Using Your Profit Sharing Plan to Meet Life Insurance Needs – "Seasoned Money"

Rarely do business owners, having spent years building and growing their businesses, or key executives, used to moving in a fast pace environment, completely retire to play golf or fish every day. Instead, they enter into a "third age", enjoying activities, pursuing unexplored passions and more leisurely business pursuits without the pressures of making a lot of money. Much of their wealth may be tied into profit sharing plans that were established in their earlier hard charging years. During this new phase in their lives, they may find themselves in situations where they still need life insurance or more of it, to protect their family. They, however, are older or may not be as healthy and therefore, insurance premiums are higher, and they may not have sufficient cash flow or other sources of funds to purchase it. As a result, they run the risk of placing their families in financial distress in the event of their death.

Example: Joe, age 65, used to be a high powered real estate guru. He contributed to the profit sharing plan maintained by his real estate business for many years. He accumulated $2,000,000 in assets before deciding to slow down, leave the real estate business, and pursue his childhood passion of running a book store. Unfortunately, he now earns only $25,000 a year selling books. After leaving the real estate business, Joe's first wife divorced him and walked away with a nice settlement, including his $1.0 million life insurance policy. Joe has since remarried a somewhat younger wife and has a new child. He now has new insurance needs to protect his new family and to ensure that they are well cared for if he is no longer around. But, he's older now and premiums are much higher and exceed his current income. Joe has insufficient cash flow or other sources of funds to purchase the policy he needs. What can Joe do?

The Solution: Life Insurance Opportunities in Profit Sharing Plans - "Seasoned" Money

While the primary purpose of profit sharing plans and other qualified retirement plans are to provide retirement benefits, looking to the money in the profit sharing or qualified plan in the prior business ("seasoned" money) may be the solution.

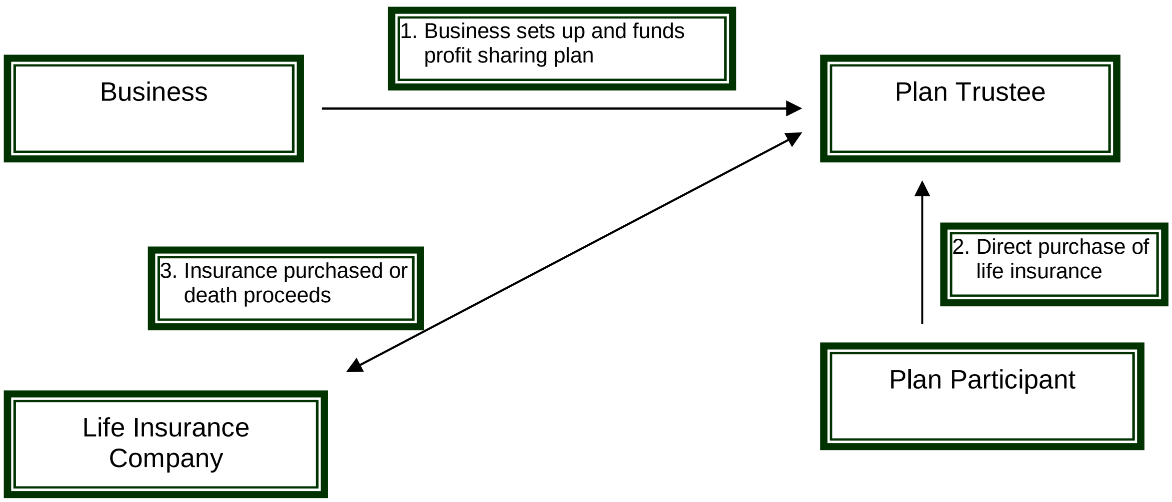
Generally, profit sharing plans and other qualified retirement plans may provide for the payment of "incidental" death benefits. Government regulations provide that life insurance may be purchased in a qualified plan so long as the death benefits are incidental. Life insurance coverage in a profit sharing plan is considered incidental if less than 50% of the company's contributions to the plan are used to purchase whole life insurance on the participant or less than 25% to purchase term insurance or universal life insurance. There are, however, two exceptions to the incidental benefit rule – the two year rule and the five year rule:

1. Two year rule – money in a profit sharing plan held for at least two years, consisting of contributions, forfeitures and earnings, could be used to purchase life insurance without restriction (Revenue Ruling 60-83).
2. Five year rule – anyone who has participated in a profit sharing plan for at least 5 years may withdraw all amounts credited to his/her account, including employer contributions made within the previous two years (Revenue Ruling 68-24). Applying the same principle as in exception #1 above, the entire account balance, if needed, could be used to purchase life insurance.

The profit sharing plan must permit a) investment in life insurance; and b) the distribution of seasoned money. So, in our example, if Joe's plan permits it (and if not, is amended to do so), he can use the balance in his account to pay the premiums regardless of whether they exceed the incidental benefit rules (or even actual current contributions if that is applicable).

Retirement Planning

How Does It Work?



1. Ensure the profit sharing plan permits investment in life insurance and the distribution of seasoned money, and if not, amend it to do so.
2. Participant directs plan trustee to apply for and pay the premium for life insurance above the incidental limits.
3. Trustee applies for the insurance on behalf of the participant to be owned by, and payable to, the plan, as beneficiary.

ADVANTAGES

1. Incidental benefit rules do not apply.
2. Can use plan balances to satisfy unmet human life value insurance needs of participants without restriction to current contributions.
3. Fills gaps in personal insurance needs.
4. Fills gaps from other employee benefit programs.
5. When the participant wants a guaranteed return on investment rather than market risks associated with mutual funds and other market related securities.
6. Pays life insurance premiums with “pre-tax” dollars that are or have been deductible to the employer.
7. For plan participants who would otherwise be uninsurable or insurable at a higher than standard risk, policies may be guaranteed issue depending upon the plan.
8. Participants may use their seasoned balances to purchase life insurance on other family members.
9. Life insurance proceeds pass to the beneficiary income tax-free to the extent they exceed cash values. Cost of the economic benefit of the insurance, previously taxed to the participant or paid with nondeductible employee contributions, is also received income tax-free.

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10. If the participant dies before retirement, the life insurance policy will provide all, or substantially all, the monies that would have been available at retirement.
11. Reduces impact on cash flow.

DISADVANTAGES

1. Stock, bonds and mutual funds may provide greater investment growth compared to internal rates of return on the insurance policy.
2. Policy expenses and commissions may be greater than for comparable investment alternatives.
3. The portion of the death benefit attributable to the cash value in the policy is taxable income, reduced by the economic benefit costs reported to the employee annually.
4. There are income tax consequences if there is a lifetime removal of the policy from the qualified plan.
5. Death benefits from the policy are includible in the insured's estate.
6. For estate tax planning purposes, life insurance owned outside a qualified plan may be more effective.

Please consult with your Guardian Financial Representative if you have any questions concerning this document.

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Guardian Financial Representatives may call the Business Resource Center for Advanced Markets, at 1.800.871.7780, Option 3, Option 1, for additional information.

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