Yanking Taxes From the Estates

By Stephen M. Margolin

Most agents think you can't avoid federal estate taxes on insurance in a qualified plan. Don't be so sure.

The traditional advantage of life insurance in a profit-sharing plan is that it allows a participant to pay premiums from a large cash pool with pre-tax dollars.

While it sounds good, some argue such an arrangement is ripe for high taxes. Upon death, they say, the face value appears in the participant's estate, but as the song goes, "It ain't necessarily so." There are ways around the problem.

We will discuss (a) buying survivor insurance with a profit-sharing plan, and (b) keeping the life insurance out of the estates of both the participant and his spouse.

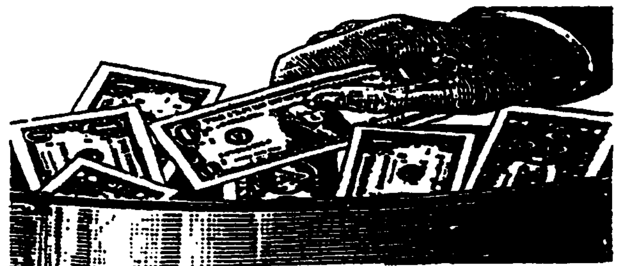
You can avoid the estate tax problem with last-to-die insurance on the participant and his spouse within a profit-sharing plan. You keep the insurance out of the estate, and you potentially keep high estate taxes out of mind.

THE AUTHORITY TO PURCHASE INSURANCE

Internal Revenue Code Sec. 1.401-1(b)(1) allows a profit-sharing plan account to provide the participant and his family incidental life or accident health insurance. A series of private-letter rulings makes insuring spouses permissible, but only within a profit-sharing plan. So there is authority for buying survivor insurance on the participant and his spouse in a profit-sharing plan.

The internal funds available for premiums from the profit-sharing plan, however, is limited. The following limitations must be kept in mind while constructing a plan such as this:

- With a whole life policy, the cumulative premiums must be less than 50 percent of the cumulative employer contributions allocated to the participant;
- With term or universal insurance, the cumulative premiums cannot exceed 25 percent of the cumulative employer contributions allocated to the participant's account;
- Funds accumulated in a profit-sharing plan after two years may be distributed to the participant. The Internal Revenue Service (IRS) ruled that these amounts can purchase life insurance under Rev. Rul. 60-83;
- There is also a five-year rule that states if a person has been in a profit-sharing plan for five years, 100 percent of his account balance can be distributed to him, regardless of when the balance accumulated. That is, whatever is payable to him



could be used to purchase life insurance.

Once purchased, the participant includes in his annual income the economic value of the death benefit. This value is generally less than the IRS PS 58 value on a single life.

KEEPING INSURANCE OUT OF THE ESTATE

Assume the participant dies first. The cash surrender value, a fraction of the policy value, is included in the gross estate, and is the only amount that is subject to federal estate tax.

The policy is then transferred into an insurance trust pursuant to a beneficiary designation previously made by the participant. The trust is responsible for the income tax on the cash surrender value of the policy less its basis. Basis includes the economic values (like PS 58) that the participant included in his income. No marital deduction applies, so the transfer consumes some unified credit belonging to the participant.

As is the case with other survivor irrevocable trusts, a surviving spouse is not a beneficiary, nor a trustee, nor may she have a general power of appointment. Because the survivor lacks ownership or other connections to the trust, the insurance proceeds are excluded from her taxable estate upon her death.

If common disaster strikes, and both the participant and spouse should die together, the estate plan should provide that the participant died first. This will have the same favorable result as the scenario described above.

In the event that the participant's spouse dies first, here's what must get done: The participant must immediately remove the policy from the plan and transfer it into an irrevocable trust.

Under Prohibited Transaction Exemption 77-8 as modified by Prohibited Transaction Exemption 92-5 and 92-6, the participant can purchase the policy from the plan for its cash value. Make sure the profit-sharing plan has the enabling language to permit this arrangement in accordance with those Prohibited Transaction Exemptions rules.

If the participant dies within three years of the transfer, then insurance proceeds are included in his estate. This is the same rule that applies to any insurance transfer to an irrevocable trust. Upon the subsequent death of the participant, the proceeds are excluded so long as you follow the mechanics of the transfer meticulously.

When the participant transfers the policy from the plan to an irrevocable trust, he's making a taxable gift equal to the cash surrender value. However, this could be mitigated by use of Crummey provisions. This uses the $10,000 per donee annual exclusion. The participant's unified credit will absorb excess amounts, thwarting gift taxes.

A profit-sharing plan's cash pool allows a participant to purchase a permanent life insurance policy for himself and his spouse. The proceeds upon their deaths can be excluded from their estates if the insurance is transferred to an irrevocable trust after the first dies. Insurance remains in force, and the family avoids undue estate taxes. ■

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