-6.
[2] The partnership agreement should dictate how much each of the partners should contribute to the insurance premiums, as well as how the death proceeds should be divided among the partners.
[3] The partnership agreement can use a traditional split dollar approach to split the insurance premiums and proceeds.
[4] As set forth in Revenue Rulings 64-328 and 66-110.

Qualified Plan Insurance Partnerships
Advantages and Disadvantages

Advantages:

- The majority of expenses associated with the maintenance of a life insurance policy are funded with pre-tax dollars from the qualified plan or IRA.
- The ILIT is able to take advantage of favorable term rates.
- The qualified plan does not own the life insurance policy, thus it does not need to be distributed at retirement.
- Reduces the estate and income taxes due upon the death of the insured, since they will be taxed only on the policy cash value.
- The ILIT may purchase the entire policy at a later date for a potentially lower amount, based on a discounted partnership value.
- The qualified plan's interest may be distributed to the participant's surviving spouse, thus avoiding any potential estate taxes[5].
- Allows an IRA to contribute to life insurance policies, since IRAs can own limited partnership interests.

Disadvantages:

- Neither the Department of Labor nor the Internal Revenue Service has issued a ruling approving this concept.
- If the QPIP is not properly structured as a partnership, it may be regarded as a trust and may trigger incidents of ownership for the plan participant, resulting in estate taxes on the insurance proceeds.[6]
- Other assets should be contributed to the partnership beyond the cash needed to fund the life insurance policy.[7]

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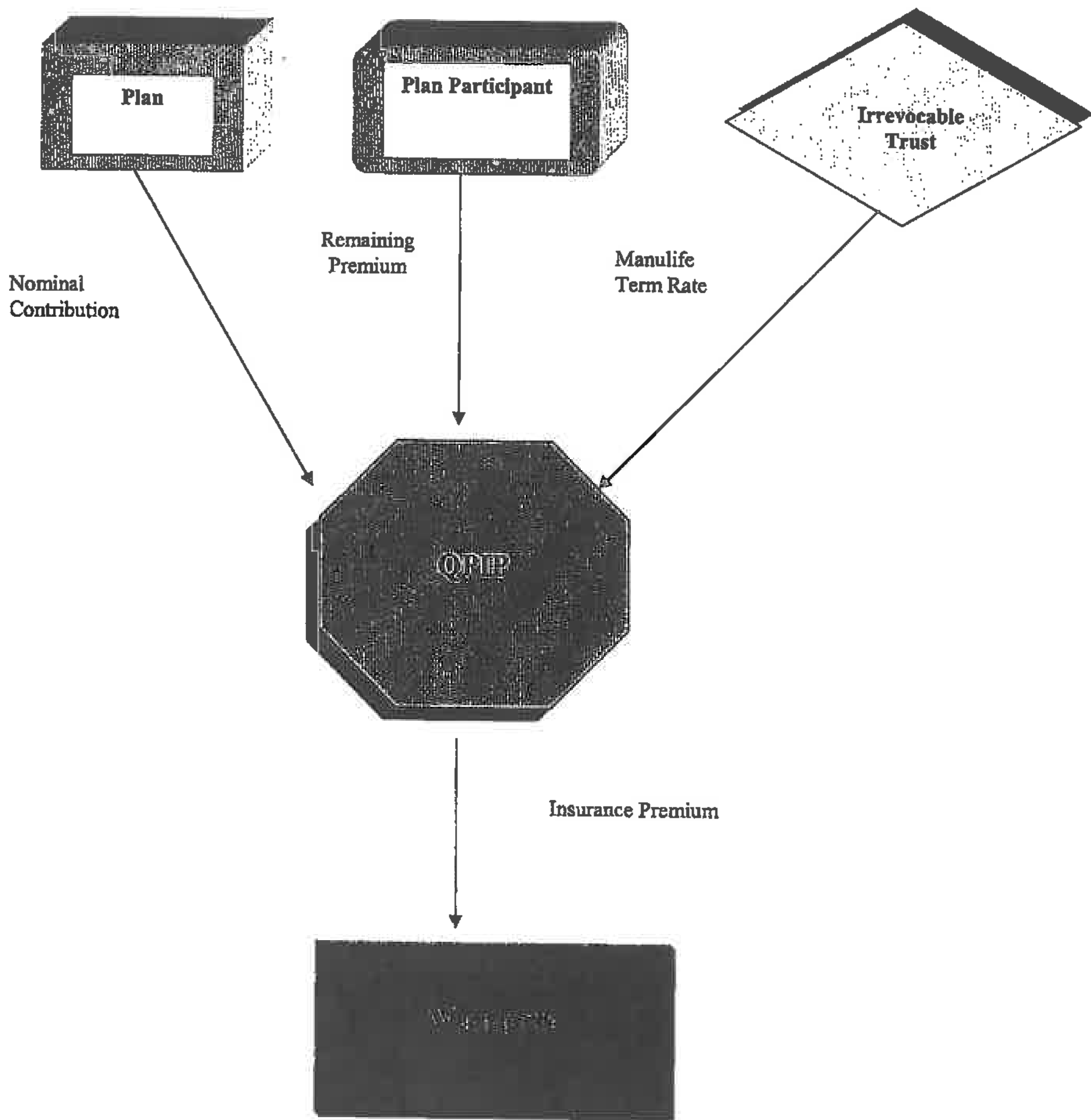
[5] A distribution to the surviving spouse should qualify for the estate tax marital deduction.
[6] See Revenue Ruling 83-147, 1983-2 C.B. 153; Treas. Reg. 20.2042-1(c) (2).
[7] Commissioner v. Culberson, 327 U.S. 738, 742 (1949).


Plan
Plan Participant
Irrevocable Trust
Nominal Contribution
Remaining Premium
Manulife Term Rate
QPIP
Insurance Premium