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Participants Allowed to Purchase Second to Die Life Insurance from Profit Sharing Plan: DOL Advisory Opinion 2006-03A

Background:

H and W were both participants in a tax-qualified profit sharing plan that allowed the plan participants to direct the investments in their accounts. H directed the amounts held in his rollover account to be used for the purchase of a second to die life insurance policy on the life of him and his wife. H and W wanted to jointly purchase the life insurance policy from the plan for its cash surrender value, provide that the transaction would not be considered a prohibited transaction.

The participants asked the Department of Labor (DOL) whether or not under Prohibited Transaction Exemption 92-6 (PTE 92-6) the second to die life insurance policy would be considered an "individual life insurance policy" and whether purchasing the life insurance policy for its cash surrender value would "put the plan in the same cash position as it would have been had it retained the contract, surrendered it, and made any distribution owing to the participant on his vested interest under the plan."

The DOL answered both question in the affirmative. However, in regards to the second issue, the DOL pointed out that under the recently updated IRS regulations, (IRS Regs to IRC Section 402, IRS Procedure 2004-16, and IRS Procedure 2005-25) dealing with the value of a life insurance policy), the fair market value of the life insurance policy could be in excess of the cash surrender value. If so, the difference between the cash surrender value and the fair market value of the life insurance policy (the bargain element) will be considered a distribution under the plan for all other purposes of the Internal Revenue Code, including the qualification requirements and in-service distributions.

Significance:

A common strategy among wealthy clients is to use seasoned money inside their profit sharing plan for the purchase of life insurance. In some situations the life insurance policy is subsequently sold by the plan to the insured participants (or directly to an ILIT) so that the policy can be subsequently transferred out of the participant's estate. This Advisory opinion is important for at least two reasons:

1. It reinforces that, at least from the DOL's perspective, a profit sharing plan may purchase second to die life insurance.
2. It highlights that PTE 92-6 and the IRS regulations dealing with policy valuation are not entirely consistent. The Opinion explains that if a life insurance policy is purchased for its cash surrender value under PTE 92-6 when the fair market value of the policy for income tax purposes exceeds the cash surrender value the difference (the "bargain element") will be treated as a taxable distribution under all relevant provisions of the Internal Revenue Code, including the sections relating to plan qualification. Although helpful, this Opinion leaves open the important question of what happens when the policy is purchased for its fair market value? Would that satisfy both the IRS and the DOL?

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Universal life insurance policies, both variable and non-variable, have charges such as premium based loads, cost of insurance, administrative and issue charges and surrender charges. These charges are different for each product and some may vary by age, gender, face amount, underwriting class, premiums and policy durations. These charges will have a significant impact on Policy Account Values.

In addition to these charges, variable universal life policies also have a mortality and expense risk charge and the underlying funds have operating expenses, which include fund management fees and 12b-1 fees, if applicable. These expenses also have a significant impact upon Policy Account Values. Together with the additional charges, these expenses are reflected in each product's prospectus and should be reviewed with your client. Policy Account values for variable universal life policies vary with actual underlying fund performance. The investment return and principal value of an investment will fluctuate so that an investor's shares, when redeemed, may be worth more or less than their original cost.

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