Estate Preservation Strategy Guide: Joint Life Insurance in Your Profit-Sharing Plan

Summary

Acquiring life insurance in your profit-sharing plan may protect the value of your estate while you are still employed with little impact on your current cash flow and preserving your annual gift exclusions.

This strategy may be a good fit for you if:

- You have a sizable estate ($2 million and up);
- You have sufficient funds in your profit-sharing plan to fund life insurance premiums *and* meet certain IRS guidelines for the purchase of insurance by a profit-sharing plan; and
- You do not want to use your current cash flow to fund your estate preservation strategy.

Joint Life Insurance in Your Profit-Sharing Plan: Benefits

Benefits:

- The major benefit, of course, is protecting your heirs from confiscatory IRS taxation. This is accomplished by placing the major portion of the life insurance benefit outside your taxable estate altogether.
- In addition, you'll purchase that life insurance using mostly pre-tax dollars in your profit-sharing plan rather than after-tax dollars from your current cash flow.
- You will provide instant liquidity to your heirs to pay estate taxes.
- Under the most likely scenarios, this liquidity can be designed to pay these estate taxes in their entirety, meaning that nearly 100% of your estate will actually reach your heirs.
- You may eliminate income taxes altogether on the amount that your premiums paid exceed the insurance policy's cash value at the time you terminate this strategy.
- Although there are risks, even under this strategy's worst-case scenario, you will deliver more of your estate intact to your heirs than without this strategy.

Joint Life Insurance in Your Profit-Sharing Plan: Implementation Steps

Here are the steps needed to implement this strategy:

Step 1. Check your profit-sharing plan: Work with your attorney to ensure that your profit-sharing plan is suitable for this strategy. The three essential elements are: explicit language allowing the purchase of insurance by the plan; the ability of the plan to buy *enough* insurance (there are limits); and language in the plan expressly prohibiting it from continuing to own second-to-die insurance after one spouse is deceased.

Step 2. Create an Irrevocable Life Insurance Trust (ILIT): Work with your attorney to create one.

Step 3. Check your wills and/or living trusts: Work with your attorney to ensure that your testamentary documents all specify that, in the event of a common disaster (both you and your spouse are killed "simultaneously"), the plan participant will be deemed to have died first. This language will help maximize the benefits under this strategy.

Step 4. Your profit-sharing plan purchases second-to-die life insurance, as both owner and applicant, with you and your spouse as the insureds and the ILIT as the named beneficiary.

Note that it is critical that your spouse not be the beneficiary either of the life insurance policy through the qualified plan beneficiary designation or of the ILIT; in fact, he or she should sign a formal waiver to negate the traditional beneficiary designation of a profit-sharing plan.

Joint Life Insurance in Your Profit-Sharing Plan: How the Strategy Works (cont.)

Step 5. This arrangement continues until one of four things causes it to end:

a. **You retire:** If all goes well and you and your spouse both live until you retire, then you will direct the profit-sharing plan trustee "distribute" the policy from the plan and gift it outright to the ILIT. Income taxes will be due on the cash value (only!) as soon as your withdraw it (just like any other profit-sharing plan withdrawal). Gift taxes (better than estate taxes!) will be due when you gift the policy to the ILIT (again, only on the cash value, and you can use your Unified Credit to shelter or offset these).

   The entire amount of the policy's death benefit will then be outside your (and your spouse's) taxable estate. Note that in this scenario (and the one following), you will need to live for three years from the time of the gift, or the IRS, using their "Three Year Contemplation of Death" rule, will try to include the death benefit in your taxable estate.

b. **Your spouse predeceases you:** Should your spouse predecease you prior to your retirement, you take similar steps to those above, with the same results. Note that, depending on your age and certain details of your participation in the plan, you may be able to receive a plan distribution of the policy, or you may have to purchase the policy from the plan. Consult with your attorney. If you need to purchase it, the language prohibiting the plan from continuing to hold the policy (as mentioned in Step 1 above) will facilitate the purchase.

   In either case, you want to remove the policy from the plan, and gift it to the ILIT.

Joint Life Insurance in Your Profit-Sharing Plan: How the Strategy Works (cont.)

c. You predecease your spouse: Should you predecease your spouse prior to retirement, the life insurance policy will pass to the ILIT as the named beneficiary of that portion of your profit-sharing plan. The trust will owe income and estate taxes on the cash value only. Be sure that these cash requirements are planned for! The entire amount of the policy's death benefit will then be outside both your and your spouse's taxable estate, and your heirs should realize majority of your estate's total value.

d. The worst case: Should you and your spouse die in a common disaster, survivorship life insurance proceeds transferred to an ILIT *may* be included in your taxable estate by the IRS. Certain language provisions in the profit-sharing plan and your testamentary documents can provide a defense against this, but even if the IRS wins, you will still have boosted the percentage of your estate reaching your heirs by a considerable amount.

Estate Preservation Summary	Base Case (situation today)	Expected Results (scenarios a-c above)	Worst Case (scenario d above)
Amount to heirs	$3,100,000	$7,400,000	$3,640,000
Percent Preserved	34%	82%	40%

Please see the appendix for details on how these results were calculated.

Joint Life Insurance in Your Profit-Sharing Plan: Strategy Risks and Rewards

Risks:

You should know that there are some risks that this strategy may not produce the desired results:

1. In the two scenarios ("a" and "b" above) where the plan participant ends up gifting the life insurance to a trust, he or she must survive that gift by three years or the IRS may include the death benefit in his or her taxable estate.

2. The language used in the profit-sharing plan, the plan participant's will, and the irrevocable trusts must be precise and match IRS-approved wording for this strategy to work. Please be sure to work with estate-planning professionals experienced in these insurance, legal and tax matters.

Rewards

Although these risks are real, please note that your estate preservation even under the worst case is still better than it is today.

Bottom Line

In short, the strategy of purchasing of life insurance in your profit-sharing plan is an excellent alternative when the more traditional irrevocable life insurance trust is not a good fit for you. Your life-style cash flow is not impacted, you reduce the tax bite on the plan dollars you spend on premiums and, even after paying the IRS, you end up delivering your estate nearly intact to your heirs.

Appendix: Illustration of Percentage of Original Estate to Heirs Under Three Scenarios

Profile & Assumptions

Total estate	$9,000,000
Profit plan	$4,000,000
Insurance DB	$5,000,000
Years before first tax event	11.0
Total Premium	$1,400,000
Cash value	$1,400,000
Unified Credit	$0
Exempt from excise tax	$0
Income tax rate	40%
Excise tax rate	15%
Estate tax rate	50%

Base scenario: Situation today

	Profit-sharing Plan	Balance of Estate	Total Estate
Taxable Assets	$4,000,000	$5,000,000	$9,000,000
Taxes			
Income Tax	$1,600,000		$1,600,000
Excise Tax	$600,000		$600,000
Estate Tax	$1,200,000	$2,500,000	$3,700,000
Net to heirs	$600,000	$2,500,000	$3,100,000
Percentage of estate to heirs			**34%**

Expected Strategy Results: Life insurance in profit sharing plan

Event 1: Plan participant retires, or death of either spouse

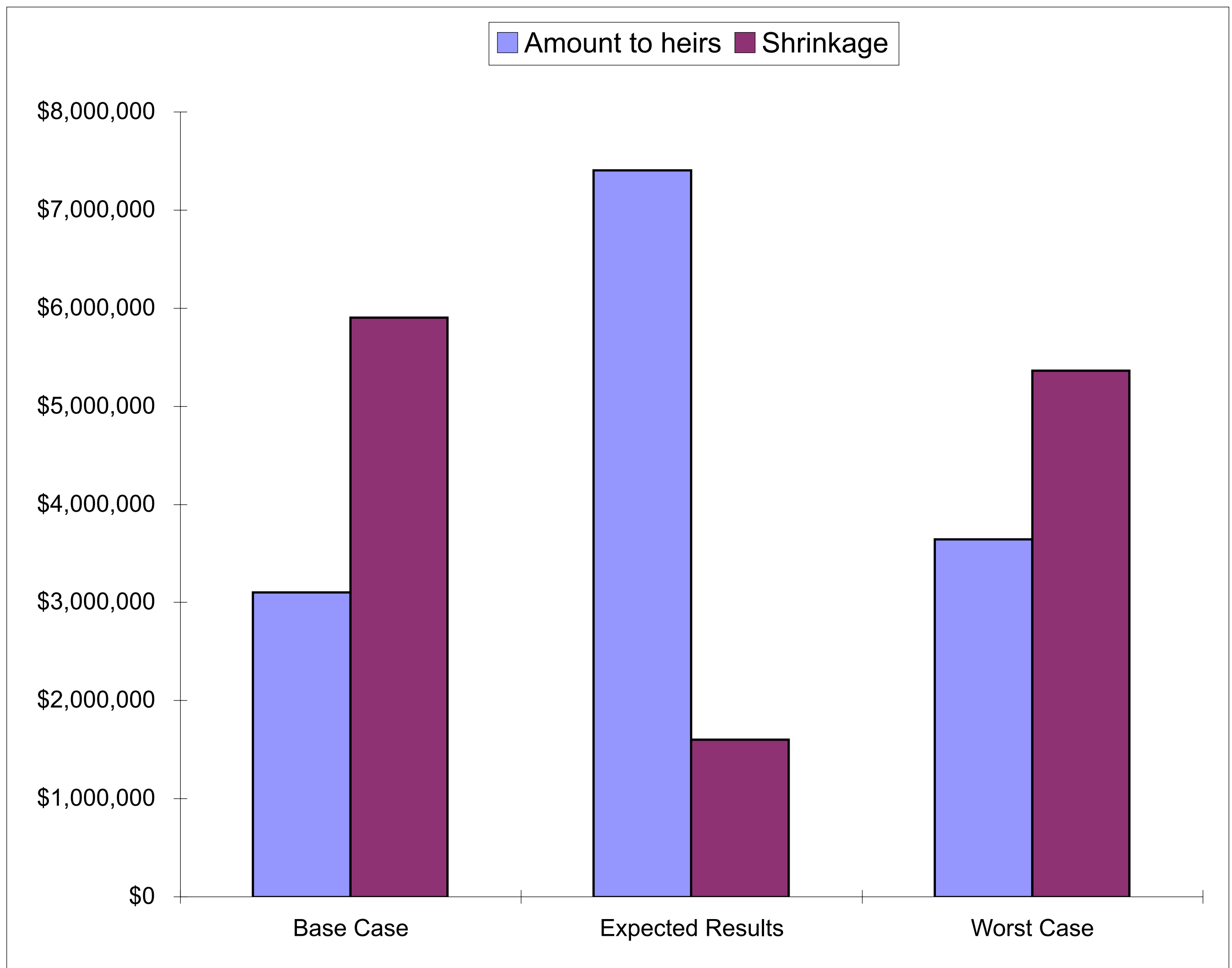
Taxable Assets (Insurance cash value = premium)	$1,400,000	(Paid from profit sharing plan)
Taxes		
Income tax	$560,000	
Gift tax	$420,000	
Excise tax	$0	
Total taxes	$980,000	(Paid from balance of estate)

Event 2: Death of second spouse	Profit-sharing Plan	Balance of Estate	Total Estate
Remaining Assets (less premium and Event 1 taxes)	$2,600,000	$4,020,000	$6,620,000
Taxes			
Income Tax	$1,040,000		$1,040,000
Excise Tax	$390,000		$390,000
Estate Tax	$780,000	$2,010,000	$2,790,000
Subtotal to heirs	$390,000	$2,010,000	$2,400,000
Plus life insurance death benefit (tax-free)			$5,000,000
Total to heirs			$7,400,000
Percentage of estate to heirs			**82%**

Worst Case: IRS gets insurance death benefit included in taxable estate

	Profit-sharing Plan	Balance of Estate	Total Estate
Taxable assets			
Estate	$2,600,000	$5,000,000	$7,600,000
Death benefit	$5,000,000		$5,000,000
Taxes			
Income Tax	$3,040,000		$3,040,000
Excise Tax	$1,140,000		$1,140,000
Estate Tax	$2,280,000	$2,500,000	$4,780,000
Net to heirs	$1,140,000	$2,500,000	$3,640,000
Percentage of estate to heirs			**40%**

Summary of Success in Estate Preservation



Summary data	Base Case	Expected Results	Worst Case
Amount to heirs	$3,100,000	$7,400,000	$3,640,000
Shrinkage	$5,900,000	$1,600,000	$5,360,000