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Internal Revenue Service Issues Rulings on Section 412(i) Plans

The Internal Revenue Service has issued a series of rulings in an attempt to crack down on the abusive use of life insurance policies to fund tax-qualified retirement plans in what are known as "412(i) plans." Though the use of life insurance products to fund retirement plans is authorized under Section 412(i) of the Internal Revenue Code, the IRS felt that some employers were abusing the rules to obtain unwarranted tax deductions or to discriminate in favor of highly compensated employees.

What the IRS Has Done

The Internal Revenue Service has issued two Revenue Rulings, a Revenue Procedure and a set of proposed regulations all intended to restrict the use of life insurance products that are designed to avoid taxes and to favor highly compensated employees.

Springing Cash Value Policies

A special type of insurance policy (often called a "springing cash value policy") was designed to use with Section 412(i) plans. It has an extraordinarily low cash surrender value for a number of years even though the up front premiums paid during those years are relatively high. This enables the employer to take a significant tax deduction for premiums paid to the plan. The policy is sold or paid to the participant as a taxable distribution after six or seven years when the cash value is still low. Shortly after the policy is distributed the cash surrender value suddenly "springs" to a much higher amount. The participant thus obtains the policy at a very low tax cost after the employer has received major tax deductions for several years.

The proposed regulations require that, if a participant acquires a life insurance policy from a tax-qualified plan, it must be taxed at its "full, fair market value". Revenue Procedure 2004-16 spells out a safe harbor method for determining this amount. It provides that the cash surrender value of the policy can be treated as the fair market value provided it is at least as large as the sum of all of the premiums paid plus amounts credited to the policy (such as dividends and interest) less reasonable charges (provided they are actually charged to the policy prior to the determination date.)

Excessive Life Insurance

Pension plans are permitted to provide death benefits, but limits are placed on the amount of the death benefit.

When a plan is funded entirely with life insurance products, the full amount of the premiums for these policies is tax deductible. This is appealing to some plan sponsors because the low, guaranteed rates of return in the insurance policies help produce larger tax-deductible contributions. Some have gone so far as to purchase exorbitant amounts of life insurance in order to increase tax deductions even further.

In addition, some plans have been purchasing life insurance policies that exceed the amount of death benefits that can be paid from the plan in an attempt to increase tax deductions. When a participant dies, he or she receives the benefit allowed by the plan. Any excess life insurance proceeds are paid back to the plan, not to the participant. The payment of excessive amounts of life insurance to the plan can result in the plan being vastly over funded. When over funded plans are terminated, excess assets can be subject to a 50% excise tax in addition to ordinary income taxes.

The IRS has now clarified the limits on these practices. Revenue Ruling 2004-20 provides that a qualified pension plan cannot be treated as a Section 412(i) plan if insurance contracts provide for benefits at normal retirement age in excess of the benefits under the terms of the plan. It further provides that employer contributions used to purchase life insurance in excess of the death benefits provided under the plan are not fully deductible when contributed.

Discrimination in Favor of Highly Compensated Employees

A basic requirement of tax-qualified retirement plans is that they do not discriminate in favor of highly compensated employees. Some plans that are funded with life insurance policies offer participants the right to purchase the policies from the plan for their cash surrender value. The Internal Revenue Service has issued Revenue Ruling 2004-21 in an attempt to prevent plans from offering these purchase rights primarily to highly compensated employees.

The Revenue Ruling provides that a qualified plan will fail to satisfy the nondiscrimination requirements if it permits highly compensated employees to purchase life insurance contracts from the plan prior to distribution of retirement benefits **unless** the purchase rights of nonhighly compensated employees have an equal or greater value. This extends to situations where the features of the policies available for purchase by highly compensated employees are more favorable than those available to nonhighly compensated employees.

Find Out More

The recent IRS rulings are not intended to affect the legitimate use of Section 412(i) plans. These plans may still make sense for people who:

- √ desire large, current tax deductions and expect to have the income to pay the required premiums for several years,
- √ can afford to leave money in a plan to avoid over funding, and
- √ have objectives that can be met by the fixed income investments.

Whatever kind of plan is used, it should be chosen with full knowledge of all its advantages and potential pitfalls. Louis Kravitz & Associates, Inc. can help you determine which kind of plan best meets your needs.

You can learn more about 412(i) plans by going to www.lkravitz.com, clicking on “Publications” then choosing “Section 412(i) Plans—An Old Plan or a New Gimmick?”.

Louis Kravitz & Associates, Inc. is the largest independent firm of retirement consultants headquartered in Southern California. We specialize in the design, implementation and administration of virtually every type of retirement plan. Our consultants, actuaries and other specialists have the experience and ability to make certain your retirement plans are properly designed, meet your needs and operate to your satisfaction. We have been dedicated to providing high quality service since our firm was founded in 1977. One of our specialties is working with our clients to maximize benefits for their key executives.