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Tax Leverage

Life in a Qualified Plan

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OUR GOAL IS YOUR LEGACY EST. 2008 SHAKOPEE, MINNESOTA

Meet Jay

- As an engineer, Jay views himself as a natural "saver" and has contributed to his profit sharing plan for years.
- He's 45, needs life insurance and is highly focused on tax efficiency.
- His earnings put him in the highest marginal tax bracket.

Tax-Effected Cost Outside of the Plan

Assume Jay's income tax bracket is 50%

Year	Age	Post-Tax Contribution	Pre-Tax Dollars	Cash Value	Tax-Free Death Benefit
1	46	$50,000	$100,000	$17,797	$710,856
2	47	$50,000	$100,000	$49,972	$717,865
3	48	$50,000	$100,000	$98,692	$728,987
4	49	$50,000	$100,000	$150,711	$744,241
5	50	$50,000	$100,000	$206,269	$763,797
6	51	$50,000	$100,000	$264,504	$785,819
7	52	$50,000	$100,000	$325,550	$810,387
8	53	$50,000	$100,000	$389,544	$837,550
9	54	$50,000	$100,000	$456,676	$867,426
10	55	$50,000	$100,000	$527,103	$900,092
11	56	$0	$0	$556,149	$933,559
12	57	$0	$0	$586,694	$968,221
13	58	$0	$0	$618,814	$1,004,128
14	59	$0	$0	$652,611	$1,041,362
15	60	$0	$0	$688,157	$1,080,004
16	61	$0	$0	$725,525	$1,120,104
17	62	$0	$0	$764,774	$1,161,705
18	63	$0	$0	$806,041	$1,204,935
19	64	$0	$0	$849,431	$1,204,935
20	65	$0	$0	$895,010	$1,296,646
		$500,000	$1,000,000		

* MMD, WL, Leg 10 WL; $707,915 Base Face Amount; Unisex, Ultra Preferred NT; age 45; NJ.

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Tax-Effected Cost Inside of the Plan

Here, Jay's is including the "economic benefit" as imputed income, which is a feature of life in a qualified plan. Recognizing the "economic benefits" preserves the tax-free nature of the policy's death benefit.

Year	Age	Imputed Income	Post-Tax Cost	Cash Value	Tax-Free Death Benefit
1	46	$1,060	$530	$17,797	$693,059
2	47	$1,115	$558	$49,972	$667,893
3	48	$1,153	$577	$98,692	$630,295
4	49	$1,175	$588	$150,711	$593,530
5	50	$1,188	$594	$206,269	$557,528
6	51	$1,199	$600	$264,504	$521,315
7	52	$1,222	$611	$325,550	$484,837
8	53	$1,259	$629	$389,544	$448,006
9	54	$1,314	$657	$456,676	$410,750
10	55	$1,361	$681	$527,103	$372,989
11	56	$1,566	$783	$556,149	$377,410
12	57	$1,786	$893	$586,694	$381,527
13	58	$2,004	$1,002	$618,814	$385,314
14	59	$2,200	$1,100	$652,611	$388,751
15	60	$2,375	$1,187	$688,157	$391,847
16	61	$2,569	$1,284	$725,525	$394,579
17	62	$2,822	$1,411	$764,774	$396,931
18	63	$3,175	$1,588	$806,041	$398,894
19	64	$3,636	$1,818	$849,431	$400,467
20	65	$4,181	$2,091	$895,010	$401,636
		$38,361	$19,181		

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That's a
$961,639
Swing in the right direction,
but...

What about plan performance?

How do I get the policy out of the plan?

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Plan Performance

- Current balance: $1,400,000
- Annual contributions: $30,000
- Profit Sharing Plan’s net ROR: 6%
- Policy contribution: $50,000 10-pay

Plan Performance Without.....

Year	Age	Plan BOY	Plan Growth	Plan Contributions	Plan EOY
1	46	$1,400,000	$1,484,000	$30,000	$1,514,000
2	47	$1,514,000	$1,604,840	$30,000	$1,634,840
3	48	$1,634,840	$1,732,930	$30,000	$1,762,930
4	49	$1,762,930	$1,868,706	$30,000	$1,898,706
5	50	$1,898,706	$2,012,629	$30,000	$2,042,629
6	51	$2,042,629	$2,165,186	$30,000	$2,195,186
7	52	$2,195,186	$2,326,897	$30,000	$2,356,897
8	53	$2,356,897	$2,498,311	$30,000	$2,528,311
9	54	$2,528,311	$2,680,010	$30,000	$2,710,010
10	55	$2,710,010	$2,872,611	$30,000	$2,902,611
11	56	$2,902,611	$3,076,767	$30,000	$3,106,767
12	57	$3,106,767	$3,293,173	$30,000	$3,323,173
13	58	$3,323,173	$3,522,564	$30,000	$3,552,564
14	59	$3,552,564	$3,765,718	$30,000	$3,795,718
15	60	$3,795,718	$4,023,461	$30,000	$4,053,461
16	61	$4,053,461	$4,296,668	$30,000	$4,326,668
17	62	$4,326,668	$4,586,268	$30,000	$4,616,268
18	63	$4,616,268	$4,893,244	$30,000	$4,923,244
19	64	$4,923,244	$5,218,639	$30,000	$5,248,639
20	65	$5,248,639	$5,563,557	$30,000	$5,593,557

Plan Performance With.....

At 6%, Jay gives up ~$285,000 in potential accumulation inside the qualified plan, but he is still ahead because he saved $961,639 in tax-effected dollars. And, most important, he wanted to provide permanent protection for his family, which his qualified plan helped him achieve.

Year	Age	Plan BOY	Plan Growth	Plan Contributions	WL Contributions	Plan EOY + CV
1	46	$1,400,000	$1,484,000	$30,000	-$50,000	$1,481,797
2	47	$1,464,000	$1,551,840	$30,000	-$50,000	$1,581,812
3	48	$1,531,840	$1,623,750	$30,000	-$50,000	$1,702,442
4	49	$1,603,750	$1,699,975	$30,000	-$50,000	$1,830,686
5	50	$1,679,975	$1,780,774	$30,000	-$50,000	$1,967,043
6	51	$1,760,774	$1,866,420	$30,000	-$50,000	$2,110,924
7	52	$1,846,420	$1,957,206	$30,000	-$50,000	$2,262,756
8	53	$1,937,206	$2,053,438	$30,000	-$50,000	$2,422,982
9	54	$2,033,438	$2,155,444	$30,000	-$50,000	$2,592,120
10	55	$2,135,444	$2,263,571	$30,000	-$50,000	$2,770,674
11	56	$2,243,571	$2,378,185	$30,000	$0	$2,964,334
12	57	$2,408,185	$2,552,676	$30,000	$0	$3,169,370
13	58	$2,582,676	$2,737,637	$30,000	$0	$3,386,451
14	59	$2,767,637	$2,933,695	$30,000	$0	$3,616,306
15	60	$2,963,695	$3,141,517	$30,000	$0	$3,859,674
16	61	$3,171,517	$3,361,808	$30,000	$0	$4,117,333
17	62	$3,391,808	$3,595,316	$30,000	$0	$4,390,090
18	63	$3,625,316	$3,842,835	$30,000	$0	$4,678,876
19	64	$3,872,835	$4,105,205	$30,000	$0	$4,984,636
20	65	$4,135,205	$4,383,318	$30,000	$0	$5,308,328

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Must I Remove the Policy From the Plan

- Distribute it when you are in a lower marginal tax bracket
- Sell it to a Trust

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Tax Cost to Distribute the Policy

Jay borrows from the cash value to cover the taxes.

Even if you assume Jay's income taxes in retirement **are still 50%** of his income (unlikely), there is ample CV to cover the taxes. If, like most retirees, he is in a lower bracket the roll-out taxes are lower

Year	Age	~FMV/Cash Value	50% Bracket	40% Bracket	30% Bracket	20% Bracket
1	46	$17,797	$8,899	$7,119	$5,339	$3,559
2	47	$49,972	$24,986	$19,989	$14,992	$9,994
3	48	$98,692	$49,346	$39,477	$29,608	$19,738
4	49	$150,711	$75,356	$60,284	$45,213	$30,142
5	50	$206,269	$103,135	$82,508	$61,881	$41,254
6	51	$264,504	$132,252	$105,802	$79,351	$52,901
7	52	$325,550	$162,775	$130,220	$97,665	$65,110
8	53	$389,544	$194,772	$155,818	$116,863	$77,909
9	54	$456,676	$228,338	$182,670	$137,003	$91,335
10	55	$527,103	$263,552	$210,841	$158,131	$105,421
11	56	$556,149	$278,075	$222,460	$166,845	$111,230
12	57	$586,694	$293,347	$234,678	$176,008	$117,339
13	58	$618,814	$309,407	$247,526	$185,644	$123,763
14	59	$652,611	$326,306	$261,044	$195,783	$130,522
15	60	$688,157	$344,079	$275,263	$206,447	$137,631
16	61	$725,525	$362,763	$290,210	$217,658	$145,105
17	62	$764,774	$382,387	$305,910	$229,432	$152,955
18	63	$806,041	$403,021	$322,416	$241,812	$161,208
19	64	$849,431	$424,716	$339,772	$254,829	$169,886
20	65	$895,010	$447,505	$358,004	$268,503	$179,002

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Jay Pulls $447,505 Tax-Free from the CV

The Policy After Roll-Out

Year	Age	Annual Dividend	Pol. Loan Accrual	Net CV	Net DB
21	66	$34,055	$462,183	$465,558	$867,890
25	70	$41,907	$525,871	$615,843	$1,015,442
30	75	$54,232	$617,960	$853,932	$1,236,580
35	80	$68,978	$726,175	$1,155,403	$1,505,581
40	85	$86,871	$853,341	$1,527,719	$1,829,030
45	90	$107,681	$1,002,775	$1,970,359	$2,219,158

As an engineer, Jay *loves* the math on this

Imputed Income:	$19,161
Opportunity Cost:	+ $285,000
Total Cost:	$304,161
Tax-Effected Cost:	$1,000,000
Total Cost:	− $304,161
Total Savings:	$695,839

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Sell to a Trust

Existing Trust

Establish a Trust

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Holy Grail

Existing, fully-funded trust purchases the policy from the profit-sharing plan for the FMV

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What if Jay Funds a Trust With the Savings?

Here, Jay's is including the "economic benefit" as imputed income, which is a feature of life in a qualified plan. Recognizing the "economic benefits" preserves the tax-free nature of the policy's death benefit.

Enough Cash for an Arm's Length Sale

Profit Sharing Plan			Trust		
Year	Age	~FMV of WL Held in PSP	Annual Gifts	BOY Trust Balance	EOY Trust Balance
1	46	$17,797	$25,000	$25,000	$26,500
2	47	$49,972	$25,000	$51,500	$54,590
3	48	$98,692	$25,000	$79,590	$84,365
4	49	$150,711	$25,000	$109,365	$115,927
5	50	$206,269	$25,000	$140,927	$149,383
6	51	$264,504	$25,000	$174,383	$184,846
7	52	$325,550	$25,000	$209,846	$222,437
8	53	$389,544	$25,000	$247,437	$262,283
9	54	$456,676	$25,000	$287,283	$304,520
10	55	$527,103	$25,000	$329,520	$349,291
11	56	$556,149	$25,000	$374,291	$396,749
12	57	$586,694	$25,000	$421,749	$447,053
13	58	$618,814	$25,000	$472,053	$500,377
14	59	$652,611	$25,000	$525,377	$556,899
15	60	$688,157	$25,000	$581,899	$616,813
16	61	$725,525	$25,000	$641,813	$680,322
17	62	$764,774	$25,000	$705,322	$747,641
18	63	$806,041	$25,000	$772,641	$819,000
19	64	$849,431	$25,000	$844,000	$894,640
20	65	$895,010	$25,000	$919,640	$974,818

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So, Why Wouldn't a Client do This plan?

- Their advisor never showed it to them.
- Insurance contributions subtract from the accumulated value in the qualified plan (see the plan performance slides).
- An IRA, one of the most common retirement plan types, can't be used for this strategy.
- The "Incidental Benefit" rules limit the amount a qualified plan can spend on insurance (PSP's are most liberal) and also require removal of the insurance at retirement.
- The qualified plan document must allow for purchase of life insurance (or be amended to do so).

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Which Clients are an Ideal Candidate?

- Business owners and executives with a Profit Sharing Plan.
- Need for permanent protection; accumulation or wealth transfer focus.
- Concerned about the pre-tax cost of coverage/looking for premium dollars.
- Client has “seasoned money” in their qualified plan.
- No age restrictions, but the client needs to have already started saving for retirement for a few years.
- Expect to be in a lower marginal income tax bracket in retirement (moving to Florida or Texas at retirement anyone?).
- Qualified accounts available for roll-over to a Profit Sharing Plan.

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Technical Notes

Slide 3 MMD, WL, Leg 10 WL; $707,915 Base Face Amount; Unisex, Ultra Preferred NT; age 45; NJ. The current dividend interest rate is 6%. The result is not guaranteed; results may be more or less favorable than illustrated.

Slide 4 Imputed income is determined based on the net amount at risk (death benefit less cash value) multiplied by the IRS Table 2001 rates per $1,000 based on the insured's age. Only the life insurance policy's net amount at risk is received income tax-free at death.

Slide 10 If the policy is distributed to the participant, they must include in gross income (in the year received) the "Fair Market Value" of the policy [See IRC Sec. 402(a)]. The fair market value of the policy must be determined at the time of the distribution (or purchase). Rev. Proc. 2005-25 provides two Safe Harbor formulas (colloquially referred to as "the greater of the ITR or the PERC amount") to determine the FMV of life insurance on the sale or distribution from qualified plans. The FMV of a life insurance policy cannot be determined in advance. However, most practitioners agree that the projected cash value in a whole life policy is a reasonable proxy for its projected FMV. The incidental benefit rules require the policy to be removed from the plan at retirement.

Slide 12 Only a qualified trusts and estates lawyer can interpret the myriad laws bearing on property rights, taxes, wills, probate, and trusts.

Slide 13 Prohibited Transaction Exemptions 92-6 establishes conditions for transferring a life insurance contract from a qualified plan. Under the exemption, the plan participant, their beneficiaries, or certain trusts may purchase the policy for its FMV. Whether or not the Table 2001 imputed income creates basis is an open question; this presentation assumes that it does not.

Slide 14 The net ROR on the trust assets is assumed to be 6%. A qualified attorney must give proper care to establishing a trust. Clients should seek legal guidance before embarking on a gifting/wealth transfer program.

Slide 15 The incidental benefit rules apply formulas to determine the maximum premium contributions depending on the plan type. Death benefits must be "incidental" (i.e., secondary) to other plan benefits. The intricacies of the Incidental Benefit rules are beyond the scope of this presentation. Additionally, the incidental benefit rules require the policy to be removed from the plan at retirement.

Thank You

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