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Section 412(i) Pension Plans
An Old Plan or a New Gimmick?

Section 412(i) pension plans are being marketed to sole proprietors and other small employers as an alternative to traditional defined benefit plans. Section 412(i) plans can provide substantially higher tax-deductible contributions in the early years of the plan. This information release is intended to help advisors evaluate these plans. For purposes of this release, we are using the term "traditional defined benefit plan" to mean a plan that does not invest its assets solely in life insurance policies or annuity contracts.

Please note, that one type of Section 412(i) plan being sold includes a new form of "springing" life insurance product. The Internal Revenue Service is aggressively attacking these plans as abusive tax shelters. We will discuss this separately at the end of this release and the following analysis does not include this type of plan.

What is a Section 412(i) Plan?

A Section 412(i) plan is a tax-qualified defined benefit pension plan that is funded solely by life insurance policies, annuity contracts or a combination of the two. By law, these policies and contracts must fund benefits using level (fixed) premiums that begin when a participant enters the plan and end at the retirement date specified in the plan. Section 412(i) was added to the Internal Revenue Code by ERISA in 1974 to exempt fully insured plans from ERISA's minimum funding standards. The law is designed to assure that a participant's benefit is fully funded by retirement age so there is no need for an enrolled actuary to determine plan contributions. Employers are required to pay the policy premiums every year. Therefore, there is no flexibility in the amount of contribution that can be made from year-to-year.

Section 412(i) Plan Characteristics and Considerations

√ Section 412(i) pension plans generally produce higher tax-deductible contributions than traditional pension plans in the initial years. This is a result of the low rate of return guaranteed in the insurance product and used to determine the contributions to these plans. The illustrations we have seen use 3% interest, which is the rate guaranteed by the insurance contracts. Actuaries who determine the contribution requirements under traditional plans are often reluctant to use long-term rates of less than 5%. This is because the Internal Revenue Service has a history of challenging the tax deductibility of contributions to traditional plans that are based on what they believe to be low interest assumptions.

- √ Section 412(i) plans are subject to the same benefit limitations as any other defined benefit plan. The annual retirement benefit cannot exceed the lesser of $160,000 or 100% of three-year average compensation. The lump sum amount that can be withdrawn is also the same under both kinds of plans. There is a tax problem if there is too much money in the plan when the participant wants to withdraw the funds or roll them into an IRA. For example, Section 412(i) plans are often designed to provide maximum benefits payable as a *joint and survivor annuity*. If a participant takes a lump sum, the amount of the payment has to be based upon a less valuable, single life annuity. As a result, there could be a large amount of excess assets in the policy that will be subject to both income and excise taxes if they cannot be distributed to participants. A Section 412(i) plan can be monitored by an actuary and converted to a traditional plan when the cash value approaches the lump sum payout limit.

- √ There is no flexibility in determining the contribution. This can be a problem if an employer cannot afford the policy premiums.

- √ All plan assets are invested under the insurance contract, and while there is a potential for dividends, there is no investment diversification. A plan sponsor needs to be comfortable with this type investment.

- √ Participants are not permitted to take loans from the plan.

- √ Contributions under the Section 412(i) plan may be higher than under a traditional plan in the early years but lower in later years.

- √ Section 412(i) plans typically provide substantial amounts of life insurance. Traditional plans can also invest in life insurance, but under the Section 412(i) plan, the low, guaranteed rates of return in the insurance policies help produce larger tax-deductible contributions. A potential plan sponsor should take into consideration both the larger contributions and the need for insurance coverage.

An Illustration

The following table shows how the same amount of money will accumulate under a 412(i) plan using an annuity contract as compared with a traditional pension plan for a sole proprietor. In each case, we have assumed that there is $184,730 of pre-tax income to invest each year. Under the 412(i) plan, this will be just enough to make the contribution in the early years. Under the traditional plan, the contribution is smaller, so the excess of the $184,730 over the contribution amount represents taxable income. The balance remaining after taxes is invested outside of a qualified plan.

We have assumed that the investments in the 412(i) plan grow at a guaranteed rate of 3.0% per year and that those in the traditional plan grow at a rate of 5.5% per year. We have further assumed that income is taxed at a combined federal and state rate of 45% and that investments outside of the qualified plan grow at an after-tax rate of 4.0% per year. Each plan funds for the maximum allowable benefit payable at age 62.

Section 412(i) Illustration

	Year				
	1	3	6	9	12
Pre-tax amount available:	$184,730	$184,730	$184,730	$184,730	$184,730
A. 412(i) Plan					
1. Annuity contribution	$184,730	$184,730	$184,730	$0	$0
2. Personal savings	0	0	0	101,602	101,602
3. Tax	0	0	0	83,128	83,128
4. Total (1 + 2 + 3)	$184,730	$184,730	$184,730	$184,730	$184,730
5. Annuity cash value	$190,272	$588,111	$1,230,756	$1,655,664	$1,943,043
6. Personal savings accumulation	0	0	0	176,310	528,171
7. Total accumulation (5 + 6)	$190,272	$588,111	$1,230,756	$1,831,974	$2,471,214
8. Amount that can be rolled to an IRA	108,046	360,639	846,473	1,490,098	1,943,043
9. Over funding (5 – 8)	$82,226	$227,472	$384,283	$165,566	$0
10. Income & excise tax on over funding	78,115	216,098	365,069	157,288	0
11. Over funding available to save (9 – 10)	$4,111	$11,374	$19,214	$8,278	$0
12. Personal savings accumulation (6 + 12)	$4,111	$11,374	$19,214	$184,588	$528,171
B. Traditional Plan					
1. Plan contribution	$102,433	$113,968	$133,749	$156,965	$0
2. Personal Savings	45,263	38,919	28,040	15,271	101,602
3. Tax	37,034	31,843	22,941	12,494	83,128
4. Total (1 + 2 + 3)	$184,730	$184,730	$184,730	$184,730	$184,730
5. Accumulation in plan	108,046	360,639	846,473	1,490,098	1,943,043
6. Personal savings accumulation	47,074	137,009	257,654	354,080	625,707
7. Total accumulation (5 + 6)	$155,120	$497,648	$1,104,127	$1,844,178	$2,568,750
8. Amount that can be rolled to an IRA	108,046	360,639	846,473	1,490,098	1,943,043
9. Over funding (5 – 8)	$0	$0	$0	$0	$0
10. Taxes on over funding	0	0	0	0	0
11. Over funding available to save (9 – 10)	$0	$0	$0	$0	$0
12. Personal savings accumulation (6 + 12)	47,074	137,009	257,654	354,080	625,707

C. Summary of Results

	1	3	6	9	12
Section 412(i) Plan					
Amount in IRA	$108,046	$360,639	$846,473	$1,490,098	$1,943,043
Personal Savings	4,111	11,374	19,214	184,588	528,171
Total	**$112,157**	**$372,013**	**$865,687**	**$1,674,686**	**$2,471,214**
Traditional Plan					
Amount in IRA	$108,046	$360,639	$846,473	$1,490,098	$1,943,043
Personal Savings	47,074	137,009	257,654	354,080	625,707
Total	**$155,120**	**$497,648**	**$1,104,127**	**$1,844,178**	**$2,568,750**

Comments on Illustration

√ The Internal Revenue Code places limits on the lump sum amount that can be withdrawn from a qualified plan. Under a traditional plan, the contributions are generally determined so that the balance in the plan is about equal to the amount that can be withdrawn at any given time. There typically is no over-funding unless there is a substantial, unexpected increase in the value of the plan's assets.

Under the 412(i) plan, the contributions are larger but the amount that can be withdrawn as a lump sum is the same. So, for many years after the plan's inception**, there are more assets than can be paid out as a lump sum**. The plan is over-funded. The excess assets are subject to both ordinary income tax and a 50% excise tax when the plan is terminated.

Take another look at the illustration. At the end of six years, the individual who chose the 412(i) plan would have accumulated $1,230,756 in the annuity contract. The individual who chose the traditional plan will have $1,104,127, of which $846,473 is in the plan and $257,654 is invested outside of the plan.

Let's look at what happens if the plan is terminated at the end of the sixth year. Regardless of whether the plan is a Section 412(i) plan or a traditional plan, $846,473 will be available to be transferred to an IRA. This is because the amount that can be withdrawn as a lump sum is the same under either kind of plan. Under the 412(i) plan, there are excess assets in the amount of $384,283. These assets must be returned to the plan sponsor where they will be subject to ordinary income tax (our assumed tax rate is 45%) and a 50% excise tax. The total taxes are $365,069, which leaves only $19,214 to be saved outside the plan.

Under the traditional plan, there are no excess assets and therefore no income or excise taxes. The total personal savings over the six-year period amounts to $257,654, which is $238,440 more than under the Section 412(i) plan.

√ Although interest rate guaranties under the insurance contracts used to fund Section 412(i) plans are low, it is possible that these contracts could pay dividends. Dividends must be used to reduce the contribution in the following year.

√ We have assumed that contributions stop when the assets in the trust are expected to be sufficient to provide the maximum lump sum payment if left invested until the participant reaches age 62. Since contributions are larger under the 412(i) plan, the assets build up faster and the contributions stop sooner than under the traditional plan.

√ If the investments in the traditional plan earn more than 5.5%, the contributions to the plan will be smaller but will still accumulate to $1,943,043 at age 62. Thus, you get the same benefit for a lower contribution, which will result in more money being invested outside the plan.

If the investments in the traditional plan earn less than 5.5%, the contributions to the plan will be larger but will still accumulate to $1,943,043 at age 62. Thus, contributions will be larger to provide the same benefit. This will result in less money being invested outside the plan.

√ An actuary is not required under a Section 412(i) plan since the minimum funding requirements do not apply as long as the policy premiums are paid. Therefore, the direct out-of-pocket cost to administer the plan may be less. Although an actuary is not required, it might be advisable to engage one to monitor the plan since Section 412(i) plans can become over funded.

√ Section 412(i) plans nearly always involve the purchase of life insurance by the plan. The analysis gets more complex when the plan is funded by whole life insurance instead of (or in addition to) an annuity. An analysis of the effect of using whole life insurance is beyond the scope of this information release. However, we do not expect the results to be substantially different.

Watch Out—IRS Plans to Attack Abusive 412(i) Plans

A special type of insurance policy was designed to use with Section 412(i) plans. It has an extraordinarily low cash surrender value for a number of years in order to minimize the taxes payable on distribution. The policy may be transferred to the participant as a taxable distribution after six or seven years when the cash value is low. Shortly after the policy is distributed the cash surrender value jumps to a much higher amount. The participant thus obtains the policy at a very low cost after having received major tax deductions for several years. The IRS believes this to be an abusive tax shelter and they have announced that they will try to eliminate the use of these "springing cash value" policies.

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In summary, a Section 412(i) plan may make sense for people who:

√ Need large tax deductions now 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
√ Are not adverse to fixed income investments.

But whatever kind of plan is used, it should be chosen with full knowledge of all the advantages and potential pitfalls. Louis Kravitz & Associates, Inc. can help you determine which kind of plan best meets a business' needs.