

Subtrust Triggers Plan Disqualification

by Natalie B. Choate, Stephan R. Leimberg, and Howard M. Zaritsky

Natalie B. Choate, Stephan R. Leimberg, and Howard M. Zaritsky review an unpublished technical advice memorandum dealing with defined benefit plan life insurance subtrusts.

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Natalie B. Choate is counsel to Bingham McCutchen LLP, Boston. She is the author of many articles and treatises, including *Life and Death Planning for Retirement Benefits* (Ataxplan Pub., 6th ed.).

Stephan R. Leimberg is CEO of Leimberg and LeClair Inc., an estate and financial planning software company; CEO of Leimberg Information Services Inc., a news analysis and database service; and author or coauthor of many articles and treatises, including *Tax Planning With Life Insurance* (RIA Group/WG&L).

Howard M. Zaritsky is vice president (estate planning strategies), Pitcairn Financial Group, Vienna, Va., and the author or coauthor of many articles and treatises, including *Tax Planning With Life Insurance* (RIA Group/WG&L).

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After Congress repealed the unlimited estate tax exclusion for qualified plan retirement benefits in 1984,¹ estate planning practitioners immediately began to search for a technique that would produce a similar exclusionary result. Their goal was to enable a client to create, from deductible contributions, a substantial sum of cash that would pass free of estate taxes at the client's death. It became immediately apparent that any solution was likely to involve life insurance policies. The defined benefit plan life insurance subtrust was the result.²

This subtrust technique calls for creating an irrevocable life insurance subtrust within a qualified defined benefit pension plan. The insured is usually the owner or a major stockholder of the sponsoring corporation. He surrenders all right to change the beneficiary of his retirement plan benefits through an irrevocable beneficiary designation. The plan is amended to deny the participant's right to have the policy distributed at retirement, to eliminate the argument that the

insured has retained a reversionary interest in the plan insurance sufficient to cause the policy proceeds to be included in the insured's gross estate for federal estate tax purposes.³ The policy is then placed in a subtrust (within the plan's master trust) over which the insured has no control, to remove the insured even further from the possession of the incidents of ownership that would cause the proceeds to be includable in the insured's gross estate under section 2042.⁴ In theory, the subtrust could then buy life insurance on the insured, using funds that were attributable to deductible contributions to the plan, and the death benefits would be excludable from the insured's gross estate for estate tax purposes.

The absence of clear authority on this point has been a serious impediment to the expanded use of this technique, though some practitioners do use it. The IRS has now issued its first review of the subtrust, in an as-yet unpublished technical advice memorandum. In this new TAM, the IRS attacks the subtrust on plan qualification grounds.

I. Background

The TAM arose from an audit of a corporation's defined benefit pension plan. The corporation created the plan in 1972 and initially resolved to terminate the plan as of December 31, 1996. In the mid- 1990s, the corporation's only stockholder was also the sole participant in the pension plan.⁵ The participant was about 51 years of age when the corporation created the plan; the plan set the normal retirement age at 55. On the proposed plan termination date, the participant was 76.

The plan provided that the accrued benefit of a participant who remained active beyond the normal retirement age would be increased according to a formula provided in the plan document, and that any participant could elect to commence benefits at any time after attaining the normal retirement age, even if the participant were still employed by the corporation.

The plan also provided that a participant could elect to receive plan benefits by segregating the actuarial equivalent of the accrued benefit into a separate account within the plan trust. The plan trustees would invest the segregated funds and credit or charge those segregated funds with their investment gains or losses, rather than with a proportionate share of the total plan gains and losses. The trustees would distribute the assets in a participant's separate account to the participant or the participant's beneficiary at the participant's retirement or death. A participant's surviving spouse would be the beneficiary in the absence of a contrary specific written designation.

When the plan's sole participant was 74, he elected to have his accrued benefit segregated into a separate account. The sole participant's segregated account was then credited with all the money and assets then held within the plan.

In 1995 the trustees amended the plan. One amendment increased the level of death benefits payable to plan participants before the commencement of benefits. The other added a subtrust feature to the plan, which became the basis for the TAM.

Before the 1995 amendments, the plan provided only one death benefit: The trustees would distribute the accrued benefits to a deceased participant's beneficiary, if the participant died before the commencement of benefits, subject to the minimum survivor annuity requirement of section 401(a)(11). The amendments provided for the purchase of insurance on the life of the sole participant, in a face amount of not more than 100 times the projected normal retirement benefit (expressed as a monthly benefit), or whatever amounts would satisfy the "66%/33% rule based on the theoretical individual-level-premium reserve."⁶

The 1995 amendments also stated that all policies purchased on the life of the sole participant were nontransferable, other than to the participant himself, and that the benefit payable on the participant's death before commencement of benefits would be equal to the sum of:

- (1) the qualified preretirement survivor annuity;
- (2) the proceeds of insurance policies maintained on the life of the participant; and
- (3) the actuarial equivalent of the accrued benefit, reduced by the sum of:
 - (i) the actuarial equivalent of the qualified preretirement survivor annuity, and
 - (ii) the cash value of the insurance policies.⁷

Both before and after the 1995 amendments, the plan made little mention of the death benefits of participants who already were receiving retirement benefits. The plan stated that those death benefits were the benefits incorporated into the particular benefit option selected by the participant, such as the survivor benefit under a joint and survivor annuity.

As amended, the plan stated that, "notwithstanding any other of its provisions," any policies of insurance on the life of the sole participant would be owned by special trustees in a subtrust of the regular plan trust. The initial special trustees were the sole participant's son and daughter. The plan stated that in the event of the sole participant's death, the special trustees would administer the life insurance proceeds in accordance with a specified irrevocable life insurance trust agreement. Under other specified circumstances, the special trustees could sell the policies to the participant for their cash values or, if greater, their interpolated terminal reserves.

The amended plan stated that the trustees would neither distribute the policies on the sole participant's life to him as partial or full payment of the benefits to which the sole participant was entitled under the plan, nor convert the policies into annuities providing benefits to the sole participant. The amended plan further stated that the cash values of the policies on the life of the sole participant were not to be used to provide benefits to the sole participant during his lifetime. The amended plan precluded further amendments or modifications to the new life insurance provisions or to any other of the new provisions addressing the coverage on the sole participant's life. The provision to preclude those further amendments was presumably included in the plan to

avoid the argument that the insured held an "incident of ownership," namely the power to modify the insurance arrangement through his control of the corporate employer that sponsored the plan.

The plan trustee bought a policy of insurance on the sole participant's life in September 1995. The name of the policy's beneficiary was left blank.

The sole participant then created the specified irrevocable life insurance trust for the benefit of his wife and descendants. The trust granted the wife a right to the greater of 5 percent of the insurance proceeds or \$5,000, plus any investment earnings on the insurance proceeds. The special trustees could, at their discretion, pay out more to the sole participant's wife, if they deemed higher amounts to be "appropriate." The trustees would distribute the trust funds, at the death of the later to die of the sole participant and his wife, to the sole participant's grandchildren and their issue.⁸

In 1996 the trustees transferred the plan assets other than the life insurance proceeds from the participant's separate account to an IRA.

On examination the IRS agent contended that the subtrust violated various pension rules and that it was therefore nonqualified. The agent sought technical advice from the IRS National Office. The agent asked:

whether this plan has retained its qualified status under Code section 401(a). [Footnote omitted.] In particular, they ask whether the Plan's "subtrust" feature, along with [the employer's] use of that feature, created an assignment -- or alienation under Code section 401(a)(13), as well as a violation of the joint-and-survivor requirements under Code section 401(a)(11). They also ask whether section 14.01 of the Plan (which prohibits any of the Plan's assets from being used for purposes other than the exclusive benefit of participants and beneficiaries) serves to render the 1995 Amendments null and void.

II. The IRS Rejects Subtrust Approach

The National Office stated in the TAM that the subtrust caused the defined benefit pension plan to be disqualified under several different pension rules, and that the creation of the subtrust constituted a currently taxable distribution to the sole participant.

A. Exclusive Benefit Rule Not Violated

The TAM first explains that the subtrust arrangement did not disqualify the plan under the exclusive benefit rule of section 401(a)(2).⁹ Section 401(a)(2) requires that the plan documents make it impossible for any part of the trust's corpus or income to be used for, or diverted to, purposes other than "the exclusive benefit of employees or their beneficiaries" at any time before the plan's satisfaction of all liabilities with respect to employees and their beneficiaries. Beneficiaries include, for this purpose, an employee's estate, dependents, persons who are the natural objects of the employee's bounty, and anyone the employee names to share in the plan benefits after the employee dies. A plan that does not satisfy the exclusive benefit rule is not qualified for income tax purposes, which may render the employer's contributions nondeductible and the employee's benefits currently taxable.

The IRS stated that the subtrust arrangement did not cause the plan to violate the exclusive benefit rule. The IRS noted that the exclusive benefit rule does not limit the plan to providing only retirement benefits. A plan may provide death benefits, through insurance or otherwise, for example. The IRS stated:

Although we find that the "subtrust" feature causes the Plan to violate various requirements of Code section 401(a), the "exclusive benefit" requirement is not one of the violated requirements.

The IRS said that the mere purchase of insurance on the participant's life might have been a disqualifying event because, when the life insurance was bought, the participant's benefit had already been segregated into a separate account. Under the terms of this plan, the segregation of the participant's benefits into a separate account was a "commencement" of his benefit, and the IRS stated that the plan's terms "addressed" death benefits "only in the context of participants who die before the commencement of their benefit." If the participant were not eligible for the insurance coverage under the terms of the plan, the insurance purchase might mean the "plan operated in violation of its terms," which would cause plan disqualification. The IRS did not expressly reach that conclusion, however, because it had not been asked to do so. Because the IRS comment was based on the terms of that particular plan, it does not appear to have further implications for subtrusts within plans that do not limit life insurance coverage to participants who have not commenced their benefits.

B. J&S Annuity Requirement Violated

The IRS next considered whether the subtrust arrangement violated the joint and survivor annuity requirement. Section 401(a)(11) requires that a defined benefit plan pay the accrued benefit, in the form of a qualified joint and survivor annuity, of a participant who has not died before the annuity starting date.¹⁰ A participant can waive the annuity requirement if his spouse consents to that election and that consent meets specific tests.

In the TAM, the IRS noted that the terms of the irrevocable life insurance trust did not require the distribution of the death benefits to the participant's wife. The special trustees had discretion to limit the amount of distributions that the participant's wife would receive, even if she demanded full distribution of the trust assets. That, the IRS stated, triggered the necessity of meeting the requirement that the participant's wife consent to the use of funds in the segregated account to purchase life insurance, because failure of the plan trustees to obtain that consent would violate the joint and survivor annuity requirements of section 401(a)(11). The TAM does not state that the trustees obtained that consent.

C. No Alienation/Assignment Violation

The third problem raised by the subtrust was, according to the TAM, the effect of the arrangement under the nonassignment and nonalienation requirement for qualified plan benefits. Section 401(a)(13) states that a qualified plan cannot permit the alienation or assignment of plan benefits. That means that there can be no arrangement, direct or indirect, revocable or irrevocable, under which any party can acquire from a participant any right or interest that is enforceable against the plan for any portion of a plan benefit that is, or may become, payable to a plan participant.¹¹ Section 401(a)(13) and reg. section 1.401(a)(13)(c) provide an exception for the assignment or alienation of plan benefits to the natural objects of the plan participant's bounty, such as the participant's spouse or heirs. The beneficiaries of the subtrust under discussion were the participant's spouse and heirs, so the IRS found that the subtrust arrangement did not violate the nonassignment and nonalienation requirements of section 401(a)(13).

D. Nondiscrimination Rule Violated

The IRS stated that the subtrust caused the plan to discriminate in favor of a highly compensated employee. Section 401(a)(4) requires that a plan must not discriminate in favor of "highly compensated" employees.

The terms of the subtrust prohibited the use of the cash values of the policy to provide the participant with lifetime retirement benefits. The IRS noted that the subtrust feature applied only to this individual participant, who was a highly compensated employee under section 414(q).

E. Incidental Benefit Rule Violated

The code allows a defined benefit plan to provide life insurance coverage if the death benefit is "incidental" to the main and central purpose of the plan -- to provide the systematic payment of definitely determinable benefits to employees over a period of years after retirement (usually for the participant's life).¹² Although a pension plan may provide for the payment of a pension triggered by a participant's disability, and provide relatively modest (incidental) death benefits (through life insurance or otherwise), the plan must focus primarily on retirement rather than disability or death benefits. A pension plan cannot allow a participant to elect irrevocably to have

all or a part of the participant's nonforfeitable interest in the plan, which would otherwise become payable to the participant during his lifetime, paid only to the beneficiary after the participant's death.

Life insurance can be used to provide an incidental life insurance benefit to participants in a qualified defined benefit or defined contribution retirement plan. The IRS will consider life insurance (or any other nonretirement benefit) as incidental if the cost of that benefit is less than 25 percent of the plan's total cost.¹³ But because that standard would be mechanically difficult to apply, the IRS created two practical tests for life insurance in a qualified plan.¹⁴

The IRS will consider the amount incidental if the amount meets either of the following tests:

1. the participant's insured death benefit must be no more than 100 times the expected monthly benefit;¹⁵ or
2. the aggregate premiums paid (over the plan's entire life) for a participant's insured death benefit are at all times less than the following percentages of the plan cost for that participant:

"Ordinary" Life Insurance	50%
Term Life Insurance	25%
Universal Life Insurance	25%

Although the common practice is for defined benefit plans to use the "100 times" limit¹⁶ and for defined contribution plans (such as a profit-sharing plan) to use the "percentage" limits in calculating how much insurance to provide, any type of plan is allowed to use either limit -- and in fact defined benefit plans more commonly use the percentage limits now that the necessary calculations can easily be performed on computer spreadsheets and stand-alone programs.¹⁷

To reiterate, a life insurance policy held by a qualified pension plan to provide a preretirement death benefit or postretirement lifetime benefit will be automatically considered incidental if the death benefit is not more than 100 times the participant's anticipated monthly lifetime benefit.¹⁸ A whole life insurance policy held by a defined contribution plan is incidental if only 50 percent of the participant's total contributions (and forfeitures) are used to pay for the insurance and none of the value of the contract is used to provide life insurance protection after retirement.¹⁹ A term life insurance policy held by a qualified plan is incidental if no more than 25 percent of the funds allocated to the participant's account are used to buy insurance and none of the value of the contract is used to provide life insurance protection after retirement.²⁰

Under an alternative test, life insurance maintained by a qualified pension plan to provide a death benefit is incidental if the death benefit is equal to the qualified preretirement survivor annuity, plus any positive incidental reserve. The incidental reserve is equal to the proceeds of the

insurance policies owned by the plan on the participant's life, plus the "theoretical ILP reserve," reduced by the present value of the qualified preretirement survivor annuity and the cash value of the policies.²¹

Under that test, the face amount of whole life insurance cannot be greater than 66 percent of the "theoretical contribution," and the face amount of term or universal life insurance cannot be more than 33 percent of the theoretical contribution. The theoretical contribution is the contribution that would be made on behalf of the participant to fund the participant's entire retirement benefit, using the individual level premium funding method, and determined without regard to preretirement ancillary benefits.²² It was apparently under this test that the plan discussed in the TAM was attempting to qualify, although the plan's wording failed in that regard.

Life insurance protection in a profit-sharing plan is incidental if the plan prohibits the use of trust funds accumulated for less than two years to buy permanent insurance and pay premiums.²³

In the TAM, the IRS noted that the subtrust violated the incidental benefit rule, because the plan bars the use of the cash value of the policy during the participant's lifetime to provide retirement benefits. The IRS cited Rev. Rul. 56-656, 1956-2 C.B. 280,²⁴ as stating that a provision or arrangement preventing the use of life insurance owned by a plan for lifetime benefits will cause a qualified plan to violate the incidental benefit rule.

F. Two Plans, One Qualified, One Not Qualified

The IRS concluded that the corporation's pension plan was not really one plan but two, and that the subtrust was a separate nonqualified plan. The IRS noted that a plan is a "single plan" only if all of its assets are available to pay all of the benefits under the plan. More than one plan exists if part of the plan assets is not available to pay some of the benefits.²⁵

The TAM stated that the purchase of an insurance policy on the life of the sole participant, together with the plan provision that prevented the cash value of the policy from being used to provide lifetime benefits, caused the plan not to be a single plan. The IRS concluded from this that the subtrust cannot be treated as part of the plan, but must be treated as a separate plan.

The IRS also stated that treating the subtrust as a separate plan caused that separate plan not to be qualified, because the only benefit provided to the participant under the subtrust was life insurance protection; the subtrust did not provide any retirement benefits.

G. Taxable Distribution

Finally, the IRS stated that, because the subtrust was not itself a qualified plan, the use of funds from a separate account to buy life insurance constituted a taxable distribution to the participant under section 402(a).

III. Estate and Gift Tax Uncertainty

The subtrust arrangement is designed to create a life insurance policy purchased with funds that are deductible from the insured's corporation's gross income, and that pays death benefits that are excludable from the insured participant's gross estate and that of his spouse. The IRS did not address estate tax questions in the TAM, but a subtrust arrangement is successful only if it can be created within a qualified retirement plan while producing death benefits that are excludable from the insured's gross estate and that of the insured's surviving spouse (and without adverse gift tax consequences).²⁶

Generally, the proceeds of a life insurance policy are included in the insured's gross estate if:

- * they are payable to the insured's personal representative;²⁷
- * the insured held incidents of ownership over the policy at his death;²⁸ or
- * the insured transferred incidents of ownership in the policy within three years of the insured's death for less than full and adequate consideration in money or money's worth.²⁹

Incidents of ownership will cause the proceeds of a policy of insurance to be included in the insured's gross estate whether held outright or in a fiduciary capacity.³⁰ Also, the term "incident of ownership" includes a retained reversionary interest in a life insurance policy that is worth more than 5 percent of the value of the policy immediately before the insured's death.³¹

Life insurance proceeds can also be included in a deceased insured's gross estate if the insured transferred the policy and retained over the policy a life estate or a power to alter or terminate the beneficial enjoyment of the policy.³² Planning to avoid estate taxation of the proceeds of a policy held in a subtrust dictates many of the terms of the subtrust arrangement.

First, the insured must terminate all incidents of ownership over the policy held in the subtrust. Life insurance policies held as part of the general plan assets will usually be included in the insured's gross estate, if the insured holds as the sole or controlling shareholder of the sponsoring corporation, incidents of ownership as a plan trustee, or has the power to alter or amend the plan's trust(s) or the beneficial enjoyment of plan assets.

The subtrust arrangement typically involves an irrevocable designation of the beneficiary of the participant's retirement plan benefits, to remove the retained power to control the beneficial enjoyment. Merely designating an irrevocable trust as an irrevocable beneficiary, however, will likely not be sufficient to deprive the insured of all incidents of ownership, if the insured retains other powers to amend the plan and change the timing or incidence of beneficial enjoyment. Further, even if the irrevocable beneficiary designation deprives the insured of all of the incidents of ownership over the plan, the proceeds will still be included in his gross estate if the insured dies within three years of the designation.

The availability of the cash value of the policy to provide retirement benefits to the insured participant could be an "incident of ownership" retained by the participant. Presumably to avoid that consequence, the plan discussed in the TAM stated that the policy (despite being an asset of the participant's segregated account that was supposed to provide retirement benefits) "shall not under any circumstances" be distributed to the participant "in partial or full payment of his benefits under the plan," or be used to purchase annuities to provide those benefits. The IRS stated that this violated the incidental benefit rule.

If the insured retires and buys the life insurance contract from the plan, the proceeds are, of course, included in his gross estate. The insured can then assign the policy, but if the insured dies within three years of the assignment, the proceeds will be included in his gross estate.³³

It is unclear whether the irrevocable designation of a beneficiary of life insurance in a qualified plan is a currently taxable gift.³⁴ Since the employer continues to make contributions to the pension plan on the insured participant's behalf, those contributions could be considered additional taxable gifts by the insured participant to the irrevocable beneficiary. The IRS could argue persuasively that those gifts exist in the same manner that an employee covered by group term life is deemed to make a gift to the irrevocable assignee of his group insurance each time his employer pays group term premiums on the employee's behalf.³⁵

A participant who owns more than one-half of the stock of a corporate plan sponsor will have a level of control over the corporation that could be viewed as providing control over the plan and the plan trust, even if the participant is not a plan trustee. Because the corporation's board of directors can be elected by the shareholder and the board can change trustees at will (and can even become the trustee), the incidents held by the trustee over the policy should be imputed to the insured stockholder.³⁶

IV. Subtrust Planning in Light of IRS Analysis

The IRS raised several problems with the subtrust that would apply to all variations on the technique, and several that could be avoided by changes in the drafting and planning. Even if the IRS analysis is correct, it may be possible to combine the desired estate tax advantages of the subtrust with the necessary pension qualification. Unfortunately, even after the TAM, the ultimate answer is far from clear.

A. The 'Separate Plan' Problem

One problem in creating a valid and effective subtrust arrangement under the TAM is ensuring that the subtrust is treated, for pension purposes, as part of the general plan rather than as a separate plan. A subtrust that is treated as a separate plan and that holds only life insurance intended to provide death benefits will, according to the analysis in the TAM, be treated as a separate plan, and as such it will not be a qualified plan, because it will meet few if any of the requirements of section 401(a).

The IRS relies for its definition of separate plans on the regulations under section 414(l), which involve merger and consolidation of plans. Section 414(l) applies to merger and consolidation of plans, and also to transfer of plan assets, typically (though not always) in the form of a split-off of a second plan from the first plan. The regulations under section 414(l) do, indeed, state that a plan is a single plan only if:

On an ongoing basis, all of the plan assets are available to pay benefits to employees who are covered by the plan and their beneficiaries. For purposes of the preceding sentence, all the assets of a plan will not fail to be available to provide all the benefits of a plan merely because the plan is funded in part or in whole with allocated insurance instruments.³⁷

The IRS analysis in the TAM appears to treat the subtrust correctly, as a separate plan, because its assets are not subject to the claims of the plan generally. That necessarily disqualifies a subtrust that holds only life insurance to pay death benefits, because retirement benefits are not the primary purpose of the independent plan, and the life insurance protection is not an incidental benefit. Arguably, a life insurance policy that had substantial cash values could be held as the sole investment of a subtrust, without disqualifying the subtrust, as long as the cash values were appropriate to pay retirement benefits.

The subtrust also would not be disqualified if it held both life insurance and adequate other assets to pay retirement benefits, rendering the insurance incidental. Unfortunately, one of the important objectives of the subtrust is to remove the insurance from the insured participant's gross estate, and that would not be available if the subtrust were to provide a lifetime annuity to the insured participant.

The subtrust also would not be a single plan if it remained subject to the claims of the creditors of the insured participant. One could create a subtrust that was expressly subject to the claims of the plan trust generally if the other plan assets proved insufficient. That might force the IRS to regard the subtrust as part of the overall plan, but the proceeds could be removed from the insured's gross estate only by having the owner/insured participant surrender all other control over the plan, including the right to alter or amend the plan or to serve as a trustee. That is probably impossible if the insured totally owns or holds control of the sponsoring corporation, and even if it were possible, it would be an unacceptably high price to pay for creating an excludable subtrust.

Assuming that the insured can and does surrender all control over the plan generally, as well as over the subtrust, the exposure of the death benefits to other plan claims may be a small real liability. The amount by which the individual participant for whose benefit the subtrust was created would have less real security would depend on the number of plan participants, the size of their benefits, and the sufficiency of the plan funding generally. A plan that is otherwise adequately funded should raise little real risk of diversion of the participant's insurance benefits

to pay the benefits of other beneficiaries, and a plan that has only one or two participants should raise even fewer risks.

That may be the most significant problem raised by this TAM for the life insurance subtrust arrangement. All of the methods for avoiding this problem seem to create situations that are unacceptable for most estate planning clients.

B. Better Drafting/Planning the Answer?

Some of the other problems raised in the TAM should be remediable by careful drafting and planning. First, a subtrust arrangement should require that the spouse of a married insured consent in writing to the waiver of the qualified preretirement survivor annuity. One does not want the death benefits paid outright to the surviving spouse because those benefits would then be needlessly included in his gross estate. The proceeds could be held in further trust for the benefit of the surviving spouse and, either concurrently or thereafter, for other family members, with the consent of the surviving spouse.

Second, unlike in the plan involved in the TAM, drafters should not provide that the creation of the subtrust (as a segregation of benefits) constitutes a commencement of benefits to a participant; instead, they should explicitly provide for the death benefit that will be paid under the subtrust following the segregation. That should avoid the IRS's argument that purchase of the life insurance violates the plan's own terms.

Third, the IRS stated that the subtrust in the TAM did not violate the nonassignment and nonalienation requirements because the beneficiaries were the natural objects of the insured's bounty. The practitioner should amend the plan to direct that the proceeds of the insurance in the subtrust on the death of the insured must be distributed to, or in trust for, the natural objects of the insured's bounty. Any contrary distribution direction in a beneficiary designation could be invalidated, and a default distribution could be created within the plan amendments, perhaps redirecting the death benefits to the insured's spouse, if one survives, or otherwise to the insured's heirs at law.

Fourth, the plan amendments should take care to satisfy the nondiscrimination requirements, which should be easy to meet if the subtrust is not treated as a separate plan. Of course, avoiding treatment of the subtrust as a separate plan requires that the insured be stripped of all powers with respect to the plan, as well as the subtrust.

C. Barring Use of Cash Value to Provide Benefits

A possibly bigger obstacle to subtrust estate tax exclusion success is the barring of use of the policy's cash value to provide benefits during the participant's life. As noted above, the insured sole participant's retention of rights to the cash value could be deemed an incident of ownership, depriving the plan of its desired estate tax advantages. The TAM notes that Rev. Rul. 56-656

treated barring the use of some assets to provide retirement benefits as a violation of the incidental benefit rule. One must wonder whether that aspect of the TAM alone dooms the subtrust technique.

Rev. Rul. 56-656 dealt with a defined contribution (profit-sharing) or "individual account" plan. In the individual account plan context, putting a portion of the participant's account off limits for use in providing retirement benefits would indeed appear to inevitably violate the incidental benefit rule, as described in Rev. Rul. 56-656. Because the TAM involved a segregated account (in effect, a defined benefit plan that had been converted to an individual account plan), the result should be the same as for a true defined contribution plan: Barring use of one asset of the participant's account (that is, the cash value of the insurance policies) to provide retirement benefits to the participant violates the incidental benefit rule.

The result might not be the same in a "real" defined benefit plan with multiple participants, as opposed to the one in the TAM, which had only one participant and held all its assets in a segregated account for that sole participant. As the TAM points out, a pension plan is supposed to be one plan and one fund providing benefits for all participants. A defined benefit plan covering multiple employees that barred use of a particular asset to provide retirement benefits might still violate the incidental benefit rule under the logic of Rev. Rul. 56-656, but the plan might not need to include such a provision to achieve the desired estate tax results, because the participant's rights to a plan asset (such as the cash value of insurance policies on the participant's life) might not rise to the level of an incident of ownership for estate tax purposes. It would be essential to specifically bar the insured participant from serving as trustee and from any power to alter the beneficial enjoyment of the plan trust in which the insurance was held as an asset.

V. Conclusion

The estate tax advantage sought to be gained by the subtrust arrangement is uncertain at best, and may be available only at a substantial surrender of control over the entire plan. Further, the subtrust raises a significant likelihood of creating taxable gifts and possible plan disqualification. If shelter from the federal estate taxes for the policy proceeds is an overriding objective, the best approach may still be to buy the insurance policy outside the retirement plan and have the incidents of ownership held from inception by someone other than the insured.

FOOTNOTES

1 Deficit Reduction Act of 1984, section 525(a), 98th Cong., 2d Sess. (1984). Section 2039(c) had previously completely excluded from the gross estate of the value of an annuity or other payment received by a beneficiary other than the executor from a qualified retirement plan, except to the extent attributable to employee contributions. Then, the Tax Reform Act of 1976, section 2009(c), 94th Cong., 2d Sess. (1976), limited the exclusion to periodic payments,

excluding lump sum distributions. The Revenue Act of 1978, section 142, 95th Cong., 2d Sess. (1978), extended the exclusion to lump sum payments if the recipient elected not to take the 10-year forward averaging then available under the income tax rules. The Tax Equity and Fiscal Responsibility Act of 1982, section 245, 97th Cong., 2d Sess. (1982), limited the estate tax exclusion to \$100,000, and the Deficit Reduction Act eliminated even that exclusion.

2 See, e.g., Zaritsky and Leimberg, *Tax Planning With Life Insurance* para. 6.08[2] (RIA Group/WG&L); Choate, *Life and Death Planning for Retirement Benefits*, para. 8.4.01 (Ataxplan Pub., 6th ed.); see also Brooks, "Does a Life Insurance Sub-Trust Create a Prohibited Assignment Within a Qualified Plan?" 34 *J. Marshall L. Rev.* 727 (Spring 2001); Fair, "Here's How to Exclude Insurance in the Pension From the Taxable Estate," 80 *Life Ass'n News* 178 (Aug. 1985); Fair, "Planning With Plans: Qualified Plans and Life Insurance," 8 *Prac. Tax Law.* 27 (Summer 1994); Falk, "Using Life Insurance in Qualified Retirement Plans," 23 *Est. Plan.* 357 (Oct. 1996); Labiner and Kaplan, "Qualified Retirement Plans, Trusts and Life Insurance: The Formula for Creative Estate Planning," 69 *Fl. Bar J.* 33 (Mar. 1995); La Vine, "Sub-Trust: A Shield for Triple Taxation Targets," *Life Ass'n News* 77 (Jan. 1993); Pincus, "Sub-Trusts and Reversionary Interests: A Review of Current Options," 46 *J. Am. Soc'y CLU & ChFC* 64 (Sept. 1992); Leimberg and Simmons, "Using Life Insurance in Qualified Retirement Plans," 31(3) *Estate Planning* 107 (Mar. 2004). Simmons and Leimberg, "Prop. Regs. Address Abusive Transactions Involving Life Insurance in Qualified Plans," 31 *Estate Planning* 163 (Apr. 2004); Williams, "Using Qualified Plan Money to Purchase Life Insurance," 52 *J. Am. Soc'y CLU & ChFC* 54 (July 1996).

3 Many of those arrangements give the insured the right to buy the policy at retirement, but the IRS is likely to treat that right as an incident of ownership (causing estate inclusion of the insurance proceeds) if the insured dies before retirement. Compare LTR 9141007 with *Estate of Smith v. Commissioner*, 73 T.C. 307 (1979), acq., 1981-1 C.B. 2.

4 That last step is particularly important if the insured is also a plan trustee, since the incidents held by the insured as a plan trustee can be sufficient to cause the proceeds to be included in his gross estate.

5 The plan had previously covered the participant's daughter, too, but she had received a distribution of her entire account some years earlier.

6 The IRS states in the TAM that it was unclear whether the trustee was actually required to buy coverage equal to the greater of the two amounts. Thus, the IRS stated, it was uncertain whether the amount of insurance coverage under the plan was "definitely determinable." If benefits were not determinable, the plan would not be qualified; see discussion later in this article for more on that point, as well as for an explanation of the 66 percent/33 percent rule.

7 This definition caused the preretirement death benefits to violate the requirement that they be incidental, which by itself would probably cause the plan to be disqualified. That defect could have been corrected by adding to subparagraph (ii) of the death benefit definition the words "in excess of the cash value of such policies"; see further discussion below.

8 The trustees were not obligated to distribute all the trust funds to the participant's wife, which was an important factor in the treatment of the joint and survivor requirements of section 401(a)(11), as discussed below.

9 For the operation of the exclusive benefit rule more generally, see Lurie, "Pension Planning After Hughes Aircraft -- 'Exclusive Benefit' Does Not Bar Employer Benefit," 90 J. Tax'n 268 (May 1999); Melbinger and Hahn, "Excess Pension Plan Assets Can be Put to Various Uses," 67 Pract. Tax Strategies 204 (Oct. 2001).

10 On the joint and survivor annuity requirement generally, see Choate, Life and Death Planning for Retirement Benefits, para. 3.4 (Ataxplan Pub., 6th ed.); Meyer, "Methods for Qualifying Plan Distributions for the Marital Deduction," 79 J. Tax'n 30 (July 1993); Wilf, "Informed Consent by Spouse Necessary to Waive Plan Benefits," 24 Estate Planning 251 (July 1997).

11 For more on the nonassignment and nonalienation rules generally, see Brooks, "Does a Life Insurance Sub-Trust Create a Prohibited Assignment Within a Qualified Plan?" 34 J. Marshall L. Rev. 727 (Spring 2001); Ice, "What Are Creditors' Rights in Retirement Plan Benefits?" 21 Estate Planning 30 (Jan./Feb. 1994); Martin, Grossman, and Kuhn, "Protection of Retirement Assets From Creditors More Clouded Since Patterson v. Shumate," 2 J. Tax'n of Employee Benefits 254 (Mar./Apr. 1995); Whitehorn and Penberthy III, "Where Patterson Stops, Debtors Must Look to State Laws for Protection for Retirement Assets," 3 J. Tax'n of Employee Benefits 165 (Nov./Dec. 1995).

12 Reg. sections 1.401-1(b)(1)(i), (ii).

13 This 25 percent rule applies to life insurance benefits provided in both defined benefit and defined contribution plans, but when the plan buys life insurance in a separate account, the 25 percent rule will be applied only to the cost of providing current ("net amount at risk") life insurance protection. See Rev. Rul. 61-164, 1961-2 C.B. 99; Rev. Rul. 66-143, 1966-1 C.B. 79; Rev. Rul. 70-611, 1970-2 C.B. 89.

14 Rev. Rul. 68-453, 1968-2 C.B. 163; Rev. Rul. 74-307, 1974-2 C.B. 126; Leimberg and McFadden, Tools and Techniques of Employee Benefit and Retirement Planning, chapter 12 (National Underwriter Company, 9th ed.); Leimberg and Simmons, "Using Life Insurance in Qualified Retirement Plans," 31 Estate Planning 107 (Mar. 2004).

15 Rev. Rul. 74-307, 1974-2 C.B. 126; Rev. Rul. 68-453, 1968-2 C.B. 163. Rev. Rul. 74-307 states that death benefits are incidental under any type of pension plan, if either (1) less than half of the employer contribution credited to each participant's account is used to buy ordinary life insurance (even if the total amount payable at the participant's death is the sum of both the amount credited to the participant's account and the life insurance death benefit) or (2) the death benefits payable meet the 100 to 1 test.

16 The 100 times limit, or 100 to 1 test, is a safe harbor rather than an absolute limit on the maximum permissible death benefit; it has an important historical background. The test is based on so-called retirement income policies, technically life insurance but mainly annuities designed to endow with the necessary amount to provide the promised defined benefit retirement benefit. The test is automatically met if the death benefit isn't greater than the amount of death benefit that would be payable if all plan benefits were funded by retirement income policies that have a death benefit of \$1,000, or the reserve, if greater, for each \$10-per-month-of life annuity guaranteed by the policy at the stated retirement age. See Rev. Rul. 61-121, 1961-2 C.B. 65 (pension plans); Rev. Rul. 68-453, 1968-2 C.B. 163 (pension plan funded by ordinary life policies). See Tax Facts on Life Insurance, Q. 369, National Underwriter Company.

17 Leimberg and McFadden, Tools and Techniques of Employee Benefit and Retirement Planning, chapter 12 (National Underwriter Company, 9th ed.).

18 Rev. Rul. 61-121, 1961-2 C.B. 65.

19 Rev. Rul. 61-164, 1961-2 C.B. 99. The second requirement is met if the trustee is required to convert the entire value of the policy at or before retirement to provide periodic income. A life insurance policy held by a money purchase pension plan (as opposed to a profit-sharing plan) may satisfy either the defined benefit test or the defined contribution test. Rev. Rul. 68-31, 1968-1 C.B. 151.

20 Rev. Rul. 61-164, 1961-2 C.B. 99; Rev. Rul. 66-143, 1966-1 C.B. 79.

21 Defined Benefit Listing of Required Modifications and Information Package, LRM 52 (Feb. 2000).

22 Id.

23 Rev. Rul. 66-143, 1966-1 C.B. 79; Rev. Rul. 71-295, 1971-2 C.B. 184.

24 Generally, Rev. Rul. 56-656 states that payments to others should be merely incidental as, for example, in a joint and survivor annuity contract, or when an unused balance in the account of the employee is paid to a beneficiary on the death of the employee. The ruling involved a provision in a profit-sharing plan that permitted deferment of benefits until after death, and states that it was possible for an employee to elect to have a beneficiary receive the entire amount standing to his account. That was not, the ruling states, "a benefit within the intendment of a qualified profit-sharing plan under section 401."

25 Reg. section 1.414(l)-1(b)(1).

26 The irrevocable designation of a beneficiary of a qualified plan may be a currently taxable gift. See reg. section 25.2511-1(h)(8). If so, the employer's continued contributions to the plan on the insured participant's account may also be additional taxable gifts constructively made by the insured participant to the irrevocable beneficiary. By analogy to an executive who makes an absolute assignment of group term life insurance to an irrevocable trust and who then is deemed

to have received income and to have made a gift each time the employer pays group term premiums on the employee's behalf, the IRS seems to have at the least an arguable position. See Rev. Rul 76-490, 1976-2 C.B. 300. If that position is correct, the situation may be even more expensive than it appears: The gift would probably not qualify for an annual gift tax exclusion, because the irrevocable beneficiary would have no immediate, unfettered, and ascertainable right to use, possess, or enjoy the gift. Zaritsky and Leimberg, *Tax Planning With Life Insurance*, para. 6.08[2] [e] (RIA/WGL).

27 Section 2042(1).

28 Section 2042(2).

29 Section 2035(a)(2).

30 Reg. section 20.2042-1(c)(4); see also Rev. Rul. 84-179, 1984-2 C.B. 195, revoking Rev. Rul. 76-261, 1976- 2 C.B. 276; Budin, "Estate Tax Treatment of Fiduciary-Owned Life Insurance," 11 *Est., Gifts & Tr. J.* 175 (1986); Pearle, "Life Insurance Owned in Fiduciary Capacity," 26 *Tax Mgmt. Memo.* 159 (1985).

31 Reg. section 20.2042-1(c)(3); see also Rev. Rul. 76-421, 1976-2 C.B. 280 (the possibility of a reversion of a right to apply for life insurance is, like the right to apply itself, not an incident of ownership); and Pincus, "Sub-Trusts and Reversionary Interests: A Review of Current Options," 46 *J. Am. Soc'y CLU & ChFC* 64 (Sept. 1992).

32 Sections 2036, 2038.

33 Generally, the trustees can remove the policy from the plan or subtrust by selling it or distributing it to the participant. Those transactions raise several important tax and nontax problems and must be structured with special care. See discussion of those rollouts and pension rescue arrangements at Leimberg and Zaritsky, *Tax Planning With Life Insurance*, paras. 6.08[4] [c] and 6.08[4] [i] (RIA/WG&L); Allen, "Purchasing Life Insurance in Qualified Retirement Plans," 55 *J. Fin. Serv. Prof.* 46 (Jan. 2001); Choate, "Life Insurance Inside the Retirement Plan," 142 *Tr. & Est.* 50 (May 2003); Simmons and Leimberg, "Prop. Regs. Address Abusive Transactions Involving Life Insurance in Qualified Plans," 31 *Estate Planning* 163 (Apr. 2004); Simmons and Leimberg, "Using Life Insurance in Qualified Retirement Plans," 31 *Estate Planning* 107 (Mar. 2004).

34 Reg. section 25.2511-1(h)(8).

35 Rev. Rul. 76-490, 1976-2 C.B. 300. The best analysis is that a gift should be deemed to be made by the employee and that transfer would be a future interest gift that would not qualify for the annual gift tax exclusion because the irrevocable beneficiary would have no immediate, unfettered, and ascertainable right to use, possess, or enjoy group insurance coverage held by the subtrust.

36 It is unlikely that a corporation would or could surrender its ability to remove a plan trustee and appoint a new one, or to give up the right to amend the plan as it sees fit.

37 Reg. section 1.414(l)-1(b)(1).

END OF FOOTNOTES

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Author: Choate, Natalie B.; Leimberg, Stephan R.; Zaritsky, Howard M.

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