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## COMMENTS

# DOES A LIFE INSURANCE SUBTRUST CREATE A PROHIBITED ASSIGNMENT WITHIN A QUALIFIED PLAN?

STEPHEN BROOKS\*

### INTRODUCTION

The combined marginal federal estate tax and income tax rates on the death benefits that a qualified pension plan<sup>1</sup> or profit-sharing plan<sup>2</sup> (qualified plan)<sup>3</sup> pays to a deceased participant's beneficiary can exceed 70%.<sup>4</sup> For illustration purposes, assume a deceased participant has a taxable estate<sup>5</sup> of \$4,000,000 with a

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\* J.D. Candidate, June 2002.

1. An employer establishes a qualified pension plan to provide for the livelihood of its employees or their beneficiaries after the retirement of such employees through the payment of benefits, which the plan determines without regard to the profits of the employer. Treas. Reg. § 1.401-1(a)(2)(i) (as amended in 1976). The amount of a pension plan's benefits must be definitely determinable from either the benefit formula that the plan specifies or from a benefit computation based on the actuarial assumptions that the plan specifies. *Id.*

2. An employer establishes and maintains a qualified profit-sharing plan to enable its employees or their beneficiaries to participate in the profits of the employer's trade or business, pursuant to a definite formula for allocating the contributions that the employer makes and for distributing the funds which the plan accumulates. *Id.* §§ 1.401-1(a)(2)(ii), 1.401-1(b)(1)(ii). A qualified profit-sharing plan may distribute the funds that it accumulates for an employee after a fixed number of years, the attainment of a stated age, or upon the prior occurrence of an event such as layoff, illness, disability, retirement, death, or severance of employment. *Id.* Whether a plan is a profit-sharing plan is determined without regard to whether the employer has current or accumulated earnings or profits. I.R.C. § 401(a)(27) (1999).

3. A qualified plan is a plan of deferred compensation which must defer income, normally until retirement. I.R.C. § 401(a); Treas. Reg. § 1.401-1(b)(1)(i) (as amended in 1976). A qualified plan provides retirement income to employees or results in a deferral of income by employees for periods extending at least to termination of covered employment. Employee Retirement Income Security Act of 1974, 29 U.S.C. § 1002(2) (1999) [hereinafter "ERISA"].

4. I.R.C. §§ 1, 2001(c)(1) (2000).

5. The decedent's taxable estate is the decedent's gross estate under IRC sections 2031 through 2046, less any expenses, indebtedness, and taxes under

\$1,000,000 death benefit in qualified plans and the death benefit's beneficiary is not the participant's spouse. If the beneficiary is in the maximum federal income tax bracket,<sup>6</sup> federal taxes would reduce the death benefit as follows:<sup>7</sup>

Death benefit—\$1,000,000

Federal estate tax<sup>8</sup> —\$550,000<sup>9</sup>

Federal income tax<sup>10</sup> —\$217,547<sup>11</sup>

Total amount of federal taxes paid —\$767,547

Amount remaining after federal taxes—\$232,453

Under the above scenario, there is a reduction of over 76% in the death benefit through federal taxation.<sup>12</sup>

IRC section 2053, any losses under IRC section 2054, any charitable contributions under IRC section 2055, and any marital deduction under IRC sections 2056 and 2056A. *Id.* § 2051.

6. Currently, the highest marginal federal income tax rate is 39.6%. *Id.* § 1.

7. For this example, we have determined the amount of taxes at their highest marginal rate.

8. The decedent's gross estate includes the entire death benefit payable under a qualified plan, although amounts which the plan pays to a surviving spouse or a charitable organization may qualify for deduction. *Id.* § 2039(a).

9. \$1,000,000 x 55%.

10. If "income in respect of a decedent" (IRD) is not properly includable in the gross income of a decedent, the decedent's transferee includes the IRD in his gross income for the tax year in which he collects the income. *Id.* § 691(a). The transferee who collects the claim may deduct the federal estate tax attributable to the item from his adjusted gross income because the decedent's gross estate includes the claim. *Id.* § 691(c). However, the transferee cannot deduct any state death taxes attributable to the item. *Id.* § 691(c)(2)(A).

11.  $39.6\% \times (\$1,000,000 - \$550,000 + \$238,800 + [(\$4,000,000 - \$3,540,000) \times 10.4\%] - \$146,800 - [(\$3,000,000 - \$2,540,000) \times 8.8\%])$ .

12. To reach this figure, the following formula was used: Total amount of federal taxes paid = death benefit - federal estate tax - [federal income tax - (estate tax - state death tax credit for estate tax)]. In this example, any state income tax, any state estate tax in excess of the maximum state death tax credit of the federal estate tax, and any state inheritance tax have been ignored because these taxes will depend upon the domiciles of the decedent and the beneficiary.

All states levy an estate tax on the estate of decedents and the following seventeen states also levy an inheritance tax on the inheritance of beneficiaries: Connecticut, Delaware, Indiana, Iowa, Kansas, Kentucky, Louisiana, Maryland, Montana, Nebraska, New Hampshire, New Jersey, New York, North Carolina, Pennsylvania, South Dakota, and Tennessee. JAMES T. COLLINS & ROBERT M. KOZUB, *STATE AND LOCAL TAXATION ANSWER BOOK* § 16.3 (1997).

Furthermore, this example does not consider the possibility of a generation-skipping tax. The generation-skipping tax applies when a transferor transfers an interest in property to a transferee who is of a generation which is at least two generations younger than the generation of the transferor. I.R.C. § 2613. The IRC imposes a generation-skipping transfer tax at a flat rate equal to the highest federal transfer rate in existence on the date of transfer. *Id.* Currently, the highest federal transfer rate is 55%. *Id.* § 2001(c)(1).

If a decedent does not possess any incidents of ownership in a life insurance policy on his life when he dies, his gross estate may exclude the proceeds from the policy under section 2042(2) of the Internal Revenue Code of 1986, as amended ("IRC").<sup>13</sup> Under this exclusion, the insurer must pay the proceeds under the life insurance policy to a beneficiary other than the estate of the insured.<sup>14</sup>

To lower the estate tax liability on the death benefit from a qualified plan, practitioners have developed the concept of a life insurance subtrust.<sup>15</sup> Through the use of a subtrust, practitioners have attempted to exclude the proceeds of life insurance policies held under a qualified plan from the gross estate of an insured participant by preventing him from having any incidents of ownership in the policies.<sup>16</sup> If the subtrust is successful, IRC section 2042(2) will treat the proceeds from life insurance policies held under the subtrust as if they came from an inter vivos irrevocable<sup>17</sup> life insurance trust and, therefore, the insured participant's gross estate will not be included in the proceeds.<sup>18</sup>

Part I of this Comment outlines the effects of various provisions of the IRC and the Employee Retirement Income Security Act of 1974, as amended,<sup>19</sup> ("ERISA") on life insurance within a qualified plan. Part I.A discusses the tax aspects of purchasing life insurance within a qualified plan. Part I.B discusses the anti-assignment requirements of the IRC and ERISA. Part I.C discusses the exclusive benefit rule under the IRC and ERISA. Part I.D discusses the survivor annuity requirements under the Retirement Equity Act of 1984 (REA).<sup>20</sup>

Part II analyzes how a life insurance subtrust attempts to remove incidents of ownership from the insured participant and whether this attempt complies with the anti-assignment

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13. *Id.* § 2042(2). See *Estate of Crosley v. Commissioner*, 47 T.C. 310, 316 (1966), *acq.*, 1967-2 C.B. 1 (holding that section 2042 includes life insurance in the gross estate of the decedent when, at the time of his death, he possesses incidents of ownership of the life insurance policies).

14. I.R.C. § 2042(1).

15. ANDREW J. FAIR, *THE GUARDIAN LIFE INSURANCE COMPANY OF AMERICA, THE QUALIFIED PLAN AS AN ESTATE PLANNING TOOL* 12 (1988). See also Kenneth C. Eliasberg, *IRS Opens the Way Toward Favorable Estate and Income Tax Treatment of Plan Distributions*, 10 *EST. PLAN.* 208, 210 (1983) (stating that an insured participant's incidence of ownership can be removed "by isolating the policy in a separate pension sub-trust over which the insured may not preside in any manner whatsoever").

16. I.R.C. § 2042(2).

17. The insured's gross estate includes a trust if it is revocable because he retained the right to alter, amend, revoke, or terminate the trust. *Id.* § 2038(a); Treas. Reg. § 20.2038-1 (as amended in 1962).

18. *Id.*

19. 29 U.S.C. § 1001.

20. Retirement Equity Act of 1984 § 203(b), I.R.C. § 417.

requirements under ERISA and the IRC, and under the survivor annuity requirements of the REA.

Part III proposes suitable exit strategies for life insurance policies within a subtrust if the Internal Revenue Service ("Service") and the courts determine that the use of a subtrust violates ERISA and the IRC.

Finally, Part IV concludes that, if a qualified plan uses a life insurance subtrust to avoid all incidents of ownership of life insurance policies in the insured participant, the subtrust will create a prohibited assignment of the participant's benefit within the plan.

## I. HOW THE IRC AND ERISA CAN AFFECT LIFE INSURANCE WITHIN A QUALIFIED PLAN

Various provisions of the IRC and ERISA should be considered before the decision is made to have a qualified plan purchase life insurance on the life of a participant. Subsection A compares how various IRC provisions treat life insurance within and without a qualified plan. Subsection B looks at the prohibition against the assignment or alienation of a participant's accrued benefits under a qualified plan. Subsection C discusses the exclusive benefit rule with which fiduciaries of every qualified plan must comply. Finally, Subsection D discusses what a qualified plan must provide for the surviving spouse of a participant.

### A. *How Federal Taxation Erodes the Value of Life Insurance Within a Qualified Plan.*

A qualified defined contribution plan<sup>21</sup> or defined benefit plan<sup>22</sup> may provide life insurance to the extent that the life insurance is incidental to the plan's primary purpose of providing deferred compensation.<sup>23</sup> If the trustee of a qualified plan

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21. A "defined contribution plan" provides an individual account for each participant. *Id.* § 414(i). The plan bases the amount of benefits to a participant solely on the amount contributed to his account plus any income, expenses, gains, losses, and forfeitures of accounts of other participants which the plan may allocate to his account. *Id.*

22. A "defined benefit plan" is a qualified plan which is not a defined contribution plan. *Id.* § 414(j).

23. Treas. Reg. §§ 1.401(b)(1)(i), (ii) (as amended in 1976). A defined contribution plan may satisfy the incidental benefit rule by limiting the aggregate of premiums that the plan may pay for ordinary life insurance on the life of a participant to less than 50% of the amount that the plan has allocated to the credit of the participant. Rev. Rul. 54-51, 1954-1 C.B. 147; Rev. Rul. 57-213, 1957-1 C.B. 157. An ordinary life insurance contract contains both non-decreasing death benefits and non-increasing premiums. Rev. Rul. 61-164, 1961-2 C.B. 99.

In the case of term insurance, the premium limitation is an amount not in

purchases insurance protection with participant consent and the plan provides the option to highly compensated employees,<sup>24</sup> the plan must also provide the option to non-highly compensated employees.<sup>25</sup>

The biggest tax advantage of buying life insurance within a qualified plan is that the employer can effectively deduct the premium.<sup>26</sup> This is because an amount equal to the premium is part of the employer's annual contribution on behalf of covered employees.<sup>27</sup>

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excess of 25% of the aggregate of the contributions that the plan has allocated to the credit of the participant. *Id.*

Any qualified plan, other than a profit-sharing plan, may satisfy the incidental benefit rule by limiting life insurance protection under the plan to no more than one hundred times the anticipated normal retirement benefit the plan provides. Rev. Rul. 74-307, 1974-2 C.B. 126; Rev. Rul. 68-453, 1968-2 C.B. 163.

If a profit sharing plan prohibits the use of trust funds that the plan has accumulated for less than two years to purchase and pay premiums on ordinary life insurance contracts, the Internal Revenue Service ("Service") deems the plan's insurance provision to be incidental. Rev. Rul. 66-143, 1966-1 C.B. 79. The Service derived this two-year accumulation rule from the general principle that a profit sharing plan may permit distribution of any funds that have accumulated in the plan for at least 18 months. Rev. Rul. 71-295, 1971-2 C.B. 184.

24. A "highly compensated employee" is:

any employee who - (A) was a 5-percent owner at any time during the year or the preceding year, or (B) for the preceding year - (i) had compensation from the employer in excess of \$80,000, and (ii) if the employer elects the application of this clause for such preceding year, was in the top-paid group of employees for the preceding year.

I.R.C. § 414(q)(1). For any year, an employee is a 5% owner if he owned, directly or indirectly, more than 5% of the employer at any time during such year. *Id.* § 414(q)(2). For any year, an employee is in the top-paid group of employees if he is in the top 20% of employees in terms of compensation paid by the employer during such year. *Id.* § 414(q)(3).

25. Treas. Reg. § 1.401(a)(4)-4(a) (as amended in 1993). The life insurance policies' terms and conditions must also be available on a nondiscriminatory basis. *Id.* at § 1.401(a)(4)-4(e)(2). However, differences in the terms of life insurance coverage based on the health conditions of participants will not violate the non-discrimination requirement. Rev. Rul. 68-245, 1968-1 C.B. 161. This is because the amount of employer contributions that a defined contribution plan allocates to the accounts of participants, or the amount of benefit that a participant accrues under a defined benefit plan, does not depend on whether the plan obtains insurance for the participant. *Id.*

26. 1A Pens. Plan Guide (CCH) ¶ 3810 (1994). Other advantages of life insurance within a qualified plan include: (1) participants secure the possibility of an immediate and substantial death benefit without relying and waiting on the returns from plan investments; (2) the cost of an annuity benefit option at retirement is fixed at current annuity prices; and (3) participants are not subject to federal income tax on the cost of any substandard risk rating by the insurer. Michael A. Laing, *Use of Life Insurance in Qualified Plans*, SE03 ALI-ABA 767, 771-72 (July 12, 1999).

27. 1A Pens. Plan Guide (CCH) ¶ 3810 (1994).

A qualified plan allows a participant to defer income tax on amounts his employer contributes to the plan, until the plan distributes the amounts to the participant.<sup>28</sup> However, if the qualified plan provides a life insurance benefit,<sup>29</sup> the benefit is taxable to the insured participant for the tax year in which the plan provides the benefit.<sup>30</sup> This result occurs because the IRC treats the insurance as a current benefit immediately distributed to the insured participant by the plan.<sup>31</sup> Also, unlike group term coverage, the insured participant cannot exclude the cost of the first \$50,000 of insurance from his income.<sup>32</sup>

If an amount of money was owed to a cash-method decedent when he died and the amount is paid to his beneficiary after his death, the beneficiary stands in the shoes of the decedent.<sup>33</sup> Such an amount is considered income with respect of a decedent (IRD) to the beneficiary because the amount is not properly includible in the final income tax return of the decedent.<sup>34</sup> A qualified plan distribution to the beneficiary of a deceased participant is taxable to the beneficiary as IRD because the plan entitled the participant to receive his vested accrued benefit under the plan when he died, and his final income tax return excludes such amount.<sup>35</sup>

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28. I.R.C. § 402(a).

29. A "life insurance benefit" is the excess of the face amount of a life insurance policy over the cash surrender value of the policy. Treas. Reg. § 1.72-16(b)(3) (1963).

30. *Id.* § 1.72-16(b)(2).

31. *Id.* An insured participant who is a common law employee is subject to federal income tax on the value of the insurance protection (P.S. 58 cost). Rev. Rul. 55-747, 1955-2 C.B. 22. The plan determines the amount of insurance protection by multiplying the participant's share of the death benefit by the one-year term rates in the P.S. 58 cost table. *Id.* The P.S. 58 cost table sets forth the lowest acceptable net premium cost per \$1,000 of insurance protection for individuals between ages 15 and 75. *Id.* As an alternative to the P.S. 58 cost table, the participant may use the current premium rates that the insurer publishes and charges for individual one-year term life insurance for standard risks if: (1) such rates are lower than the rates in the P.S. 58 cost table; and (2) the insurer applies the lower rates to initial issue insurance. Rev. Rul. 66-110, 1966-1 C.B. 12; Rev. Rul. 67-154, 1967-1 C.B. 11. The participant obtains a basis for any P.S. 58 cost that he must include in his gross income. I.R.C. § 72(f); Treas. Reg. § 1.72-16(b)(4) (1963).

An insured participant who is self-employed may not deduct from his gross income that portion of his qualified plan contribution that is allocable to the P.S. 58 cost. I.R.C. § 404(e); Treas. Reg. § 1.404(e)-1(b)(1), § 1.404(e)-1(f) (as amended in 1979). A self-employed individual does not obtain any basis for the P.S. 58 cost that IRC § 404(e) prevented him from deducting from his gross income. I.R.C. § 72(m)(2); Treas. Reg. § 1.72-16(b)(4) (1963).

32. I.R.C. § 72(m)(3)(B).

33. Treas. Reg. § 1.691(a)-1(b) (as amended in 1965).

34. *Id.*

35. Rev. Rul. 69-297, 1969-1 C.B. 131; Rev. Rul. 68-506, 1968-2 C.B. 332; Rev. Rul. 54-601, 1954-2 C.B. 197. See also *Hess v. Commissioner*, 271 F.2d 104, 106 (3d Cir. 1959) (holding that lump-sum payments that the decedent's

A beneficiary does not fare as well with insured death benefits paid by a qualified plan as the beneficiary would have with life insurance paid outside of a qualified plan.<sup>36</sup> Upon an insured participant's death, the beneficiary of the life insurance proceeds must include the cash value of the policy in gross income as IRD,<sup>37</sup> but the beneficiary may exclude any insurance proceeds in excess of the cash surrender value of the policy.<sup>38</sup> Conversely, if the proceeds were payable under a policy maintained outside of a qualified plan, the beneficiary would generally exclude the entire proceeds from his gross income.<sup>39</sup>

For purposes of the federal estate tax, to the extent a decedent had an interest in property when he died, his gross estate includes the value of the property.<sup>40</sup> Former IRC section 2039(c) set forth the estate tax exclusion for death benefits, including life insurance proceeds, from a qualified plan.<sup>41</sup> The Deficit Reduction Act of 1984 ("DEFRA") repealed IRC section 2039(c).<sup>42</sup> There currently is some question whether estate tax inclusion for life insurance proceeds from a qualified plan should be determined under IRC section 2042 as life insurance proceeds or under IRC section 2039(a) as annuity payments.<sup>43</sup>

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children received, pursuant to provisions of pension plans in which the decedent participated, were taxable to the children as gross income).

36. I.R.C. § 72(m)(3)(C).

37. *Id.* The plan determines cash value immediately prior to the death of the participant. Treas. Reg. § 1.72-16(c)(2)(ii) (1963).

38. I.R.C. § 101(a). The exclusion is subject to the transfer for value provisions of IRC section 101(a)(2). Treas. Reg. § 1.101-1(b)(1) (as amended in 1982). The portion of the life insurance proceeds which the beneficiary includes in gross income may be eligible for income averaging or, if the beneficiary is the participant's surviving spouse, for rollover to an individual retirement arrangement ("IRA") in the same manner as any other plan benefits. I.R.C. §§ 402(c)(9), 402(d).

39. I.R.C. § 101(a)(1).

40. *Id.* § 2033. The decedent's gross estate includes all property which the decedent beneficially owned when he died. Treas. Reg. § 20.2033-1(a)(1) (as amended in 1963). Prior to the enactment of the Tax Reform Act of 1976 ("TRA"), the IRC exempted a qualified plan distribution from federal estate tax to the extent the distribution was attributable to employer contributions and was payable for the benefit of a beneficiary other than the estate of the participant. I.R.C. § 2039(c) (1976). Under the TRA, the IRC no longer excluded payments of lump-sum distributions which a qualified plan made on account of the death of the participant from the gross estate of the participant. I.R.C. § 2039(c) (1977). The Tax Equity and Fiscal Responsibility Act of 1982 placed a \$100,000 ceiling on the exclusion. I.R.C. § 2039(c) (1983).

41. I.R.C. § 2039(c) (1983). The exclusion under IRC section 2039(c) applied regardless of any other provisions of the IRC. *Id.*

42. Deficit Reduction Act of 1984 § 525(a), I.R.C. § 2039(c). DEFRA eliminated the exclusion completely, but there are grandfather exceptions to the elimination of the estate tax exclusion for qualified plan distributions. *Id.*

43. In 1967, the Service ruled that life insurance proceeds were subject to IRC section 2039 and, therefore, the insured participant's estate could fully

Under IRC section 2042, if the insured participant's beneficiary is not the participant's estate, the proceeds from the life insurance policy on the participant's life are included in his estate only if he died while possessing some "incident of ownership" in the policy.<sup>44</sup> The Supreme Court has held that these

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exclude the proceeds under IRC section 2039(c). Rev. Rul. 67-371, 167-2 C.B. 329. The Service made this ruling prior to the enactment of TEFRA and DEFRA. However, in 1982, the Service concluded that IRC section 2042 controls the life insurance portion of a distribution from a qualified plan. Rev. Rul. 82-199, 1982-2 C.B. 211. This is provided in IRC section 2039(a).

The Joint Committee on Taxation concluded that an insured participant's gross estate includes the proceeds from life insurance policies payable under a qualified plan on the life of the participant if the proceeds are payable, directly or indirectly, to the estate or the executor under IRC section 2042(1). THE JOINT COMMITTEE ON TAXATION, 98TH CONG., TAX REFORM PROPOSALS: PENSION AND DEFERRED COMPENSATION 133 (1985). The Joint Committee on Taxation also concluded that the insured participant's gross estate includes such proceeds payable to any other beneficiary if the decedent possessed any of the incidents of ownership on his date of death. *Id.*

44. I.R.C. § 2042(2). For purposes of determining incidents of ownership, the Service does not limit the meaning of "ownership" to a policy's technical legal ownership. Treas. Reg. § 20.2042-1(c)(2) (as amended in 1974). Instead, "ownership" refers to such things as: (1) the right to the economic benefits of the policy; (2) the power to change the beneficiary; (3) the power to surrender the policy; (4) the power to cancel the policy; (5) the power to revoke an assignment; (6) the power to pledge the policy for a loan; and (7) the power to obtain a loan from the insurer against the cash value of the policy. H.R. REP. NO. 77-2333, at 218 (1942). Compare *Nance v. United States*, 430 F.2d 662, 663 (9th Cir. 1970) (holding that the insured retained an incident of ownership when he retained the right, in conjunction with the beneficiary, to change the beneficiary), and *Broderick v. Keefe*, 112 F.2d 293, 296 (1st Cir. 1940) (holding that the insured retained an incident of ownership when the insured made a gift of a policy's proceeds contingent upon the primary beneficiary surviving the insured and the insured retained the power to cancel the interest of the contingent beneficiaries without their consent), and *Newbold's Estate v. Commissioner*, 158 F.2d 694, 695 (2d Cir. 1946) (holding that the power to terminate the trust is an incident of ownership), and *Schwager v. Commissioner*, 64 T.C. 781 (1975) (holding that the power to veto any change in the beneficiary designation or an assignment or cancellation of the policy is an incident of ownership), and *St. Louis Union Trust Co. v. United States*, 262 F. Supp. 27, 29 (1966) (holding that the grantor held an incident of ownership where the trust instrument provided that "all payments, dividends, surrender values, options and benefits of any kind which may accrue on account thereof during the lifetime of the said Grantor shall be for his benefit and shall not be subject to this Trust"), and *Estate of Lumkin v. United States*, 474 F.2d 1092 (5th Cir. 1973) (holding that the insured had an incident of ownership because he had the power to elect the mode of settlement), and Tech. Adv. Mem. 91-28-008 (July 12, 1991) (ruling that the option to repurchase the policy from the assignee is an incident of ownership), with Tech. Adv. Mem. 88-19-001 (May 13, 1988) (ruling that an insured does not have an incident of ownership if the life insurance trust provides that the insured has a power to terminate the interest of his spouse if he is divorced), and *Estate of Connelly v. United States* 551 F.2d 545, 548 (3d Cir. 1977) (holding that the insured did not have an incident of ownership, even though he had the right to assign the power to

powers are general powers to exercise ownership over a life insurance policy and that, in determining incidents of ownership at death, the insured's actual ability to exercise these powers when he died is irrelevant.<sup>45</sup> The insured participant's reservation of any incident of ownership in a life insurance policy will cause his gross estate to include proceeds from the policy.<sup>46</sup>

If the insured participant retained a reversionary interest in the policy worth in excess of 5% of the policy's value immediately before he died, IRC section 2042 treats him as possessing some incidents of ownership in the policy.<sup>47</sup> A reversionary interest is the possibility that a life insurance policy or its proceeds will return to the decedent or his estate or will be subject to a power of disposition by him.<sup>48</sup> So, in other words, the insured having a reversionary interest in excess of 5% of the value of the policy will cause his gross estate to include the proceeds from the policy.<sup>49</sup>

In contrast, under IRC section 2039(a), the insured participant's gross estate includes the policy proceeds regardless of whether he died while possessing any incident of ownership in the policy.<sup>50</sup>

### *B. The Prohibition Against Assignment or Alienation Under the IRC and ERISA.*

To ensure that a participant's accrued benefits are actually available for retirement purposes, a qualified<sup>51</sup> plan must prohibit

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elect optional modes of settlement exercisable in conjunction with his employer and the insurer, because the insured could change only when the beneficiary would receive the proceeds), *and* Estate of Chapman v. Commissioner, 56 T.C.M. (CCH) 1451, 1453 (1989) (holding that the decedent did not possess any incidents of ownership because he did not have the capacity to do anything to affect the disposition of the proceeds).

45. Commissioner v. Estate of Noel, 380 U.S. 678, 684 (1965).

46. Rev. Rul. 79-129, 1979-1 C.B. 306. See also St. Louis Union Trust Co. v. United States, 262 F. Supp. 27, 28 (E.D. Mo. 1966) (holding that the proceeds of policies were includible in the estate of the decedent because she had the right, during her lifetime, to obtain the cash surrender value of the policies); Farwell v. United States, 243 F.2d 373, 376 (7th Cir. 1957) (holding that the decedent retained incidents of ownership over life insurance policies where he retained the right to change the policy beneficiaries, even though the last beneficiaries he named were trustees of an irrevocable trust).

47. I.R.C. § 2042(2).

48. *Id.*

49. *Id.*

50. *Id.* § 1039(a).

51. "To be qualified, both a plan's terms and operations must meet the statutory requirements." Fazi v. Commissioner, 102 T.C. 702 (1994). See also Guidry v. Sheet Metal Workers Nat'l Pension Fund, 493 U.S. 365, 371 (1990) (holding that section 206(d)(1) of the Employee Retirement Income Security Act of 1974 prohibits the assignment or alienation of pension plan benefits).

the assignment or alienation of the plan's benefits.<sup>52</sup> According to the Service, this prohibition means that benefits under a qualified plan may not be "anticipated, assigned (either in law or in equity), alienated or subject to attachment, garnishment, levy, execution, or other legal or equitable process."<sup>53</sup> The Service's interpretation of this prohibition also applies to ERISA section 206(d).<sup>54</sup>

"Assignment" or "alienation" includes any direct or indirect arrangement, whether or not revocable, whereby a party acquires an enforceable right or interest against a qualified plan in any portion of a payment which is or may become payable to a participant or beneficiary from the participant or beneficiary.<sup>55</sup> The Service has ruled that, if a key employee<sup>56</sup> waives any portion of the present value of the employee's accrued benefit within a

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52. 29 U.S.C. § 1056(d) (1999); I.R.C. § 401(a)(13); Treas. Reg. § 1.401(a)-13(b) (as amended in 1988); H.R. REP. NO. 93-807, at 68 (1974).

53. Treas. Reg. § 1.401(a)-13(b)(1) (as amended in 1988).

54. Exec. Order No. 12,108, 44 Fed. Reg. 1,065 (1978). Under the ERISA Reorganization Plan No. 4 of 1978, the Carter administration transferred authority to issue regulations, rulings, opinions, variances, and waivers from the United States Department of Labor to the United States Department of the Treasury under most sections of Part 2, Subtitle B, Title I of ERISA, including ERISA section 206. *Id.*

55. Treas. Reg. § 1.401(a)-13(c)(1) (as amended in 1988). *See Merchant v. Kelly, Haglund, Garnsey & Kahn*, 874 F. Supp. 300, 303 (D. Colo. 1995) (holding that a post-nuptial agreement violated the anti-alienation rule because it provided a participant's spouse with rights and interest in plan assets even though the spouse did not participate in the plan).

The following arrangements are exceptions to the anti-assignment rule: (1) an arrangement for the recovery of certain benefits that a terminated plan pays; (2) an arrangement for withholding federal, state, or local tax from benefit payments; (3) an arrangement for recovering overpayments of benefits that a plan previously paid to a participant; (4) an arrangement for transferring benefit rights between qualified plans; and (5) an arrangement for the direct deposit of benefit payments to a participant's account in a bank, savings and loan, or credit union. Treas. Reg. § 1.401(a)(13)(c)(1) (as amended in 1988). Also, a divorced-related assignment is not a prohibited assignment if it is made pursuant to a qualified domestic relations order. I.R.C. §§ 401(a)(13)(B), 414(p).

A qualified plan may permit a participant to direct the plan to pay any portion of a benefit payment to a third party if: (1) the participant may revoke the arrangement; and (2) the third party acknowledges that, except to the extent of the payments that the third party actually receives under the arrangement, the third party has no enforceable right to any portion of a benefit payment. Treas. Reg. § 1.401(a)-13(e) (as amended in 1988).

56. A "key employee" is a participant who, at any time during the plan year or any of the four immediately preceding plan years: (1) owns, directly or indirectly, more than 5% of the employer; (2) owns, directly or indirectly, more than 1% of the employer and receives annual compensation of more than \$150,000 from the employer; (3) owns, directly or indirectly, one of the ten largest interests in the employer and is one of the ten employees who receives annual compensation of more than \$30,000 from the employer; or (4) is an officer of the employer and receives annual compensation of more than \$65,000 from the employer. I.R.C. § 416(i).

qualified plan, such waiver violates the restriction on causing an impermissible assignment or alienation of the benefit of the employee.<sup>57</sup>

Generally, a participant may not waive or assign his rights under an ERISA plan.<sup>58</sup> The Supreme Court has refused to recognize any implied exceptions to the prohibition on the assignment or alienation of pension benefits.<sup>59</sup> The Service has taken the position that a prohibited assignment or alienation can disqualify a plan from taking advantage of the preferential tax treatment available under the IRC.<sup>60</sup>

### C. *The Exclusive Benefit Rule Under the IRC and ERISA.*

A qualified plan must be for the exclusive benefit of participants or their beneficiaries.<sup>61</sup> However, the plan must be primarily for the benefit of participants and benefits for beneficiaries must be merely incidental.<sup>62</sup> Therefore, a qualified plan may not provide that a participant may irrevocably elect, prior to retirement, to have the plan pay any portion of his interest in the plan, which would otherwise be available to him while he is alive, only to a designated beneficiary after he dies.<sup>63</sup>

ERISA<sup>64</sup> applies to all qualified plans.<sup>65</sup> Under the exclusive benefit rule under ERISA, a plan fiduciary must discharge his duties in the sole interest of participants and beneficiaries and for the exclusive purposes of providing benefits and paying reasonable

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57. Priv. Ltr. Rul. 91-46-005 (Nov. 20, 1991).

58. *Ferris v. Marriot Family Restaurants, Inc.*, 878 F. Supp. 273, 277 (D. Mass. 1994).

59. *Guidry v. Sheet Metal Workers Pension Fund*, 493 U.S. 365, 369 (1990).

60. *McLean v. Central States, Southeast & Southwest Areas Pension Fund*, 762 F.2d 1204, 1206 (4th Cir. 1985).

61. I.R.C. § 401(a). A qualified plan may restrict a participant's beneficiary designation to specified persons or a class of specified persons who are the natural objects of the participant's bounty, the participant's estate, or the participant's dependents. Rev. Rul. 70-173, 1970-1 C.B. 87. A plan may restrict a participant's beneficiaries to the participant's spouse or spouse and children. *Rehmar v. Smith*, 555 F.2d 1362, 1369 (9th Cir. 1976). A plan may permit the plan trustee to designate the beneficiary of a participant after the participant advises the trustee. *Commissioner v. Meldrum & Fewsmith, Inc.*, 20 T.C. 790 (1956).

62. Treas. Reg. § 1.401-1(b)(1) (as amended in 1976).

63. Rev. Rul. 56-656, 1956-2 C.B. 280.

64. Congress enacted ERISA to establish "a comprehensive federal scheme for the protection of pension plan participants and their beneficiaries." *American Tel. & Tel. Co. v. Merry*, 592 F.2d 118, 120 (2d Cir. 1979). Congress intended ERISA to assure that American workers "may look forward with anticipation to a retirement with financial security and dignity, and without fear that this period of life will be lacking in the necessities to sustain them as human beings within our society." S. REP. NO. 93-127, at 13 (1974).

65. 29 U.S.C. § 1002(2)(A) (1999).

administrative expenses.<sup>66</sup> If a plan fiduciary breaches the exclusive benefit rule, the breach could result in the loss of the tax-qualified status of the plan.<sup>67</sup>

*D. The Survivor Annuity Requirements of the REA.*

If a married<sup>68</sup> participant survives to his annuity starting date,<sup>69</sup> the IRC requires most qualified plans<sup>70</sup> to pay his vested accrued benefit in the form of a qualified joint and survivor annuity (QJSA) unless he elects otherwise with the consent of his spouse.<sup>71</sup> A QJSA is an annuity for the life of the participant with a survivor annuity for the life of his surviving spouse.<sup>72</sup> The survivor annuity may not be less than 50%, nor greater than 100%, of the amount which is payable during the joint lives of the participant and spouse.<sup>73</sup>

If a married participant dies before his annuity starting date and the qualified plan is subject to the QJSA requirements, IRC sections 401(a)(11) and 417 require the plan to pay the participant's accrued benefit to his surviving spouse in the form of a qualified pre-retirement survivor annuity (QPSA).<sup>74</sup> A QPSA is an annuity for the life of the participant's surviving spouse.<sup>75</sup>

A participant's waiver of the QJSA and QPSA forms of benefit is effective only if his spouse consents or the plan establishes that

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66. *Id.* §1104(a)(1)(A).

67. H.R. CONF. REP. NO. 93-807, at 463 (1974).

68. If the participant was not married to the applicable spouse for the period of one year or more preceding the earlier of the participant's annuity starting date or the date of his death, the IRC does not treat him as married for purposes of the survivor annuity requirements. I.R.C. § 417(d); Treas. Reg. § 1.401(a)-20 at Q&A 25(b)(2) (1988).

69. The "annuity starting date" is the first day of the first period for which a qualified plan pays an amount as an annuity or in any other form. Treas. Reg. § 1.401(a)-20 at Q&A-10(b)(1) (1988).

70. The survivor annuity requirements apply unconditionally to defined benefit plans and defined contribution plans (other than profit-sharing plans and stock bonus plans), except for government plans, church plans, plans which have not permitted employer contributions after the passage of ERISA, and plans of fraternal organizations. I.R.C. § 401(a)(11)(B). The survivor annuity requirements apply to a profit-sharing plan or a stock bonus plan unless: (1) on the death of a participant, the plan provides that it will pay his vested accrued benefit in full to his surviving spouse or, if his surviving spouse consents, to his designated beneficiary; (2) the participant does not elect to have the plan pay his benefits in the form of a life annuity; and (3) as to the participant, the plan is not a direct or indirect transferee of a plan to which the survivor annuity requirements applied. I.R.C. § 411(a)(11)(B); Treas. Reg. § 1.401(a)-20 at Q&A 3 (1988).

71. I.R.C. §§ 401(a)(11), 417.

72. *Id.* at § 417(b).

73. Treas. Reg. § 1.401(a)-11(b)(2) (as amended in 1988).

74. I.R.C. §§ 401(a)(11), 417.

75. *Id.* § 417(c)(1).

there is no spouse or that the plan cannot locate the spouse.<sup>76</sup>

If a participant in a defined benefit plan dies after attaining the earliest retirement age<sup>77</sup> under the plan, the amount of payments under the QPSA may not be less than the payments that the plan would have made under a QJSA had the participant retired with an immediate QJSA on the day before he died.<sup>78</sup> If a participant in a defined benefit plan dies on or before the earliest retirement age under the plan, the amount of the payments under the QPSA must be equal to at least the amount of the payments to the surviving spouse under a QJSA if the participant had: (1) survived to the earliest retirement age; (2) taken a QJSA upon surviving to the earliest retirement age; and (3) separated from service and died on the day after surviving to the earliest retirement age.<sup>79</sup>

If a defined contribution plan is subject to the survivor annuity requirements, the present value of the payments under the QPSA must be at least 50% of the participant's vested account balance as of the date of his death.<sup>80</sup>

## II. WILL A LIFE INSURANCE SUBTRUST WORK?

If life insurance proceeds are payable to the insured decedent's estate, his gross estate includes the proceeds.<sup>81</sup>

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76. *Id.* § 417(a)(1). A participant may waive a QJSA within ninety days of his annuity starting date. *Id.* §§ 417(a)(1)(A)(i), 417(a)(6)(A). A participant may waive a QPSA on or after the first day of the plan year in which he attains age 35 or, if he does not survive until age 35, before the first day of the plan year in which he would have attained age 35. *Id.* §§ 417(a)(1)(A)(i), 417(a)(6)(B). If the participant waives the QJSA or QPSA form of benefit, the qualified plan must give him an opportunity to revoke the waiver within the relevant election period. *Id.* § 417(a)(2).

77. The "earliest retirement age" is the early retirement age under the plan or, if there is no early retirement age, the normal retirement age. Treas. Reg. § 1.401(a)(20) at Q&A 17 (1988).

78. I.R.C. § 417(c)(1)(A). The plan must calculate the amount of the QPSA as of the date of death of the participant. Treas. Reg. § 1.401(a)(2)-20 at Q&A 18 (1988).

79. I.R.C. § 417(c)(1)(A). A plan must calculate the amount of the QPSA as of the date of earliest retirement or, if the participant separated from service prior to death, by reference to the date of separation from service. Treas. Reg. § 1.401(a)(2)-20 at Q&A 19 (1988). The surviving spouse must be permitted to direct the plan to commence benefits under the QPSA not later than the calendar month in which the participant would have attained the earliest retirement age under the plan if he had survived. Treas. Reg. § 1.401(a)-20 at Q&A 22(a) (1988). However, the plan may permit benefits under the QPSA to commence earlier. *Id.*

80. I.R.C. § 417(2); Treas. Reg. § 1.401(a)(2)-20, at Q&A 20 (1988). A defined contribution plan must permit the surviving spouse to direct the commencement of payments under a QPSA within a reasonable period after the participant dies. Treas. Reg. § 1.401(a)(20) at Q&A 22(b) (1988).

81. I.R.C. § 2042(1). If the life insurance proceeds are "receivable by or for

Similarly, the insured decedent having any incidents of ownership over a life insurance policy when he died will cause his gross estate to include the proceeds from the policy.<sup>82</sup>

A common strategy to avoid estate tax on life insurance proceeds is to transfer the policy to an inter vivos irrevocable life insurance trust in order to eliminate any incidents of ownership of the insured, including the right to designate beneficiaries or borrow against the policy.<sup>83</sup> The insured must not retain any incident of ownership in the policy under the trust or his gross estate will include the proceeds from the policy upon his death.<sup>84</sup>

An insured may establish an irrevocable life insurance trust by purchasing a life insurance policy on his life and placing that policy in trust or by having the trustee purchase a policy directly.<sup>85</sup> When the insured dies, the insurer pays the proceeds from the insurance policies on the life of the insured to the trustee.<sup>86</sup> Then, the trustee allocates the proceeds to the trust principal and distributes the principal as set forth in the trust document.<sup>87</sup>

The irrevocable life insurance trust is a proven method of excluding life insurance proceeds from the gross estate of an insured decedent. To qualify for irrevocability, a life insurance trust must contain certain restrictive provisions in order to sever any relationship between the individual establishing the trust and

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the benefit of the estate," the decedent's gross estate includes the proceeds. Treas. Reg. § 20.2042-1(a)(1) (as amended in 1974). In cases where life insurance proceeds are receivable under the terms of an insurance policy, but are subject to a legally enforceable obligation against the estate, the amount of such proceeds the estate needs to pay such obligation is includible in the estate of the decedent. Treas. Reg. § 20.2042-1(b)(1) (as amended in 1979). If one-half of the life insurance proceeds belong to the decedent's spouse because the proceeds are community assets under state community property law, the Service considers the other one-half of the proceeds to be receivable by or for the benefit of the estate of the decedent. Treas. Reg. § 20.2042-1(b)(2) (as amended in 1979). See *Estate of Street v. Commissioner*, 73 T.C.M. (CCH) 1787 (1997) (holding that the decedent's gross estate included the entire amount of insurance proceeds on his life under IRC section 2042 because state law converted the policies from community property to separate property).

82. I.R.C. § 2042(2).

83. *Estate of Crosley v. Commissioner*, 47 T.C. 314 (1966), *acq.*, 1967-2 C.B. 1.

84. *St. Louis Union Trust Co. v. United States*, 262 F. Supp. 27, 29 (E.D. Mo. 1966).

85. An inter vivos trust may own a life insurance policy, regardless of whether the trust is irrevocable or whether it is funded with other assets. WILLIAM F. FRATCHER AND AUSTIN W. SCOTT, *THE LAW OF TRUSTS* § 57.3 (4th ed. 1989). If the insured transfers a life insurance policy to an irrevocable life insurance trust within the three-year period ending on his date of death, his gross estate includes the proceeds from the policy even if he does not retain any incidents of ownership in the policy after the transfer. *Id.*

86. 3 Est. Plan. & Tax'n Coordinator ¶ 43,845 (Apr. 20, 1999).

87. *Id.*

the trustee.<sup>88</sup> A life insurance trust accomplishes this by transferring all incidents of ownership to a third party, the trustee of the trust, with regard to the life insurance policy or policies.

The life insurance subtrust encompasses the rationale of an irrevocable life insurance trust in the context of insured death benefits from a qualified plan.<sup>89</sup> The subtrust concept is based on third party ownership with the insured participant in the plan holding no incidents of ownership.<sup>90</sup>

The plan's sponsor irrevocably<sup>91</sup> designates a trustee (special trustee) to hold the life insurance policies under an irrevocable trust (subtrust) with the special trustee as the owner and beneficiary of the policies.<sup>92</sup> The subtrust gives the special trustee the responsibility of purchasing<sup>93</sup> the policies.<sup>94</sup> The special trustee must offer to purchase policies for all participants in the plan because death benefits are ancillary benefits which a plan must offer on a nondiscriminatory basis.<sup>95</sup> The special trustee owns the policies as a trustee of the qualified plan.<sup>96</sup> As such, the special trustee is subject to the fiduciary standards established by ERISA.<sup>97</sup>

The special trustee is usually a bank, a trust company, a non-beneficiary family member or friend, or a professional adviser to

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88. See *Commissioner v. Holmes' Estate*, 326 U.S. 480, 484-90 (1946) (holding that a trust is revocable if the grantor retained the power to revoke or terminate the trust); *Commissioner v. Hager Estate* 173 F.2d 613, 614-16 (3d Cir. 1949) (holding that a trust is revocable if the grantor retained the power to control and manage the trust principal); *Millard v. Maloney*, 121 F.2d 257, 258 (3d Cir. 1941), *cert. denied*, 314 U.S. 636 (1941) (holding that a trust is revocable if the grantor retained the power to change the beneficiary).

89. Sherwin P. Simmons, *Contemporary Use of Life Insurance - Qualified Plans; Split Dollar; COLI*, CA02 ALI-ABA 107, 109 (Nov. 13, 1995) [hereinafter *Contemporary Use of Life Insurance*].

90. *Id.* At 109-10.

91. The designation must be irrevocable to prevent the insured participant from having power to exercise control over the special trustee. Andrew J. Fair, *Death Before Retirement: Life Insurance Funded Through Qualified Plans*, C660 ALI-ABA 119, 128 (Oct. 16, 1991) [hereinafter *Death Before Retirement*]. When a plan sponsor establishes a subtrust, the sponsor should select successors to the special trustee because the subtrust's terms are irrevocable. *Id.*

92. *Id.*

93. If the life insurance policy has already been purchased, the special trustee receives the policy from the owner. *Contemporary Use of Life Insurance*, *supra* note 89, at 109.

94. *Id.* at 110.

95. Treas. Reg. § 1.401(a)(4)-4 (as amended in 1983).

96. *Death Before Retirement*, *supra* note 91, at 128.

97. *Id.* ERISA requires a plan trustee to discharge his duties "in accordance with the documents and instruments governing the plan." 29 U.S.C. § 1104(a)(1)(D) (1999). A participant, beneficiary, fiduciary, or the United States Department of Labor may file a civil action to enjoin any act or practice violating ERISA or the terms of a plan. *Id.* §§ 1132(a)(3), (5).

the participant.<sup>98</sup> The special trustee must not be the insured participant or a potential beneficiary.<sup>99</sup> The participant cannot be the special trustee as he cannot possess any powers over a policy on his life.<sup>100</sup> In most states, an insured's beneficiary cannot be the special trustee because a trustee in those states may not exercise discretion over trust assets for his own benefit.<sup>101</sup>

If an insured has the right to remove and replace the trustee of an irrevocable life insurance trust, such a right is a prohibited power which results in the trust's principal being subjected to estate tax.<sup>102</sup> Therefore, a subtrust's insured participant must not have any power to control the special trustee directly or indirectly through the participant's control of the plan sponsor or the plan trustee.<sup>103</sup> If a trust's governing instrument or applicable state law requires that a replacement trustee be unrelated and non-subordinate to a taxpayer, the Service will not impute the taxpayer's right to remove and replace a trustee to the taxpayer.<sup>104</sup> Under the subtrust agreement, the special trustee has the power to select the beneficiary of the life insurance proceeds from the insured participant's intended class of beneficiaries.<sup>105</sup> This class usually includes the participant's family members, the

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98. *Death Before Retirement*, *supra* note 91, at 128.

99. *Id.* at 127.

100. *Id.* at 128.

101. *Contemporary Use of Life Insurance*, *supra* note 89, at 110.

102. See Rev. Rul. 79-353, 1979-2 C.B. 325 (ruling that the grantor's right to remove and replace a corporate trustee with another corporate trustee was the equivalent of reserving the trustee powers); Priv. Ltr. Rul. 89-22-003 (Feb. 24, 1989) (ruling that the Service will attribute any power a trustee possesses to the insured if the power would be an incident of ownership under IRC section 2042 and the insured can remove the trustee and appoint a successor, regardless of whether the successor must be a corporate trustee). *But see* Estate of Wall v. Commissioner, 101 T.C. 300, 305-6 (1993) (rejecting the Service's position in Rev. Rul. 79-353 that a grantor's right to remove and replace a corporate trustee with another corporate trustee is the equivalent of reserving the trustee powers); Estate of Headrick v. Commissioner, 93 T.C. 171 (1989), *aff'd*, 918 F.2d 1263, 1264 (6th Cir. 1990) (holding that the decedent's gross estate did not include an insurance policy on his life under IRC section 2035(A) even though he could replace any of the original trustees with a corporate trustee).

103. Sherwin P. Simmons, *Current Estate Planning Problems: Insurance in Qualified Plans - Selected Topics*, SA 70 ALI-ABA 449, 466-67 (Apr. 22, 1996) [hereinafter *Current Estate Planning Problems*].

104. Rev. Rul. 95-58, 1995-2 C.B. 191. A non-adverse party is unrelated and non-subordinate to a taxpayer if the party is not: (1) the taxpayer's spouse living with the taxpayer, parent, sibling, or employee; (2) a corporation in which the taxpayer and the trust hold significant stock in terms of voting control; or (3) a corporation's employee who is subordinate to the taxpayer who is an executive within the corporation. I.R.C. § 672(c).

105. *Death Before Retirement*, *supra* note 91, at 128. A qualified plan does not have to grant a participant the right to designate his own beneficiary. Rev. Rul. 70-173, 1970-1 C.B. 87.

participant's estate, and a revocable or irrevocable trust which the participant established.<sup>106</sup>

If the special trustee selects the beneficiary after the participant dies, the special trustee can select a trust which is revocable during the lifetime of the insured participant.<sup>107</sup> If the special trustee designates a trust and the Service does not treat the trust's corpus as an asset of the insured participant or his spouse, the insurance proceeds should be excluded from the estates of the participant and his spouse.<sup>108</sup>

If the insured participant does not control the selection of the beneficiary and the special trustee does not select the beneficiary until the participant dies, the insured participant does not possess the power to designate the beneficiary under the subtrust.<sup>109</sup> To prevent the 5% possibility of reverter, the subtrust must not allow the special trustee or the plan trustee to distribute the policy to the participant or to convert the policy to an annuity payable to the participant.<sup>110</sup>

Upon the insured participant's death, the insurance company pays the policy proceeds to the special trustee as the policy's named beneficiary.<sup>111</sup> The special trustee then distributes the proceeds to the selected beneficiary.<sup>112</sup> If the special trustee must pay all of the policy proceeds to the selected beneficiary, the amount at risk<sup>113</sup> payable as a death benefit will not be subject to income tax.<sup>114</sup>

If the subtrust arrangement allows for the exclusion of the life insurance proceeds from the insured participant's estate, the only federal taxation that the plan's insured death benefits will accrue will be federal income tax on the cash value of the policy.<sup>115</sup> The cash value will be included in the beneficiary's gross income as income with respect to a decedent and the cash value will be

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106. *Death Before Retirement*, *supra* note 91, at 128.

107. *Death Before Retirement*, *supra* note 91, at 129.

108. *Id.*

109. *Id.*

110. *Current Estate Planning Problems*, *supra* note 103, at 466. Avoiding the 5% possibility of reverter should be easier in a defined benefit plan than a defined contribution plan. *Id.* This is because a defined benefit plan's trustee holds all assets other than life insurance policies in an unallocated fund, while a defined contribution plan uses account balances. *Id.* However, if there are a small number of defined benefit plan participants, the plan's funds may be insufficient to distribute a benefit to an insured participant without applying the cash value of the policy towards that distribution. *Id.*

111. *Contemporary Use of Life Insurance*, *supra* note 89, at 110.

112. *Id.*

113. The "amount at risk" under the policy is the difference between the amount which the special trustee pays as a death benefit and the cash value of the policy. I.R.C. § 72(m)(3)(C).

114. *Id.*

115. *Id.*

determined as of the time immediately prior to the death of the insured participant.<sup>116</sup>

Assuming that a subtrust arrangement is successful in removing all of an insured participant's incidents of ownership in the policy, the most important question that the arrangement raises from the qualified plan prospective is whether the arrangement creates a violation of ERISA section 206(d)(1)<sup>117</sup>, IRC section 401(a)(13)<sup>118</sup>, and Treasury Regulation section 1.401(a)-13(c)(1)(ii)<sup>119</sup>. In other words, how can a life insurance subtrust remove all of a plan participant's incidents of beneficial ownership from a benefit which ERISA and the IRC prohibit the participant from assigning or alienating?

In *Merchant v. Kelly, Haglund, Garnsey & Kahn*, an agreement between the trustee of a plan and a participant in the plan established a subaccount from the participant's account within the plan.<sup>120</sup> Under the agreement, the plan's trustee was to distribute the subaccount's proceeds to the participant's spouse.<sup>121</sup> The plan trustee was not to make the distribution pursuant to a qualified domestic relations order.<sup>122</sup> The participant asserted that the agreement violated IRC Section 401(a)(13) by granting his spouse rights and interests in the assets of the plan even though his spouse was not a participant in the plan.<sup>123</sup>

The Federal District Court held that the agreement's partition of assets was not simply an accounting measure, but a voluntary partition of the participant's benefits without the benefit of a qualified domestic relations order.<sup>124</sup> Therefore, the Court found that the agreement was at least an indirect assignment or alienation of benefits in violation of IRC section 401(a)(13).<sup>125</sup> Further, the Court found that IRC section 401(a)(13) and the regulations under IRC section 401(a)(13) would make questionable any attempt to create an interest within a plan for anyone other than a participant, regardless of the lack of case law on the issue.<sup>126</sup>

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116. Treas. Reg. § 1.72-16(c)(2)(ii) (1963).

117. 29 U.S.C. § 1056(d)(1) (1999).

118. I.R.C. § 401(a)(13).

119. Treas. Reg. § 1.401(a)-13(c)(1)(ii) (as amended in 1988).

120. *Merchant*, 874 F. Supp. at 301.

121. *Id.* at 303.

122. *Id.* A "qualified domestic relations order" is a domestic relations order creating or recognizing the existence of an alternate payee's right to receive any portion of the benefits payable with respect to a participant under a qualified plan. I.R.C. § 414(p)(1)(A). A qualified domestic relations order is an exception to the prohibition against assignment and alienation. *Id.* § 401(a)(13)(B).

123. *Merchant*, 874 F. Supp. at 303.

124. *Id.*

125. *Id.*

126. *Id.* at 304. See also Priv. Ltr. Rul. 87-35-032 (June 2, 1987) (ruling that

The irrevocable designation of a beneficiary or a class of beneficiaries by the special trustee will probably constitute an assignment.<sup>127</sup> If a subtrust arrangement causes an assignment of part of an insured participant's benefit within the plan, subtrust proponents counter that the prohibition against assignment applies only to retirement benefits the plan provides to the participant.<sup>128</sup> These proponents claim that the prohibition against assignment does not apply to death benefits the plan provides to the participant's beneficiary. However, the legislative history of ERISA section 206(d)(1) and IRC section 401(a)(13), and the background to the adoption of Treasury Regulation section 1.401(a)-13(c)(1)(ii)<sup>129</sup> by the Service shows nothing to support this claim.<sup>130</sup> Before ERISA, the Service concluded that a participant could not irrevocably assign his death benefits.<sup>131</sup>

By their nature, a participant's death benefits in a qualified plan are always assigned to someone other than the participant at his death. However, IRC section 401(a)(13) entitles the participant to receive, while he is alive, the entire value of his vested benefit which he has accrued<sup>132</sup> within the plan.<sup>133</sup>

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a plan may not partition the account balance of a participant into two separate accounts, pursuant to a voluntary partition agreement, without violating IRC section 401(a)(13)).

127. *Current Estate Planning Problems*, *supra* note 103, at 470.

128. THE QUALIFIED PLAN AS AN ESTATE PLANNING TOOL, *supra* note 15, at 14.

129. T.D. 7534, 43 Fed. Reg. 6943 (1978).

130. *Current Estate Planning Problems*, *supra* note 103 at 470. In ERISA's legislative history, Congress did not distinguish between retirement benefits and incidental death benefits in prohibiting assignment or alienation of benefits within a plan. H.R. CONF. REP. NO. 93-1280, at 280 (1974).

131. Rev. Rul. 56-656, 1956-2 C.B. 280. A qualified plan must not permit a participant to elect irrevocably before retirement to have the plan trustee pay any part of the participant's vested interest in the plan to his designated beneficiary after the participant dies. *Id.*

132. In the case of a defined benefit plan, the participant's "accrued benefit" is his accrued benefit determined under the plan and expressed in the form of an annual benefit commencing at normal retirement age. I.R.C. § 411(a)(7)(A)(i). Normal retirement age is the earlier of: (1) the date on which the participant attains normal retirement age under the plan; or (2) the later of his sixty-fifth birthday or the fifth anniversary of the date the participant commenced participation in the plan. *Id.* § 411(a)(8).

In the case of a defined contribution plan, the participant's "accrued benefit" is his account balance within the plan. *Id.* § 411(a)(7)(A)(ii).

133. *Id.* § 401(a)(13). A qualified plan must provide that, upon a participant attaining his normal retirement age, he will not forfeit his right to his normal retirement benefit. *Id.* § 411(a). A participant's normal retirement benefit is the greater of his early retirement benefit under the plan or the benefit under the plan commencing at his normal retirement age. *Id.* § 411(a)(9).

IRC section 411(a)(9) specifies that the plan is to determine the normal retirement benefit of a participant without regard to any medical or disability benefits the plan may provide. *Id.* However, IRC section 411(a)(9) does not

Therefore, a subtrust arrangement may violate IRC section 401(a)(13) while the participant is alive, not after his death.<sup>134</sup>

Another problem would occur when the insured participant retires from their employer. If the special trustee disposes of the life insurance policies by selling or surrendering them, what will happen to the proceeds from the policies' cash value? If the participant lives long enough after his required beginning date,<sup>135</sup> the minimum distribution rules of IRC section 401(a)(9) may require the plan to distribute the proceeds to the participant.<sup>136</sup> If the subtrust prevents such a distribution, it would violate both IRC sections 401(a)(13) and 401(a)(9).<sup>137</sup>

On the other hand, it is possible the minimum distribution rules under IRC section 401(a)(9) will require the plan to distribute the policies' cash value to the participant, thus creating a possibility of reverter exceeding 5%.<sup>138</sup> This result will depend on the significance of the policies' cash value in comparison to the amount of the participant's entire accrued benefit.<sup>139</sup> If the cash value is significant enough, it could cause the subtrust arrangement to fail to exclude the policies' proceeds from the gross estate of the insured participant.<sup>140</sup>

The subtrust document must not give the insured participant the option to purchase the life insurance policies, if the subtrust is no longer being able to maintain the policies, because the power to purchase the policies would be an incident of ownership.<sup>141</sup> Such an incident of ownership would cause the participant's gross estate to include the proceeds from the policies.<sup>142</sup>

exclude any death benefits the plan provides from the determination of the normal retirement benefit of a participant. *Id.*

134. Mervin M. Wilf, *Estate Tax on Life Insurance Held in Qualified Plans*, Q239 ALI-ABA 273, 279 (June 22, 1995).

135. A participant's "required beginning date" is April 1st of the first calendar year following the calendar year in which he attains age 70.5. I.R.C. § 401(a)(9)(C).

136. *Id.* § 401(a)(9). A qualified plan must distribute a participant's entire interest in the plan to him: (1) not later than his required beginning date; or (2) beginning not later than his required beginning date, over his life or life expectancy or over the joint lives or life expectancies of him and his designated beneficiary. *Id.* § 401(a)(9)(A).

If the participant does not survive until his required beginning date, the plan must distribute his entire interest: (1) within five years after his death; or (2) beginning within the calendar year immediately following the calendar year in which he dies, over the life or life expectancy of his designated beneficiary. *Id.* §§ 401(a)(9)(B)(ii), (iii).

137. *Id.* §§ 401(a)(9), (13).

138. *Current Estate Planning Problems*, *supra* note 103, at 466.

139. *Id.*

140. *Id.*

141. *Estate of Smith v. Commissioner*, 73 T.C. 307 (1979), *acq.*, 1981-1 C.B. 2.

142. Priv. Ltr. Rul. 80-49-002 (Sept. 21, 1980).

To satisfy the REA's pre-retirement survivor annuity requirements in a qualified plan, insured death benefits in excess of an insured participant's accrued benefit are includible in determining the amount of the survivor annuity.<sup>143</sup> If the plan requires all or any portion of the life insurance proceeds in the subtrust to pay the pre-retirement survivor annuity, the class of beneficiaries selectable by the special trustee must include the surviving spouse of the insured participant or the plan will violate IRC section 417.<sup>144</sup>

For a plan to benefit from the provisions of the IRC favoring retirement plans, it must comply with the requirements for qualified plan status.<sup>145</sup> If a plan's use of a subtrust arrangement violates IRC section 401(a)(13), disqualification would lead to plan earnings being taxed, employer contribution not being deductible and participants being currently taxed on amounts the employer contributed on their behalf.<sup>146</sup>

### III. HOW TO REMOVE LIFE INSURANCE POLICIES FROM A SUBTRUST WITHOUT TRIGGERING THE TRANSFER FOR VALUE RULES

If the Service and the federal courts interpret ERISA section 206(d)(1) and IRC sections 401(a) and 2042(2) to frustrate the intended purpose of a subtrust arrangement or if Congress modifies these laws to prevent a subtrust arrangement from being successful, an existing subtrust will require exit strategies. Also, if the plan sponsor terminates the plan before the insured participant dies, the special trustee will have to remove the policies from the subtrust.<sup>147</sup>

ERISA and the IRC prohibit a plan fiduciary from causing the plan to engage in a transaction the fiduciary knows or should know is a direct or indirect transfer of plan assets to a party in interest.<sup>148</sup> However, the U.S. Department of Labor may grant an

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143. Treas. Reg. § 1.401(a)-20 at Q&A-12 (1988).

144. Sherwin P. Simmons, *Insurance in Qualified Plans - Selected Topics*, SB26 ALI-ABA 369, 389 (Nov. 18, 1996). The special trustee would have to name the surviving spouse as the beneficiary for at least that portion of the life insurance proceeds that represent payment of a part of the pre-retirement survivor annuity. *Id.*

145. I.R.C. § 401(a).

146. *Id.* §§ 501(a), 404(a), and 402(b).

147. Lawrence Brody, *Sophisticated Uses of Life Insurance in Estate Planning*, C960 ALI-ABA 553, 568 (Oct. 26, 1994).

148. 29 U.S.C. § 1106(a) (1999); I.R.C. § 4975(c)(1)(D). With respect to an employee benefit plan, a party in interest includes: (1) a plan fiduciary; (2) a service provider to the plan; (3) an employer whose employees are covered under the plan; (4) an employee organization whose members are covered under the plan; (5) an owner, directly or indirectly, of 50% or more of the combined voting power or total share value of all classes of stock, the capital or

exception from this prohibition if the exception is administratively feasible, in the interest of the plan and its participants and beneficiaries, and protects the rights of participants and beneficiaries.<sup>149</sup>

The U.S. Department of Labor has made the transfer of a life insurance policy from a qualified plan an exception from the prohibited transaction rules.<sup>150</sup> However, if a qualified plan transfers a life insurance policy to the insured participant, his gross estate will include the proceeds from the policy on his death unless he survives three years from the date on which he subsequently makes a gratuitous transfer of the policy to his family member or to an irrevocable trust.<sup>151</sup> To avoid this three-year rule, someone other than the insured participant must purchase the policy because a plan cannot distribute a participant's benefits to anyone other than the participant while he is alive.<sup>152</sup>

If the special trustee does not distribute the policy to the insured participant, the purchase by someone else may be a transfer for value.<sup>153</sup> If the special trustee transfers the policy for

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profits interest, or the beneficial interest of an employer whose employees are covered under the plan or an employee organization whose members are covered under the plan; (6) any individual's spouse, ancestor, lineal descendant, or spouse of a lineal descendant if the individual is a plan fiduciary, a service provider to the plan, an employer whose employees are covered under the plan, or an owner, directly or indirectly, of 50% or more of the combined voting power or total share value of all classes of stock, the capital or profits interest, or the beneficial interest of an employer whose employees are covered under the plan or an employee organization whose members are covered under the plan; (7) a corporation if any person described in clause (1), (2), (3), (4), or (5), above, owns 50% or more of the combined voting power or total share value of all classes of stock of the corporation; (8) a partnership if any person described in clause (1), (2), (3), (4), or (5), above, owns 50% or more of the capital or profits interest of the partnership; (9) a trust or estate if any person described in clause (1), (2), (3), (4), or (5), above, owns 50% or more of the beneficial interest of the trust or estate; and (10) an employee, officer, director, 10% shareholder, 10% partner, or 10% joint venturer of any person described in clause (2),(3),(4),(5), or (6), above, or of the plan. 29 U.S.C. §§ 1103(14) (1999).

149. I.R.C. § 4975(c)(2).

150. Prohibited Transaction Exemption 92-6, 57 Fed. Reg. 5189 (1992), formerly Prohibited Transaction Exemption 77-8, 42 Fed. Reg. 31574 (1977). Under this class exemption from the prohibited transaction rules, the U.S. Department of Labor allows a qualified plan to sell an individual life insurance policy on the life of a participant to him, to his beneficiaries, to the employer sponsoring the plan, or to another employee benefit plan. *Id.*

151. I.R.C. § 2035.

152. *Id.* § 401(a).

153. § 101(a)(2). See *Estate of B.J. Rath*, 608 F.2d 254, 256 (6th Cir. 1979) (holding that a decedent's estate transferred life insurance proceeds to his surviving spouse for valuable consideration because the decedent had no incidents of ownership in the policy); *Haverty Realty & Inv. Co.*, 3 T.C. 161,

valuable consideration, the transferee must include the policy's proceeds in his gross income when the insured dies.<sup>154</sup> However, the transferee may deduct from the proceeds an amount equal to the sum of the consideration's actual value, plus any policy premiums the transferee pays after the transfer.<sup>155</sup>

However, if the transferee has a tax basis that IRC section 101 determines by reference to the basis of the transferor, the transfer for value limitation does not apply.<sup>156</sup> The transfer for value limitation will be inapplicable if the policy was transferred to the insured, a partner of the insured, a partnership including the insured, or a corporation of which the insured was a shareholder or officer.<sup>157</sup>

The IRC does not automatically exempt transfers of life insurance to a family member of the insured.<sup>158</sup> However, if the family member is a partner of the insured, the transfer is exempt from the prohibited transaction rules pursuant to the class exemption and is exempt from the transfer for value rules.<sup>159</sup> To provide an exit strategy and also to avoid the three-year rule of IRC Section 2035, the insured participant and appropriate family

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169 (1944) (holding that a corporation did not acquire policies for valuable consideration when it acquired the policies from another corporation with identical ownership); *Hacker v. C.I.R.*, 36 B.T.A. 659, 662 (1937) (holding that the insured's wife acquired a policy for valuable consideration when the insured assigned all of his right, title, and interest in and to the insurance to his wife upon her payment of the policy's cash surrender value to him). *But see Pritchard v. Commissioner*, 3 T.C.M. (CCH) 1125, 1128 (1944) (holding that the insured's wife acquired the policies for inadequate consideration when she paid the policies' cash surrender value because the insured transferred the policies in contemplation of his imminent death.)

154. I.R.C. § 101(a)(2). *See Hacker*, 36 B.T.A. at 662 (holding that the transferee becomes an investor in the policy if the insured transfers the policy for valuable consideration).

155. I.R.C. § 101(a)(2). *See Hacker*, 36 B.T.A. at 662 (holding that only the actual value of the consideration and the amount of premiums the investor pays are exempt from income tax when he receives the policy proceeds).

156. I.R.C. § 101(a)(2).

157. I.R.C. § 101(a)(2)(B).

158. The Service will not issue a ruling or determination letter as to whether a transfer of a life insurance policy will be exempt from the transfer for value rules under IRC section 101 if: (1) the transfer is to an unincorporated organization and substantially all of the organization's assets consist of life insurance policies on the lives of the members of the organization; or (2) in a situation involving a grantor trust, (a) substantially all of trust's corpus consists of life insurance policies on the life of grantor or his spouse, (b) any person has the power to apply the trust's income or corpus to the payment of premiums on the policies, (c) any person has a power to use the trust's assets to make loans to the estate of the grantor or to purchase assets from the estate of the grantor, and (d) any person has a right or power which would cause IRC sections 673 through 677 to treat the grantor as the owner of any portion of the trust. Rev. Proc. 98-3, 1998-3 I.R.B. 100.

159. *Id.*

members could establish a family limited partnership.<sup>160</sup>

If the estate tax exclusion is not applicable to a subtrust, another defensive strategy would be to provide for the marital deduction within the subtrust.<sup>161</sup> Because a third party, the special trustee, is exercising control over the subtrust's assets, the subtrust would have to limit the class of beneficiaries available to the special trustee to ones who can qualify for the marital deduction.<sup>162</sup> Available beneficiaries may include a trust in which trust assets qualify as qualified terminable interest property and a trust in which the participant's spouse can exercise a general power of appointment.<sup>163</sup>

### CONCLUSION

If a life insurance subtrust is successful in removing all of the insured participant's incidents of ownership in a life insurance policy held under a qualified plan, the subtrust is assigning the participant's insured death benefit to the subtrust's beneficiaries while the participant is still alive. Such an assignment violates the prohibition against assignment or alienation of the participant's benefit within the plan under ERISA section 206(d)(1) and IRC section 401(a)(13). This violation could disqualify the plan under IRC section 401(a), causing the plan's sponsor and participants to lose the tax-favored benefits that the IRC provides them under a qualified plan.

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160. See Priv. Ltr. Rul. 93-47-016 (March 16, 1993) (ruling that a partnership holding a life insurance policy as its sole asset may not qualify as a partnership for tax purposes because it may not be carrying on a business). *But see* Treas. Reg. § 301.7701-2(c) (as amended in 1996) (stating that, unless a business entity makes an affirmative election to have the Service treat it otherwise, the Service will usually treat the entity as a pass-through entity by default if at least two persons comprise the entity and they formed it after January 1, 1997).

161. *Death Before Retirement*, *supra* note 91, at 129.

162. *Id.* at 129-30.

163. *Id.* at 130.