The ins and outs of owning life insurance in a QRP

MAR 29, 2013 | BY RUSSELL E. TOWERS, J.D., CLU, CHFC

Small-business owners have the opportunity to buy tax-deductible life insurance as long as they are willing to provide retirement benefits to all their eligible employees in a qualified retirement plan (QRP). Typical QRP plans that might fit the needs of C Corp, S Corp, or LLC owners include a defined contribution/profit-sharing option or a defined benefit type of plan.

Although these qualified plans are primarily intended to provide **retirement benefits** to participants, certain incidental death benefits can also be provided with life insurance. The trustee of the qualified plan trust will be the owner and beneficiary of the policy. The participant will name a plan beneficiary to receive any death benefit should the participant die prematurely.

In a rising income tax rate environment, business owners may be seeking tax-deductible ways to fund their retirement objectives. They need to know the ins and outs of owning life insurance in a QRP. This way, they can make an informed decision about whether insurance should be purchased inside the QRP or outside the QRP.

Advantages of owning life insurance inside a QRP

- The “net amount at risk” (death proceeds in excess of cash value) will be received income tax free by the plan beneficiary.

- Uses business cash flow to provide a personal benefit for participants to “self-complete” the plan upon an early death.

- Premiums are a tax-deductible expense to the business and currently not taxable income to the participant.

- Business owners and key employees with higher salaries will receive larger death benefits based on favorable tax rules.

- Policy ownership is portable and may be distributed from the QRP trust to the participant at retirement.

QRP life insurance limits based on “incidental tests”

- For the profit-sharing type of defined contribution plans, aggregate annual life premiums must be less than 50 percent of the total contribution for whole life and no more than 25 percent for universal life. The remainder of the contribution can be placed into a side fund, such as an annuity contract.

- For defined benefit plans, either a face amount test or a premium test may be used. The face amount test requires that the death benefit cannot be greater than 100 times the projected monthly benefit at normal retirement date. The premium test is based on Revenue Ruling 74-307, which expands the “incidental test” rules up to a maximum **life insurance** contribution of 50 percent for whole life in defined benefit plans and 25 percent for universal life in defined benefit plans.

Economic benefit costs

- Participants must report the taxable economic benefit each year on their QRP life insurance coverage based on IRS Table 2001.

- The cumulative Table 2001 costs create a cost basis in the policy that can be recovered tax free if the policy is transferred to the participant as a **taxable distribution**.

Distribution options at retirement

- Distribute ownership of the contract to the participant. The policy value minus the cumulative Table 2001 economic benefit cost basis is taxable income to the participant. The value should be determined by the safe harbor fair market value guidelines of Rev. Proc. 2005-25.

- Surrender the contract in the plan for cash. Then execute a transfer of the resulting cash QRP funds to the participant’s IRA.

- Annuitize the contract. The annuitized insurance policy cash value plus annuitized annuity side funds can provide a guaranteed taxable income stream.
- Create a grantor **irrevocable life insurance trust** (ILIT) funded with annual exclusion or lifetime exemption gifts. Then the ILIT can buy the policy from the QRP trust for its fair market value. This transfer is considered an exemption to the prohibited transaction rules (Prohibited Transaction Exemption 92-6). The transfer to the grantor irrevocable trust is also an exception to the transfer for value rule, which keeps the ultimate death benefit income tax free.

Distribution options if participant dies with policy still in the plan

- The “net amount at risk” (death proceeds in excess of cash value) is income tax free to the plan beneficiary. The cash value amount, less the cumulative Table 2001 economic benefit cost basis, is taxable income to the plan beneficiary.
- However, if the plan beneficiary is a surviving spouse, this taxable cash value portion can be rolled directly to a spousal rollover IRA to defer taxation.
- The full death proceeds will be included in the taxable estate of the participant for federal estate tax purposes. However, if the plan beneficiary is a surviving spouse, there is a 100 percent estate tax marital deduction at the participant’s death.

Tax-deductible premiums going in for life insurance owned by a QRP can be very attractive for high-income tax bracket **business owners** and professionals. However, the taxable benefits coming out, upon certain lifetime or death distributions, must be anticipated and pre-planned.

If the coming out part of the overall plan appears too onerous or complicated for the business owner, then life insurance may be purchased outside the QRP from the start. When fully advised of the coming out distribution technicalities of owning insurance in a QRP, business owners will often purchase personally owned or trust-owned insurance outside the QRP. The qualified plan will then be 100-percent funded in a more traditional way, with either mutual funds or annuity products.