Course Objective

This course was created to teach advisors (CPAs, EAs, accountants, attorneys, financial planners, and insurance advisors) about how to mitigate the 70-80% tax trap of money in a qualified plan or IRA as well as how to coordinate the purchase of life insurance and retirement benefits.

Most advisors do not make recommendations when they find clients with estate tax problems who also have sizable assets in IRAs or qualified plans. Many advisors do not understand that the deferred income is a double tax trap waiting to explode. This material will explain how to calculate the double tax as well as provide a unique solution to mitigate the double tax dilemma (this is **not** the marginally useful "stretch IRA"). Once advisors know about the problem, and how to solve it, they will truly be unique in their local areas.

Steps for Successful Coordination of Life Insurance and Retirement Benefits Mitigating the "70-80% Tax Trap"

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Introduction[1]

There are thousands of clients in this country who have estates in excess of $5,000,000 with $1,000,000 or more in an IRA or qualified plan (401(k)/profit sharing plan/defined benefit plan). There are more people every day who have this problem as the baby boomers get closer to retirement. Why are these statistics important? Because the vast majority do not know that the deferred money is ticking time bomb when it comes to income and estate taxes.

The income and estate tax dilemma is caused by Income in Respect to Decedent (IRD). IRD includes any income an individual is entitled to but does not receive over their lifetime. This includes IRA and pension plan account balances. The theory behind IRD is simple—the government does not want qualified (tax deferred) money to pass to a client's heirs without someone paying income tax.

While most advisors create estate plans to avoid probate and large estate taxes, most forget to address the IRD problem (or do not have a solution to mitigate the problem). This material was created to give estate planning attorneys, CPA/accountants, financial planners and insurance advisors

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information on a very unique strategy for what to do with the money a wealthy client has in his/her pension plan or IRA to mitigate the tax dilemma.

Before detailing the strategy, it is important to understand and keep in mind the double taxation dilemma of income tax deferred money.

Example of the 75% tax trap[2]

Assume Dr. Smith, who is age 60, is married, has two children, and five grandchildren. He has a $7,000,000 estate, $1,000,000 of which is in an IRA. What would happen to Dr. Smith's IRA money if he died today? Nothing. Dr. Smith's IRA would pass to his spouse without income or estate taxes.

Assuming Dr. Smith had a revocable living trust and the estate tax exemption was $1,000,000, Mrs. Smith would be left with a $6,000,000 estate (because $1,000,000 would pass into Dr. Smith's revocable living trust and be removed from Mrs. Smith's estate). What would happen to the IRA if Mrs. Smith died in the next few years? Mrs. Smith would still have a $6,000,000 estate at her death (which would include the $1,000,000 IRA) and, therefore, the IRA would pass to her heirs, at which time **income and estate taxes** would be levied against the IRA. Let's look at the math.

IRA	$1,000,000
Estate Tax:	($500,000)
Assets after Estate Taxes:	$500,000
Income Taxes (State and Federal)*	$250,000
Total Taxes	($750,000)
TOTAL IRA ASSET AFTER TAX	$250,000

So the heirs of Dr. Smith received only $250,000 of the $1,000,000 IRA.

*The exact calculation of the income tax due in the above example is quite complicated and the $250,000 number used is an approximation. For the exact math, please contact The WPI.

So the heirs of Dr. Smith received only $250,000 from a $1,000,000 IRA. (The above example assumes a 5% state income tax. If the state tax is zero the taxes obviously would less and if the state income tax is higher the taxes would be higher.) The range of taxes paid by the client's heirs is approximately 70-80%.

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Steps for Successful Coordination of Life Insurance and Retirement Benefits

Step 1: Consider The Power Of Tax-Free Compounding

A. While most people appreciate the benefits of tax-deferred growth while they are alive, far too many underestimate the benefits of continuing tax-deferred growth after death.

B. The benefits of tax-deferred compounding cannot be overstated. Consider the following example:

Example 1:

Mary, age 30, contributes $3,000 to an IRA each year until she attains age 65. If those contributions grow at an average rate of 7% (pre-tax), then when Mary turns 70, the IRA account will have a balance of $626,576.49.

Assume Mary designates her grandchild, Jake, age 20, as the beneficiary of her IRA, then begins taking minimum distributions. At Mary's death Jake continues to withdraw the smallest amount permissible. In this scenario the total amount distributed to Mary and Jake would be $7,218,036.

Step 2: Review The Minimum Distribution Rules

A. **Internal Revenue Code ("IRC") § 401(a)(9) provides for minimum distribution rules governing:**

1. when qualified plan distributions must begin;

2. the minimum amount which must be distributed to the participant during life; and

3. the payment of plan benefits after the participant's death.

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B. **Minimum Amount to be Distributed to the Participant.**

1. Section 401(a)(9)(A) provides that distributions cannot extend for a period longer than:

a. the life of the participant;

b. the lives of the participant and a designated beneficiary;

c. a period (which may be a term certain) not extending beyond the life expectancy of the participant; and

d. a period (which may be a term certain) not extending beyond the life expectancies of the participant and the designated beneficiary.

2. The amount of the minimum distribution is determined by dividing the account balance as of December 31st of the preceding calendar year by the applicable life expectancy.[3]

3. The final regulations to Section 401(a)(9) eliminate much of the former complexity surrounding retirement account distributions by (1) making it easier for account owners to calculate the amount they must withdraw during life and (2) delaying the determination of the account's designated beneficiary until the end of the year following the year of the account owner's death.

4. The regulations contain a uniform table that can be used by all account owners when determining the minimum amount that must be withdrawn annually from the account prior to death. This table can be found at Exhibit A.

a. Required minimum distributions ("RMDs") can be determined without regard to the beneficiary's actual age (except as provided below).

b. More specifically, the uniform table provides distributions based on the joint life expectancy of the account owner and a hypothetical person who is 10 years younger than the account owner.

c. The only exception occurs when the required distributions could be reduced. This would apply only when a spouse who is more than 10 years younger than the account owner is the only beneficiary - in which case the actual joint life expectancy is used.

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This benefits the account owner, as it results in smaller required distributions during his or her lifetime.

5. The rate of distributions after a participant's death depends in large part on three factors.

a. Did distributions commence prior to the participant's death?

b. Did the participant designate a qualified beneficiary to receive amounts remaining in his or her account after death?

c. Was the designated beneficiary the participant's spouse?

6. The regulations also specify the rate of distributions following the account owner's death if there was no designated beneficiary.

a. The "5-year" rule provides that if the account owner dies <u>before</u> his or her required beginning date and there is no designated beneficiary as of the December 31st of the year following the year of death, then the entire plan balance must be distributed by December 31st of the year containing the 5th anniversary of the account owner's death.

b. If the account owner dies <u>after</u> his or her required beginning date and there is no designated beneficiary as of December 31st of the year following the year of death, then the person(s) receiving the account can take into account the account owner's remaining life expectancy at the time of death.

7. The planning ramifications of the Section 401(a)(9) regulations include:

a. There is no longer any need to decide whether to recalculate life expectancies.

b. If a spouse who is named as the primary beneficiary of a retirement account dies first, then the account owner can simply change the designated beneficiary and the new beneficiary's life expectancy will determine the rate of distributions after the account owner's death, even if the change occurs after the account owner's required beginning date.

c. As a result of b. above, second-to-die life insurance will be a much more feasible way to pay estate taxes on retirement accounts.

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d. If the designated beneficiary makes a qualified disclaimer of account benefits, and as a result the benefits pass to a person with a longer life expectancy than the designated beneficiary, then the longer life expectancy can be used to determine the rate of distributions after the account owner's death. As a result, it is important to draft beneficiary designations that include younger persons (such as grandchildren) as alternate beneficiaries.

C. **Distribution Rules for Roth IRAs.**

1. The minimum distribution rules of § 401(a)(9) do not apply to Roth IRAs during the IRA owner's life.[4] As a result, distributions from a Roth IRA are not required while the owner is living.

Example 2:

Assume the same facts as Example 1, but with a Roth IRA. The Roth IRA would be worth $1,411,191 at Mary's death assuming no lifetime withdrawals were made. The Roth IRA could distribute $12,532,544 to Jake if minimum distributions were taken and estate taxes were paid from a different source.

2. If the designated beneficiary of a Roth IRA is the owner's spouse, the spouse can roll the account over to his or her own Roth IRA.

a. As a result, distributions can be deferred until the spouse's death.

b. Likewise, if the beneficiary designation for a traditional IRA designates the owner's spouse as beneficiary and the spouse survives the owner, then the surviving spouse can make a qualified rollover of the owner's IRA to a spousal IRA after the owner dies. The spousal IRA can then be converted to a Roth IRA (a taxable event), which means distributions could again be postponed until the spouse's later death.

Step 3: Plan For The Payment Of Estate Taxes

A. Where a "stretch out" of an IRA after the account owner's death is contemplated, it is very important to identify a source of liquid funds that can be used to pay estate taxes attributable to the IRA.

B. The first option is for the account owner's will to apportion the liability for those taxes to the account owner's residuary estate or living trust. However, consider the following:

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1. The IRA may trigger more estate taxes than there are assets outside of the IRA to pay the taxes.

2. The assets outside the IRA may be illiquid.

3. The beneficiaries of a person's will or living trust are often different from the designated beneficiaries of his or her retirement accounts.

a. A "boiler plate" tax clause which provides that all estate taxes are payable from the residue of the decedent's probate estate or living trust (including estate taxes attributable to property not included in the probate estate or living trust) could produce disastrous consequences.

b. As a result, for individuals with significant retirement (or other non-probate) assets, the tax apportionment clause must be carefully and thoughtfully prepared.

C. The second option is for the IRA assets to be used to pay the tax

1. IRA distributions after the participant's death are income in respect of a decedent (IRD).[5] IRD is income taxed to the recipient in the year it is received.

2. Generally, IRD must be included in the gross income of the recipient without any deduction for the built-in income tax liability.[6]

3. IRD does not receive a step-up in basis at death.[7] However, a deduction is allowed for federal estate taxes attributable to the IRD.[8]

a. The amount of the deduction is determined by computing the federal estate tax with the net IRD included and then recomputing the tax with the net IRD excluded. The deduction is the difference between the two.[9]

b. A deduction is not allowed for state estate taxes payable. As a result, the amount of the federal income tax deduction will be equal to the total estate taxes paid, less the state death tax credit.

c. In addition, only beneficiaries who itemize can claim the deduction.

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D. Stretch IRAs do not work for people with estate tax problems[10]

1) Recently, "stretch IRAs" have been discussed as a viable option to help avoid taxes. It seems as though any advisor with a security license is pushing the "stretch" as the solution for everyone's IRA tax problems. Stretch IRAs lengthen the time over which distributions must be taken from retirement plans or rollover IRAs. The common belief underlying this strategy is that "tax-deferred growth" is always a great idea. However, when you crunch the numbers, you will realize that the Stretch IRA is generally a bad idea for anyone who will have an estate tax liability (although a good idea for those who do not have estate tax problems).

2) Why does a stretch not work? Because when a stretch IRA passes to a client's heirs, estate taxes are due. If a client passed a $1,000,000 stretch IRA to his/her heirs, there would be $500,000 in estate taxes due. Where are the children going to get $500,000 to pay the estate taxes? They will take money from the IRA. When the children take money from the IRA to pay the estate taxes, income taxes will be due on that money. This creates a vicious cycle that can be avoided with the strategy discussed below.

E. Life insurance could be used to pay the tax

1. An irrevocable life insurance trust (an "ILIT") could be created as part of the estate plan.

2. If the irrevocable insurance trust is designated as the beneficiary of the retirement benefits, then the insurance proceeds collected at death could be used to pay the estate taxes due when the IRA or "stretch" IRA is passed to the heirs.

Step 4: Investigate The Use Of Retirement Accounts To Pay Insurance Premiums

A. When an insurance policy will be purchased to fund estate taxes payable on qualified plan benefits, consideration should be given to using retirement account assets to pay the policy premiums.

B. There are four "traditional" ways which amounts held inside a retirement plan can pay insurance premiums.

1. The first is for the retirement plan to make a distribution from the plan to the participant. The participant then uses the amount remaining after paying tax to pay insurance premiums, or to make contributions to an irrevocable life insurance trust, which in turn purchases the policy.

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2. The second option is for the retirement plan to purchase and own the policy.

a. The advantages of purchasing a policy inside a retirement plan include:

(1) The insured does not have to draw upon his or her personal liquid assets to pay the insurance premiums.

(2) The possibility of an immediate and substantial increase in the value of the plan's assets if the insured plan participant died prematurely.

(3) The ability to use pre-tax dollars to pay insurance premiums.

(4) Death benefits in excess of the cash value are received income tax free.[11]

(5) Acquisition and administrative costs are paid with pre-tax dollars.

b. If the plan owns the policy at the time of the participant's death, the plan will collect the insurance proceeds and distribute them along with the other plan assets.

(1) The life insurance proceeds would be included in the participant's estate and thus **subject to estate taxes** (depending upon the size of the participant's estate).

(2) The amount "at risk" is not subject to income tax, however.

c. The plan could distribute the policy to the participant prior to the participant's death. If the participant then **transferred** the policy to an irrevocable life insurance trust more than 3 years prior to death, the entire insurance proceeds would avoid estate taxation.

d. The plan also could **sell** the policy to an irrevocable life insurance trust.

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(1) If the policy is sold for its fair market value[12], then the three-year inclusion rule of §2035 would not apply.[13]

(2) A sale would, however, cause the policy proceeds to be income taxable unless the sale satisfies one of the exceptions to the transfer for value rule.[14]

(3) A policy sale raises the possibility of a violation of the imprudent investment rules.[15]

(a) PTE 92-6 specifically states that compliance with that exemption does not relieve the fiduciary of "general fiduciary responsibility provisions of the Act, which among other things require a fiduciary to discharge his duties respecting the plan ... in a prudent fashion in accordance with Section 404(a)(1)(B) of the Act".

(b) Therefore, an insurance policy sale which is exempt from the prohibited transaction rules could still trigger penalties if the sale were imprudent from the plan's perspective.

3. Some commentators have suggested that it should be possible to avoid estate taxes on a policy owned by a retirement plan if an irrevocable trust (referred to as a "subtrust") is created inside the retirement plan to own the insurance policy.[16] However, the use of a subtrust also raises certain issues.

a. Does the plan document authorize ownership of life insurance? If second-to-die insurance is to be used, does the plan document authorize ownership on the life of someone other than the plan participant? If not, it will be necessary to amend the plan to do so.

b. To avoid estate taxes, the participant cannot retain an incident of ownership over the policy.[17] Also, consider whether the transfer of all incidents of ownership results in the alienation of plan benefits, which is prohibited.[18]

c. When the subtrust technique is used in connection with a defined contribution plan, the amount contributed by the plan to the

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trust for the payment of insurance premiums may result in a taxable gift by the participant.

d. If the plan covers both highly and non-highly compensated employees, consideration must be given to whether the subtrust violates the non-discrimination rules of IRC §401(a)(4).

4. The fourth option has been for a profit-sharing plan to purchase a second-to-die life insurance contract which insures the life of both the participant and his or her spouse.

a. If a profit-sharing plan buys a second-to-die policy, an irrevocable life insurance trust can be designated as the beneficiary of that portion of the participant's account consisting of the survivorship policy. If the participant dies first, the plan can transfer ownership of the policy directly to the irrevocable trust, bypassing the participant's estate.

b. At the time of the participant's death, only the cash value of the policy at that time would be included in his or her gross estate. However, this amount could be significantly less than the premiums paid up to this point. The participant's estate tax exemption could be allocated to this amount.

c. Before purchasing a second-to-die policy inside a qualified plan, make sure that the plan document permits the ownership of insurance on the life of someone other than the participant.

d. The principal drawback to purchasing a second-to-die insurance policy inside a profit-sharing plan is the risk that the participant's spouse will die first.

(1) In that event, the policy may need to be distributed from the plan to the participant so that the participant could transfer the policy to an irrevocable life insurance trust.

(2) This transfer to the insurance trust could trigger an estate tax if the participant dies within three years of his or her spouse.

C. Valuing a life insurance contract owned by a qualified plan

1. Revenue Procedure 2004-16 sets forth proposed regulations which, among other things, provide interim rules for determining the fair market

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value of a life insurance contract which is owned or has been distributed from a qualified plan.

2. Under these rules, a policy's cash value may be used as determinative of the policy's fair market value for income tax purposes only if the cash value is equal to or greater than the aggregate of:

a. Premiums paid from the date of the issue of the contract through the date of distribution; plus

b. All amounts credited (or otherwise made available) to the policy holder with respect to those premiums, including (but not necessarily limited to) interest, dividends and similar income items; minus

c. Reasonable mortality charges and policy expenses, but only if those charges are actually charged on or before the date of distribution and are actually expected to be paid.

3. Note that the proposed Regulations do not attempt to provide a definition of fair market value. Rather, they only provide when cash value may be used as determinative of a policy's fair market value.

4. If the cash value of a policy cannot be used to determine its fair market value, then the policy must be valued under traditional rules, i.e., the amount a willing buyer would pay and a willing seller would accept for such a life insurance contract, with neither party being under a compulsion to buy and sell and both having reasonable knowledge of the relevant facts.

D. IRC § 408(a)(3) prohibits IRAs from owning life insurance. Therefore, the above options cannot be used with IRAs. However, if the owner of the IRA is also a participant in a qualified plan, then the IRA account can be "rolled back" to the qualified plan

1. What if the account owner is no longer a participant in a qualified plan? Some advisors recommend that the IRA owner establish a profit sharing plan of which he or she may be the sole participant and then roll his or her IRA account into this plan.

2. This technique will only be effective if all of the following can be demonstrated:

a. The acquisition of the life insurance policy is not the primary purpose for establishing the plan.[19]

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b. The profit sharing plan is permanent (*i.e.*, will continue even after the life insurance contract is transferred out of the plan to the participant).[20]

c. The owner of the IRA is prepared to establish a business entity which will provide him with earned income and which can serve as the sponsor of the plan.

3. If the IRA is rolled back to a profit sharing plan followed by a purchase of the policy by the plan, then avoiding estate taxes again becomes a significant issue.

E. **A Qualified Plan Insurance Partnership ® (or "QPIP ®") is a strategy originated by Willms Anderson, S.C. that is intended to permit an existing business entity to contribute to the costs of purchasing life insurance on an owner thereof without running afoul of either the ERISA or the Internal Revenue Code.**

1. With a QPIP, a retirement account, the participant, and an irrevocable trust ("IT") together form a limited liability company ("LLC") in a manner which does not violate the "prohibited transaction" rules of ERISA and the Internal Revenue Code.

2. The first step is for the account owner to establish and fund an IT.

a. Contributions to the IT could be sheltered from gift tax by the gift tax annual exclusion if the IT beneficiaries hold withdrawal powers over those contributions.[21]

b. The donor's lifetime gift exemption could also be allocated to IT contributions.

3. The participant, the retirement account, and the IT make contributions to an LLC in exchange for a membership interest.

a. The retirement account's and the account owner's contributions to the LLC are limited to these initial contributions.

b. The LLC invests these contributions and uses the earnings (and principal, if necessary) to purchase an insurance contract on the life of the participant, which names the LLC as beneficiary.

4. The LLC operating agreement determines how much each member is obligated to contribute to the LLC toward the payment of insurance premiums, and how the insurance proceeds collected by the LLC will be divided among the members upon the death of the insured.

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a. Each year, an amount equal to the cost of the death benefit protection offered by the contract is charged against the capital account of the IT. The balance of the premium is charged against the capital account of the retirement account and the account owner.

(1) It is recommended that the amount to be charged to the IT's capital account with respect to the cost of the mortality protection provided by the insurance contract be determined in accordance with the Treasury Regulations governing split-dollar life insurance arrangements. For this reason, it is wise for many clients to use a **2nd-to-die life insurance policy** due to the fact that the annual costs of insurance are substantially less than non-2nd-to-die policies.

(2) In general, the value of the death benefit protection is equal to the amount of the death benefit payable allocable to the irrevocable trust's capital account multiplied by a life insurance premium factor. Currently, this premium factor is set forth and payable via the 2001 table one costs.

(3) Alternatively, the insurer's one year term rates can be used provided several stringent requirements are met with regard to the application and availability of those rates to the general public.

b. Upon the death of the insured, the capital accounts of the retirement account and account owner (or his children, if he gave away his units during life) would be credited with the policy's fair market value.

c. If this approach were used, the insurance proceeds collected by the irrevocable trust should escape estate taxation.[22]

d. This arrangement should also satisfy the partnership allocation rules since each member will receive the economic equivalent of that portion of the insurance proceeds which were acquired with its respective contributions.[23]

5. At some future point, the trustee of the retirement account might want to withdraw from the LLC. Upon withdrawal the LLC would receive an amount equal to the policy's fair market value.

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6. Example 1. Bill and Monica are married. The intended beneficiaries of their estates are their children and grandchildren. While Bill and Monica have a significant combined taxable estate, their wealth is comprised largely of their retirement accounts held in a rollover IRA for each of them and their remaining interest in the family business (a large portion of which they have transferred to their children as part of a lifetime gift program.)

Bill and Monica's accountant recommended their grandchildren be designated as the beneficiaries of their IRAs, in order to "stretch-out" the tax deferral of those accounts for as long as possible after their deaths. A second-to-die life insurance policy was also recommended to assist in the payment of estate taxes and to replace (for the children) amounts passing to the grandchildren.

Facing a large annual premium outlay, Bill and Monica needed to identify a source of funds that could be used to cover this expense. Given their limited liquidity, they were uncertain how the premiums would be funded. (Bill and Monica were not interested in taking taxable withdrawals from their IRAs beyond the RMDs, which are used for their living expenses.) Their insurance advisor suggested the use of the QPIP strategy as the solution and after careful consideration of the strategy, they agreed.

Upon establishment of the LLC, Bill's IRA contributed cash and securities held inside the IRA in exchange for an ownership interest, while an irrevocable trust established by Bill and Monica received a gift from them and then contributed those funds to the LLC in exchange for a 5% ownership interest. (If the cumulative annual term costs for the LLC's life insurance policy at some point exceed the amount initially contributed by the trust to the LLC, then the trust would contribute such additional amounts, as needed.) Finally, Bill and Monica also make a cash contribution to the LLC in exchange for a 5.0% interest (part of which they intend to transfer to their children in the future).

When the survivor of Bill and Monica dies, the capital accounts of Bill's IRA and Bill and Monica (and/or their children) would be credited with an amount equal to the policy's fair market value, while the capital account of the irrevocable trust would be credited with the balance of the insurance proceeds.

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7. Example 2. Consider the case of Jane, a retired executive. Jane's estate consists of her IRA ($5,000,000), cash and investments ($250,000), and her residence ($450,000). Jane also will receive payments pursuant to a deferred compensation plan from her former company for the next 10 years that will cover her living expenses.

Jane would like to leave $1,000,000 (after all taxes) to each of her three children, but also is committed to providing significant amounts to charity upon her death. Jane's estate planning attorney explains that this may not be possible in light of the estate and income taxes that could be imposed upon the IRA at the time of her death.

Jane's life insurance advisor recommended a $3,000,000 life insurance policy, to be owned outside of Jane's taxable estate. This policy would allow Jane to provide for her children as stated above, and also permit her to leave her IRA to charitable organizations and thus avoid both income and estate taxes on the IRA.

Assume the scheduled annual premium for the recommended policy is $75,000 for 10 years. One of Jane's options for funding the premiums was to make taxable withdrawals from her IRA, followed by a contribution (after-tax) each year to an irrevocable life insurance trust that would own the policy. Jane was concerned that such withdrawals could significantly diminish the IRA and thus frustrate her charitable intentions.

Jane's estate planning attorney suggested that she consider the QPIP strategy to assist in the payment of premiums. After considering the strategy and its potential benefits and risks, Jane decided to establish a QPIP. Upon establishment of the LLC, Jane's IRA contributed securities to the LLC in exchange for a 90% ownership interest, while an irrevocable trust that Jane established received a cash gift from her and then contributed those funds to the LLC in exchange for a 5% ownership interest. Finally, Jane contributed cash in exchange for a 5% interest (part of which she intends to transfer to her children in the future.)

Each time the LLC pays an insurance premium, an amount equal to the cost of the death benefit protection offered by the contract is charged against the capital account of the irrevocable trust. The balance of the premium is charged against the capital accounts of Jane and the retirement account.

Once the period for paying premiums has expired, the IRA trustee might elect to withdraw from the LLC. The LLC operating agreement provides that a member is entitled to the fair market value of his interest if the member withdraws from the LLC prior to the date set for its termination. For this purpose, the fair market value of the insurance policy

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held by the LLC would be determined in accordance with Revenue Procedure 2004-16.

While the LLC will have assets other than the life insurance policy, it may not have assets sufficient to satisfy its obligation to the IRA if the IRA chooses to withdraw. In that event, the best option would be for the LLC to borrow the needed funds from the policy's cash value or from a third party. If a third party loan is not possible, then the LLC could issue a note payable to the IRA equal to the balance of the amount to which the IRA is entitled upon withdrawal. The interest on the note could be payable annually or accrued until maturity (*i.e.*, Jane's death or dissolution of the LLC.)

At Jane's death, the note to the IRA would be paid from the life insurance proceeds. The balance of the insurance proceeds would be retained by the LLC, free of income and estate taxes. This amount could later be withdrawn pro-rata by Jane's children and by the trust free of estate taxes (the trust's portion would be distributed to Jane's children in the manner specified in the trust agreement). In addition, Jane's IRA would be distributed tax-free to the charities listed on her beneficiary designation, and her residence and personally owned investments would pass tax-free to her children sheltered by her estate tax exemption.

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

a. It allows the retirement plan to bear much of the expense associated with acquisition and maintenance of the policy with pre-tax dollars.

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

c. It provides an estate tax-free death benefit that can be used to pay estate taxes on retirement accounts, thereby facilitating the "stretch out" of those accounts, and the tax deferred growth associated therewith.

d. It eliminates the need to distribute the insurance policy at retirement (since the plan does not own an insurance policy).

e. 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 LLC is distributed.

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f. There is no taxable gift when the LLC pays the insurance premiums.

g. The plan document does not have to be changed and the expenses of obtaining a determination letter are avoided.

h. The QPIP does not have to be made available to all employees.

F. For a QPIP to be effective, the following additional precautions must be taken

1. The insurance contract must designate the LLC as beneficiary.[24]

2. The operating agreement must not obligate the LLC to pay taxes, debts or expenses imposed on a deceased member's estate.[25]

3. The insurance proceeds collected by the LLC cannot be used as collateral for a loan to a partner.[26]

4. The QPIP must be regarded as a valid entity for tax purposes.[27]

a. A LLC will be recognized for income tax purposes only if 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."[28]

b. If the only asset held by the LLC is an insurance policy, then the IRS may not recognize the LLC for income tax purposes. Therefore, it is important that the LLC at all times own significant assets in addition to the insurance policy.

Step V: Prohibited Transaction Rules

A. The Internal Revenue Code and ERISA impose penalties if a qualified retirement plan or IRA engages in a prohibited transaction with a "party in interest" (in DOL terminology) or a "disqualified person" (in IRC terminology).

- Since the definition of "party in interest" and "disqualified person" are essentially the same, this outline uses the term disqualified person to refer to both.

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B. A partnership is considered a disqualified person if 50% or more of the partnership's capital and profit interests are owned by a fiduciary, a person who provides services to the plan or an employer whose employees are covered by the plan.[29]

1. A fiduciary is anyone who controls the investment of the retirement account in question.[30]

2. Accordingly, the person who owns a custodial IRA and an employee who directs the investment of his or her plan account are regarded as fiduciaries.

C. With a QPIP, the LLC itself would not be a disqualified person so long as (i) the LLC's manager personally owns (directly or indirectly) less then 50% of the LLC; and (ii) the IRA owner/plan participant owns (directly or indirectly) less than 50% of the LLC.

1. The LLC manager should be someone other than the IRA owner and someone who is not an investor in the LLC.

2. However, if the plan/IRA's share of the LLC is regarded as being indirectly owned by the account owner/plan participant and the account owner/plan participant is a fiduciary, then the LLC would be a disqualified person.

a. To avoid this result, the account owner must not, either directly or indirectly, retain investment authority over the IRA.

b. Of course, the purpose of the prohibited transaction rules is to prevent plan benefits from accruing benefits to disqualified persons *at the expense* of the plan/IRA.

c. For this reason, it seems unlikely that the share of the LLC owned *by the plan or IRA* would be counted when applying the 50% test. *In accord see*: DOL Advisory Opinion 2000-10A.

d. Note too that if the participant/IRA owner transfers his or her personal interest in the LLC to his or her children or a trust for their benefit immediately after the insurance policy is acquired, he or she could no longer personally benefit from the retirement plan/IRA's investment in the LLC. Thus, the possibility of a prohibited transaction being present would seem to be even more remote.

e. In *Swanson v. Comm'r.*,[31] the tax court concluded that a corporation whose only shareholder was a fiduciary did not become a disqualified person until after the corporation issued stock to its

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shareholders. As a result, an IRA's initial contribution to the corporation was determined to not be a prohibited transaction.

(1) If *Swanson* is correctly decided, the retirement account's investment in the QPIP does not result in a prohibited transaction even if the LLC is a disqualified person after its formation.

(2) For this reason, the retirement account's contributions to the LLC should occur upon its formation.

D. Of course, the DOL could attempt to disregard the existence of the LLC and assert that the plan's investment in the LLC was really a transaction with the ILIT, which is a disqualified person.

1. The IRS has had virtually no success with this argument when challenging LLCs established in order to reduce gift and estate taxes so long as the LLC is operated with the appropriate legal formalities.

2. In DOL Advisory Opinion 2000 -10A, the Labor Department respected the existence of a family partnership in which an IRA invested and which included an IRA owner as a partner, notwithstanding the fact that the only assets of the partnership were marketable securities.

IRAs

A. While IRAs are prohibited from owning life insurance, an IRA may nonetheless be able to participate in a QPIP, since with a QPIP the IRA would not own an insurance contract, but rather would own an interest in a LLC.[32]

B. It has been suggested that the Department of Labor's "Plan Asset Rule" could be applied to an IRA's investment in a LLC which owns life insurance.[33]

1. The Plan Asset Rule provides that in the case of a qualified plan or IRA's investment in a non-publicly traded entity, the plan or IRA assets will include an undivided interest in each of the entity's underlying assets, unless it is established that:

a. the entity is an operating company; or

b. equity participation in the entity by the plan or IRA is not significant.[34]

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2. Thus, it has been suggested that the application of the Plan Asset Rule to a QPIP could cause the IRA to be deemed to own life insurance in violation of IRC §408(a)(3).

C. In the author's opinion, the Plan Asset Rule should not be applicable to a QPIP so as to result in a violation of 408(a)(3)

1. The enforcement of IRC §408(a)(3) falls within the exclusive province of the IRS.

- The Treasury Regulations to IRC §408 do not contain a Plan Asset Rule.

2. The Department of Labor's interpretive and enforcement authority over IRAs is limited to prohibited transactions.[35]

a. While an IRA is not permitted to invest in life insurance, such an investment is not a prohibited transaction.[36]

b. Thus the DOL regulations which set forth the Plan Asset Rule would not seem to apply for purposes of enforcing §408(a)(3).

3. Of course, the IRS could always develop its own "look-through" rules in connection with its enforcement of IRC §408(a)(3).

a. However, the adoption of such a rule would seem to be highly impractical, and hence seemingly improbable, since the result would be to prohibit an IRA from investing in any entity that owns life insurance.

b. Theoretically, the IRS could attempt to develop a "§408(a)(3) Plan Asset Rule", the application of which would be limited only to entities which were deemed to be established primarily to circumvent the restrictions of §408(a)(3).

c. However, since a properly constructed QPIP LLC will always own substantial other assets, the QPIP would not necessary violate a "§408(a)(3) Plan Asset Rule" crafted in this manner.

4. Finally, even if a Plan Asset Rule were developed by the IRS in connection with the enforcement of IRC §408(a)(3), a properly structured QPIP, in the author's view, should still not violate §408(a)(3) since the IRA's interest in the insurance policy belonging to the LLC would be limited to the policy's cash value.

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a. The IRA would not share in the death benefit provided by the contract or the cost of that benefit.

b. Therefore, even if the Plan Asset Rule were to apply, the IRA would not own life insurance as defined by the Internal Revenue Code.[37]

Summary

A. **While the above analysis supports the conclusion that a QPIP will not result in a violation of ERISA or the imposition of excise taxes under the IRC, caution should still be exercised before the QPIP strategy is utilized.**

1. Clients should be fully informed at the potential drawbacks associated with the use of the QPIP concept.

2. The client should be advised to make a tax-free division of his or her IRA into two IRAs, with one IRA holding only those amounts needed to make the required contribution to the LLC.

➢ If this were done, the worst case scenario would be that amounts invested in the LLC would be subject to tax.

3. Using after tax dollars to fund contributions to a "stretch out" irrevocable trust will, in most cases, produce better results than if no insurance were purchased.

B. Additional information pertaining to the purchase of insurance inside a qualified plan can be found at www.estatecounselors.com.

DISCLAIMER

Information contained in this outline is not a substitute for professional estate planning advice nor should any information provided in this outline be construed as legal advice. Therefore, none of the information being provided should be relied on without seeking the advice of legal counsel or other professionals regarding the tax and non-tax consequences associated with the same. Neither Willms Anderson, S.C. nor any of its attorneys assumes any responsibility for any individual's reliance on any of the information contained in this outline.

Exhibit A **The Table**

Below is the table for determining minimum distributions from a retirement account. All account owners can use this table, unless (1) the account owner's spouse is the account beneficiary and (2) the spouse is more than 10 years younger than the account owner. In that case, a separate, more advantageous table can be used.

Uniform Lifetime Table

Age of employee	Distribution period	Age of employee	Distribution period
70	27.4	92	10.2
71	26.5	93	9.6
72	25.6	94	9.1
73	24.7	95	8.6
74	23.8	96	8.1
75	22.9	97	7.6
76	22.0	98	7.1
77	21.2	99	6.7
78	20.3	100	6.3
79	19.5	101	5.9
80	18.7	102	5.5
81	17.9	103	5.2
82	17.1	104	4.9
83	16.3	105	4.5
84	15.5	106	4.2
85	14.8	107	3.9
86	14.1	108	3.7
87	13.4	109	3.4
88	12.7	110	3.1
89	12.0	111	2.9
90	11.4	112	2.6
91	10.8	113	2.4
92	10.2	114	2.1
93	9.6	115+	1.9

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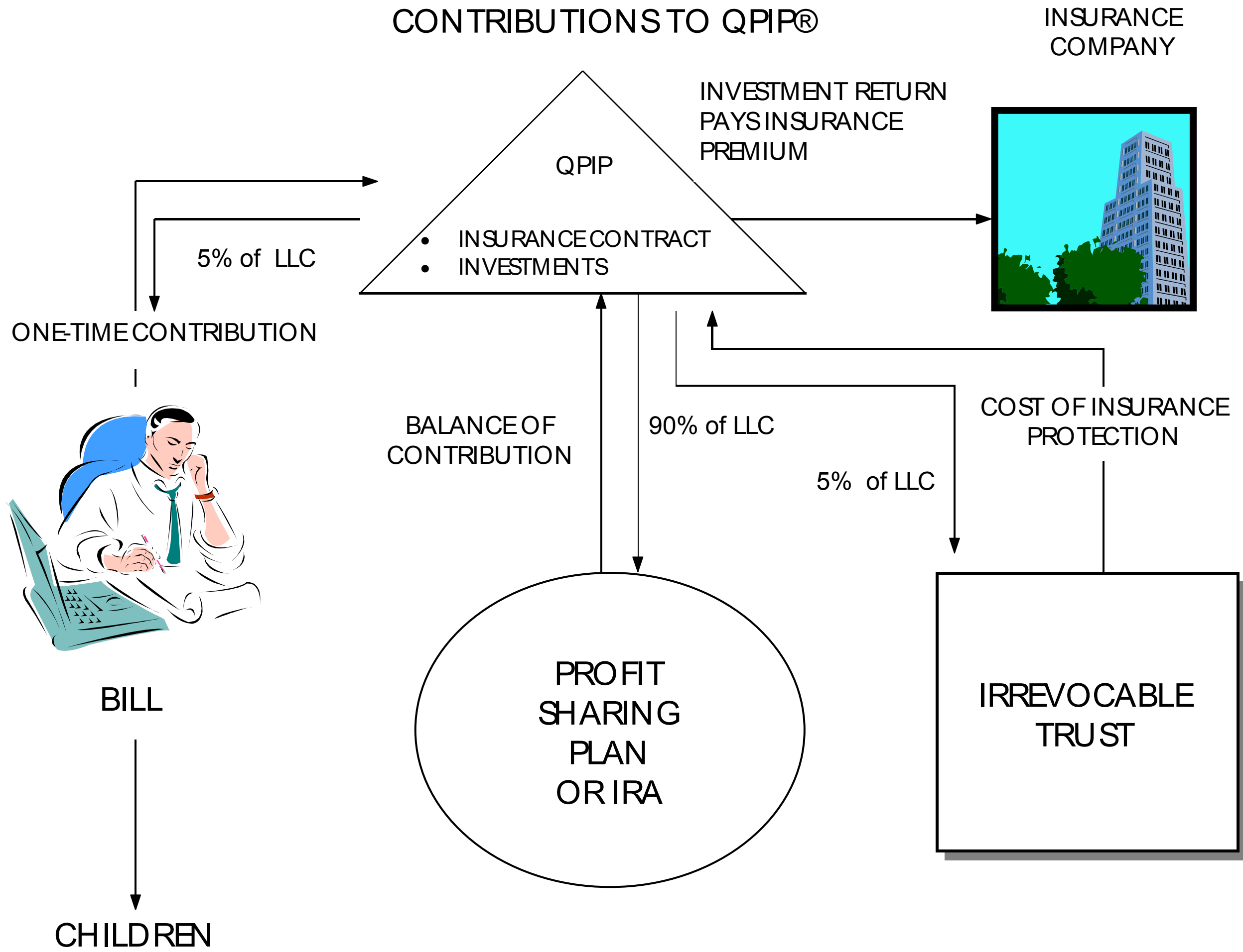

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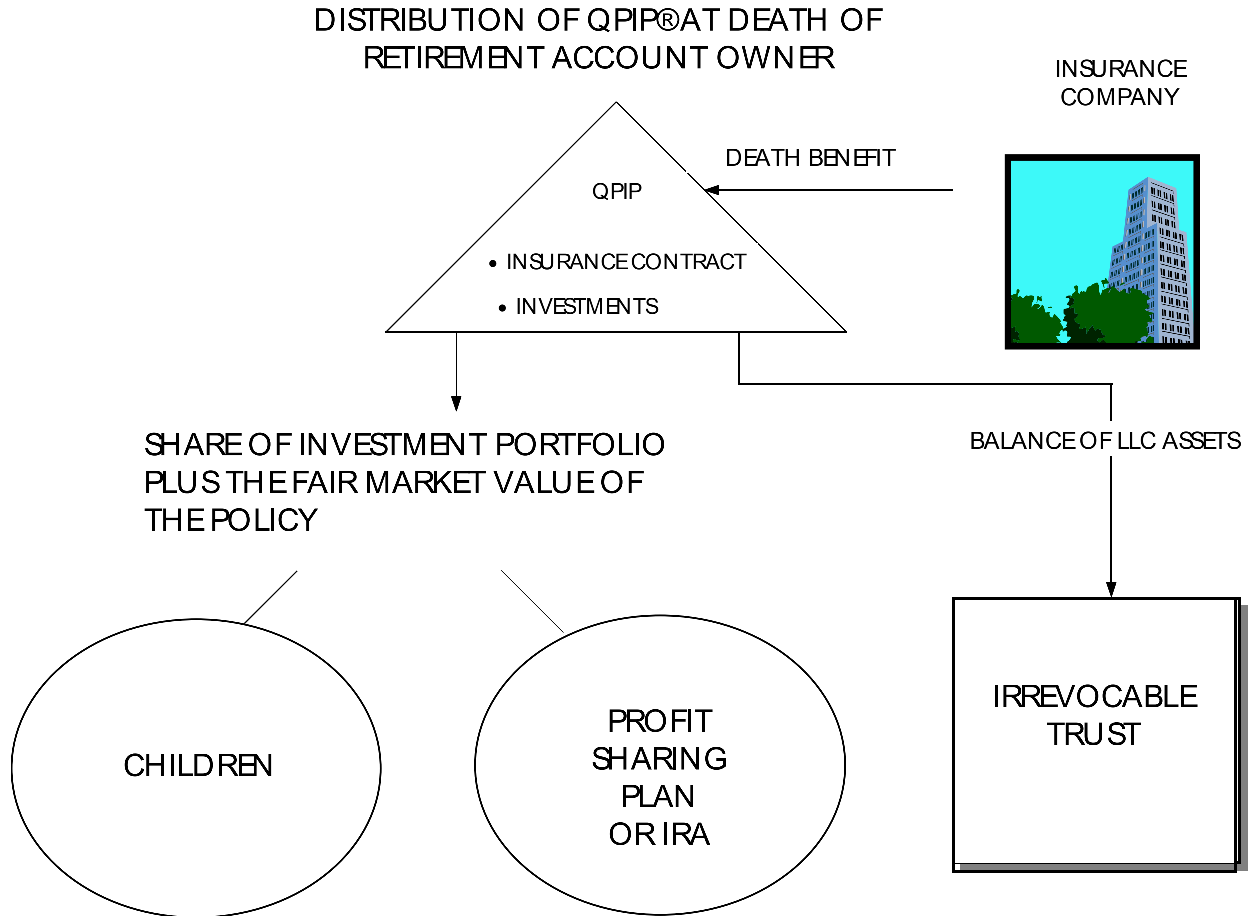

*Determined as of amount prior to death under 412(i) regulations.

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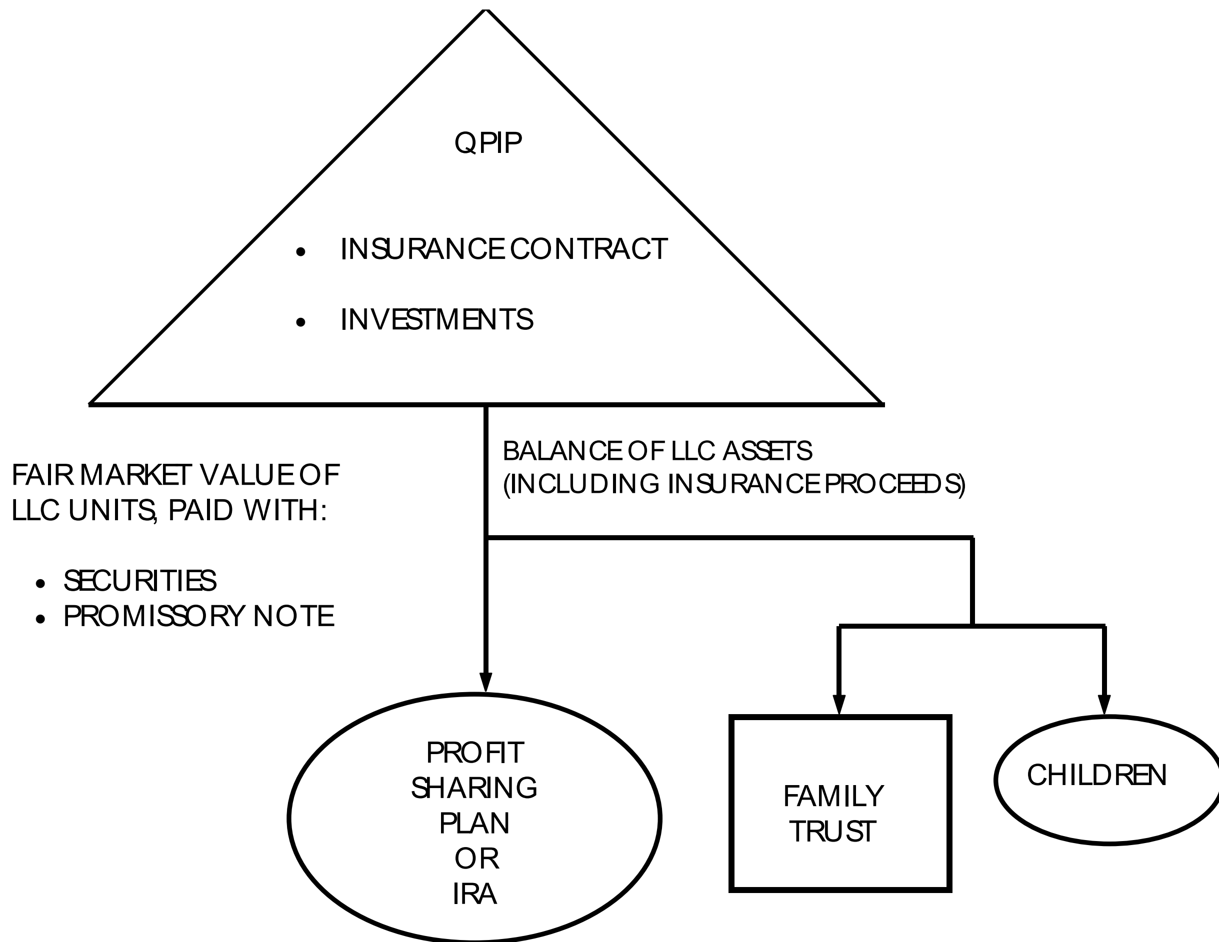
DISTRIBUTION OF QPIP® IF RETIREMENT ACCOUNT WITHDRAWS FROM LLC BEFORE POLICY MATURES



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[1] The introduction was written by Roccy DeFrancesco
[2] The 75% Tax Trap was written by Roccy DeFrancesco
[3]. Prop. Reg. §1.401(a)(9)-5.
[4]. IRC §408A(c)(5).
[5]. IRC §691(a).
[6]. Treas. Reg. §1.691(a)-3(a).
[7]. *Id*.
[8]. IRC §691(c); Treas. Reg. §1.691(c)-1(a).
[9]. Treas. Reg. §1.691(c)-1(a).
[10] Step 3, D. was written by Roccy DeFrancesco
[11]. IRC §101(a); Treas. Reg. §1.402(a)-1(a)(4) and 1.72-16(c)(2)(ii).
[12]. *See* Reg. Proc. 2004-16.
[13]. IRC §2035(d).
[14]. IRC §101(a)(2)(B).
[15]. *See* ERISA §404(a)(1) and (2).
[16]. *See generally* Fair, Andrew, *The Qualified Plan As An Estate Planning Tool - Advance Techniques Using Life Insurance*, The Guardian Life Insurance Company of America, Pub. 1261, December 1992.
[17]. IRC §2042(2); Treas. Reg. §20.2042-1(c).
[18]. IRC §401(a)(13); ERISA §206(d)(1).
[19]. Treas. Reg. §§1.401-1(b)(1)(i), (ii) and (iii); Treas. Reg. §1.403(a)-1(d). *See also* Rev. Rul. 73-501, 1973-2 C.B. 127; Rev. Rul. 68-24, 1968-1 C.B. 150; Rev. Rul. 66-143, 1966-1 C.B. 79; Rev. Rul. 60-83, 1960-1 C.B. 157; Rev. Rul. 54-51, 1954 C.B. 147.
[20]. Treas. Reg. §1.401-1(b)(2).
[21]. *Crummey v. Comm'r.*, 397 F.2d 82 (9th Cir. 1968); Rev. Rul. 73-405, 1973-2 CB
[22]. *See* e.g. PLR 9636033 dated March 12, 1996.
[23]. *See* Treas. Reg. §1.704-1; *see also* PLR 9639053 dated June 20, 1996.
[24]. Rev. Rul. 83-147, 1983 C.B.-2 158.
[25]. I.R.C. §2042(1).
[26]. Treas. Reg. §20.2042-1(c).
[27]. If the LLC were not treated as a partnership for tax purposes, then the LLC may be regarded as a trust, which would result in the insured having an incident of ownership in the policy owned by the LLC, thereby resulting in estate taxation of the insurance proceeds. *Compare* Rev. Rul. 83-147, 1983-2 C.B. 153; Treas Reg. §20.2042-1(c)(2).
[28]. *Commissioner v. Culberson*, 327 U.S. 738, 742 (1949); *Torres v. Comm'r*, 88 T.C. 702, 736 (1987); Treas. Reg. §1.701-2 as amended by IRS Notice 95-7, IRB 1995-7 at 56.
[29]. ERISA §3(14)(G); IRC §4975(e)(2)(G).
[30]. IRC §4975(e).
[31]. *See* 106 T.C. 76 (1996),
[32]. PLR 9639053 dated June 20, 1996 supports the conclusion that so long as the irrevocable trust contributes an amount equal to the value of the insurance protection it receives as a result of its interest in the LLC, the purchase of an

insurance policy by the LLC should not result in the trust receiving an economic benefit at the expense of the retirement plan.

[33]. The Plan Asset Rule can be found at 29 CFR §2510.3-101.
[34]. 29 CFR §2510.3-101(a).
[35]. ERISA §502, 504, 505, 506; ERISA Reorganization Plan No. 4 of 1978, §102, 179-1 CB 480.
[36]. *See* IRC §4975(c).
[37]. *See* IRC §7702 et. seq.

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