Understanding 412(e)(3)Defined Benefit Plans

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I. Understanding 412(e) (3) Defined Benefit Pension Plans

Introduction

The Defined Benefit Pension Plan is one of the least understood methods for accumulating assets for retirement. The 412(e) (3) defined benefit plan is even less understood, although the concept and implementation is, in fact, rather simple. The 412 (e) (3) plan does not need an enrolled actuary to sign a schedule SB and generally will not require a Form 5500 until assets exceed $250,000. In addition, a 412 (e) (3) defined benefit plan may be adopted along with a 401(k) profit sharing plan to provide an asset allocation for a small company retirement plan. This makes a 412(e) (3) plan an ideal plan for a small business owner.

History of Section 412(e) (3) f/k/a 412(i)

Section 412(i), the predecessor section to 412(e) (3), was written into law in 1974 under ERISA, the Employee Retirement Income Security Act of 1974. The insurance contract plans were exempt from the minimum funding rules under section 412 (now section 430). The insurance contract plans actually pre-date ERISA. These insurance contract plans were known as group annuity contracts. The first group annuity contract was issued by the Metropolitan Life Company in 1921. (1) Hence, the history of these plans may be traced back to 1921 actually pre-dating ERISA. In 1924, The Equitable Life Assurance Society of the United States announced its intention of offering a group annuity.(2) Equitable aggressively marketed these style plans in the late 1970s and 1980s to major law firms and others. These style plans used guaranteed insurance products (GICS) which provided for guaranteed interest rates as high as 19%. In *Vinson & Elkins v. Commissioner,* 7 F.3d 1235 (5th Cir.1993) and *Wachtell***,** *Lipton***,** *Rosen* **&** *Katz v***.** *Commissioner***,** 26 F.3d 291 (2d Cir.1994), the law firms defeated the IRS attack on their defined benefit plans that used guaranteed insurance products where the IRS asserted the plans failed nondiscrimination testing. When interest rates plummeted, Equitable Life (which sold high interest rate guaranteed plans) was forced to draw down from their reserves and finally had to be sold to a French consortium called AXA. Hence today, the company is known as AXA-Equitable. In addition, the 412(e) (3) insurance contract plans still maintain their exemption from the minimum funding rules under section 412(e) (2) (B). The reason for the exemption is the annuity plan provides the retirement benefit with a guaranteed interest rate buildup and a guaranteed lifetime income. A traditional defined benefit plan or cash balance plan has no such guarantee. The traditional defined benefit or cash balance plan is generally funded with stocks, mutual funds and bonds which can produce disastrous results especially when the stock market declined rapidly. This happened prior to ERISA in 1974 with the famous *Studebaker-Packard* case. This case prompted Congress to enact ERISA in 1974 and form the Pension Benefit Guarantee Corporation (PBGC). However, an annuity contract with a guaranteed interest rate and guaranteed lifetime income does not face this result. Hence, there is no need for an enrolled actuary to determine the value of the plan, make assumptions as to interest earned on the plan, and certify the plan by filing a valuation statement under Form 5500 schedule SB. However, absent the 412/430 rules, all of the other ERISA rules apply to a 412(e) (3) plan. (3)

Is a 412(e) (3) plan - a Tax Deductible Annuity?

To make life simple, look at a fixed annuity. An annuity is basically a CD issued by a life insurance company. Imagine an annuity which grows at a guaranteed compound rate of 3% (or the crediting rates of the insurance company whichever is greater).

Example”

A client buys the annuity and plans to place $100,000 a year into the annuity for 10 years at age 55. At age 65 he or she plans to retire. The annuity will grow to $1,176,865.25. This amount may be rolled over to an IRA or distributed as a lifetime income. The lifetime income would be $5,554.81 a month (using an annuity conversion rate of .00472).

In a 412(e) (3) plan, a client buys an annuity and funds it every year and deducts the contributions into the fixed annuity. The plan sponsor may not even need a Trust. (4) All the other rules under ERISA apply. If these rules are violated, the plan is disqualified and loses 412(e) (3) status. For example, if the plan sponsor does not use an annuity with a "unisex rate" the plan violates *Arizona v. Norris* 463 U.S. 1073 (1983). This violation applies to all defined benefit plans and the plan sponsor not only loses 412(e) (3) status but the plan may become disqualified. For example, the plan sponsor funds the plan with a variable unisex annuity. The plan may become a 'traditional defined benefit plan" which requires a schedule SB. For example, if you have one common law employee, the plan may require a PBGC filing. For example, if the plan has two common law employees, the plan is subject to non-discrimination testing under section 401(a)(4), section 410(b) and 401(a)(26). The IRS rules relating to qualified plans are extensive. (5)

412 (e) (3) Pension Plans

The 412(e) (3) plan has the ability to withstand the changing velocity of the market which may create inadvertent underfunded or overfunded plans-(6) This is due to the guaranteed rates placed into the insurance or annuity contracts. For this reason, a 412(e) (3) plan can be a superior retirement plan, with less regulation then a traditional defined benefit plan and even more tax efficient then a 401(k) plan. The 412(e) (3) plan is more tax efficient due to the lack of payroll taxes being removed from the contributions to the plan. For example, in a 401(k), the employer pays the employee after removing 13.3% of pay for social security and Medicare taxes-then the employee makes the contribution to the 401(k). In a 412(e) (3), the employer makes a contribution directly to the plan. No social security tax. No Medicare tax. Basically this plan eliminated a 13.3% “load”.

Abusive Life Insurance had been a problem with 412(e) (3) plans. Unfortunately, in fact, most of the life insurance policies actually worked well in a 412 (e) (3) plan. However, 5 insurance companies created “suppressed cash value policies” with the intent to spring them later outside of the plan. These plans were an attempt to abuse or “game” the tax system of the United States. Most insurance companies actually did not play this game and instead issued Life insurance policies that work well in these plans. These are policies that are paid up at age 62 or 65 a/k/a LPL 65 or LPL 62. To be safe, the plan administrator would follow Rev. Rule 74-307 and the death benefit is set at 100X monthly earnings. In some cases a plan administrator would follow the 66 2/3d rule. However, the 66 2/3d rule is not a “rule”. This is a method of funding is based on a letter written from Phoenix Home Life to the Commissioner which was not even a Private Letter Ruling. In fact it was informal guidance. (7) Under Revenue Ruling 74-307, if you fund a plan with 50% life and 50% annuity and the small business owner cannot make the full contribution by year 2, the plan may fall out of compliance. No reduction can take place in the Life contract, as the premiums are fixed by contract. The plan cannot reduce the annuity, as a 74-307 violation would take place where more than 50% of the contributions would be for the life insurance. Hence the 100X monthly earnings is a safer contribution to the plan. Third, adjustments now can be made to the annuity although you may lose 412(e) (3) status and become a traditional defined benefit plan as you no longer provide “level annual funding”. (8)

Conclusion

An advisor should look at non-abusive 412(e) (3) along with non-abusive 401(k) plans. Certain 401(k) plans as well as certain 412(i) plans are "listed transactions". (9) If the plan sponsor does not use abusive policies, the plan sponsor does not need to fill out a Form 8886. Although there is much discussion today on the internet about "abusive 412(i) plans", it does not mean all 412(i) plans are abusive. In addition, annuity only 412 (i) plans are not listed transactions and have outperformed the market over the last decade (see schedule A, pg14).

MAP-21-NEW LAW FOR 2012-

On July 6, 2012, President Obama signed the Moving Ahead for Progress in the 21st Century Act a/k/a MAP-21 which contained three provisions relating to defined benefit plans. The act provided for adjustments in the interest rate assumptions beginning in 2012 which will result in employers contributing less money into their pension by allowing higher interest rate assumptions. The act also increased the PBGC premium from $35.00 per participant to $42.00 in 2013 and $49.00 in 2014. Variable rate premiums also increased. Finally, the act allowed transfers of excess pension assets to fund future retiree health benefits and transfer of excess pension assets for retiree life insurance. This Act could have a positive effect on overfunding DB plans under section 404(o). Perhaps an overfunded 412(e) (3) plan could also use the overfunded amounts to provide for post retirement medical benefits. A plan sponsor may overfund the plan under 404(o) and then using the overfunded amounts to provide for post-retirement health benefits. This Act is new and regulations have not been promulgated as of this date.

DATA SUBMITTED BY DR. SMITH: Retirement through a cross tested plan.

SMITH MEDICAL CENSUS

Participant Name	Compensation	Age
Dr. Smith	$200,000	55
Dr. Jones	$200,000	50
Amy Zucker	$40,000	45
Beth Unizker	$30,000	40
Charles Taylor	$25,000	35
Will Stewart	$20,000	30
David Sopk	$20,000	25
Ely Richards	$20,000	21

RESULTS FOR DR. SMITH

SMITH MEDICAL CUSTOM CARVE-OUT PLAN

Participant Name	401(k) Plan	DB Plan	DBEBAR	DCEBAR	401a4EBAR
Amy Zucker	—	$3,239	2.00	—	2.00
Beth Unizker	—	$1,580	2.00	—	2.00
Charles Taylor	—	$897	2.00	—	2.00
David Sopk	$1,000	—	—	8.66	8.66
Dr. Jones	$10,000	—	—	1.13	1.13
Dr. Smith	—	$152,416	8.00	—	8.00
Ely Richards	$1,000	—	—	8.66	8.66
Will Stewart	—	$503	2.00	—	2.00

Funding the plan with Pension Annuity and Pension Life Products

The Pension annuity is a simple product. The insurance company provides a guaranteed interest rate for the life of the contract with a guaranteed lifetime income. No loads or fees are removed from the product, however they do pay producers to install and manage the account. The Pension Life product is also a simple product. The insurance company provides a guaranteed death benefit for the life of the participant and a guaranteed cash value account which builds up cash values for retirement. If the participant surrenders the policy at retirement, the participant may use the cash values to supplement his or her retirement.

Example:

Client A decides to create a 412(e) (3) defined benefit plan. Client A selects 100X monthly earnings as a death benefit. The maximum monthly earnings for 2012 is $16,666/month or $200,000 a year. This translates to $1,666,666 in death benefit.

Funding the Life Policy

The producer finds a high cash value pension life product which is funded with $87,936.63 a year for 10 years. This contribution will reduce each year to the extent the current dividends, interest and mortality expenses exceed the guaranteed rate. Currently, this would decrease the contribution to $69,876 by year ten. The product will provide the participant with a $1,666,666 death benefit and $898,234 in cash value at retirement in 10 years. The total contribution to the plan in 10 years is $775,034. The life insurance policy will have a non-taxable gain on the cash value of $123,200. ($898,234-775,034=$123,200). However, when the life policy is surrendered and the funds are used to purchase a lifetime income, the monthly lifetime income is $4,238.66 a month or $50,863 a year-far short of the $16,666 a month income or $200,000 a year income. The plan would not provide the benefits promised under the plan, so the plan administrator purchases an annuity and funds $223,701 into the annuity each year.

Funding the Pension Annuity

The pension annuity provides a guaranteed interest rate of 3% plus a conversion rate of .00472. The funding of $223,701 is for 10 years which will provide a cash value of $2,632,668 which translates to $12,427/month.

Total funding

The total funding of the plan in year one is $87,936+223,701= $311,637. This provides a death benefit of $1,666,666, a guaranteed lifetime income of $16,666 a month ($4,239+$12,427) cash value of $3,530,902 ($898,234+$2,632,668).

Risk of Loss

The plan assets are supported by the State insurance guarantee funds (13) and in some cases the Pension Benefit Guarantee Corporation (PBGC) (14). The assets are exempt from creditor claims and bankruptcy and arguably are the safest assets in the client's portfolio.

Conclusion:

Cross Tested plans provide asset protection and tax benefits. Contributions are simply determined on a "benefits basis" as opposed to a contribution basis. The population of baby boomers need to fund more for retirement, a cross tested plan can be an ideal solution as they are generally older and more highly compensated and will achieve larger contributions on a benefits basis. There is not much guidance in performing cross testing with a 412(e) (3) plan and a profit sharing plan. No regulations or examples have been promulgated by the IRS at the time of this writing which places the administrator in a position of using a "reasonable" standard. Perhaps the Supreme Court will give "deference to the administrator" in performing this task.

ABOUT THE AUTHOR:

Nick Paleveda MBA J.D. LL.M, Adjunct Professor, Graduate Tax Program, Northeastern University, received his B.A. in 1977 and M.B.A. degree in 1979 from the University of South Florida. Mr. Paleveda received his J.D from the University of Miami in 1982. Next, Mr. Paleveda attended the University of Denver and received his Master of Laws in Taxation in 1984. During the summer, Mr. Paleveda attended programs in Oxford University for law in England and international business at Harvard University in the U.S.

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Endnotes:

(1) *See* Kenneth Black Jr., Group Annuities (Philadelphia: University of Pennsylvania Press,

1955 p.9).

(2) Ibid p. 11

(3) T.D. 7706 issued on July 15,1980 addressed issues relating to insurance contract plans which provided these plan have "level premiums" T.D. 7762 January 23, 1981 allows the use of variable annuities in a 401(j) plan. This rule also limits that cash value of a 412(i) plan that allows direct distribution of the annuity contract. Fortunately T.D. 7762 was
Repealed by 1983.

(4) S*ee* Reg. 1.401-8(b) (iii) (b). You do not even need to file a form 5500 until the assets exceed $250,000-see Instructions to form 5500. For those who are reading this article, the footnotes are important.

(5) Nick Paleveda MBA J.D. LL.M, 412(i) Defined Benefit Plans, A.R.I.S. 2005

(6) *See* Paleveda and Podleski, "Small Retirement Plans face funding Dilemma", *Journal of Accountancy*, May 2009.

(7) Revenue Ruling 74-307, as clarified by the November 8, 1979, letter from Winfield C. Burley of the IRS to Robert G. Chipkin at Phoenix Mutual Life Insurance Company (Chipkin Letter), provides that the maximum amount that may be used to pay premiums for whole life insurance products in a defined benefit pension plan is 66 2/3% of the theoretical reserve under the Individual Level Premium (ILP) funding method. If greater, the insured death benefit may be as high as 100 times the projected monthly benefit.

(8) "Premium payments may be considered to be level even though items such as experience gains and dividends are applied against premiums, Reg. 1,412(i)-1(b)(2)(ii).

(9) The first "listed transaction" under Revenue Ruling 90-105 was a 401(k) plan requiring a Form 8886.

PRELIMINARY RETIREMENT PLAN PROPOSAL

For

Jones Inc.

June 2012

Age 65-NRA

National Pension Partners
4164 Meridian Street, Suite #31`0
Bellingham, WA 98226
Telephone – (360) 733-1356
Fax – (360) 756-9033
www.NationalPensions.com

Introduction

Retirement is a vital component of any solid financial plan. At National Pension Partners, our goal is to provide you with a retirement plan that is suited to your situation and will achieve your goals within your budget. A comfortable, financially secure retirement is the reward for many years of sacrifice and hard work. It may also be needed at a time when even minor health issues reduce one's capacity or energy to sustain a small business. Our plans allow for some flexibility, but it is vital that we work closely with you and your CPA to make changes on a proactive basis. The proposal presented here is a place to start a detailed discussion of your goals and concerns.

This program has three elements:

The first is a 401(k) Plan. This plan allows employees to defer from income tax part of their compensation up to $17,000 until they reach age 50. At age 50, in addition to the $17,000 regular salary deferral, the law allows a catch up contribution of $5,500. The company may contribute to this plan. The investments are primarily mutual funds.

The second element is a profit sharing plan. This plan must be made available to all participants who are not in the defined benefit plan. Contributions are generally 7.5% of pay.

The third element is a defined benefit plan. This plan is designed for a key group of employees, no less than 40% of the eligible employee. This plan will provide a guaranteed income for life beginning at normal retirement age or a lump sum distribution. Currently, the law mandates that Normal Retirement Age cannot be less than age 62 to 65 or 5 years of participation. This plan is funded with guaranteed pension annuities. The pension annuities must meet the specifications of the Internal Revenue Service and the Department of Labor. The contracts offered by the insurance carrier must have a guaranteed rate. The plan may also have guaranteed death benefits as long as they comply with Revenue Ruling 74-307.

The plan may actually earn more or less than 3%, but we use that assumption in designing the plan. This combination of the pension plan with the 401(k) Profit Sharing plan will generally provide the optimal tax deduction and the most secure retirement program for you and your family.

Preliminary Retirement Plan Proposal
Plan Year Beginning January 1, 2012

EMPLOYEE NAME	ELIGIBLE COMPENSATION	ELECTIVE DEFERRAL	EMPLOYER PROFIT SHARING CONTRIBUTION	EMPLOYER GUARANTEED PENSION CONTRIBUTION	TOTAL CONTRIBUTION
Mr. Jones	200,000	22,500	12,000	205,650	240,150
Mrs. Jones	200,000	17,000	12,000	118,067	147,067
					$387,217

Estimated 5 year tax deferral-$691,380

TAX SAVINGS	
Employer Contribution	$387,217
Federal	135,525
State	-
Medicare	2,751
Total	**$138,276**

Based on the data we received, we created this plan design as an initial proposal. This does not include every alternative. It is offered as a place to start our exploration of your goals and concerns. Each plan may operate collectively or independently.

This plan has three key elements to maximize your tax deduction and to provide a secure retirement. The first element is a 401(k) employee contribution-the maximum contribution is $17,000-however you may contribute an additional 5,500 if over age 50.

The second element is a profit sharing plan, which you can contribute 6% of pay or 25% of pay if the defined benefit plan is covered by the PBGC with a maximum of $50,000.

The third element is a fully guaranteed defined benefit plan to provide retirement security in the form of a guaranteed monthly income.

401(k) Elective deferrals are considered employee contributions and are subject to Social Security and Medicare taxes. 401(k) contributions are excluded for State and Federal Income Tax purposes.

The actual compensation can exceed this amount. For purposes of this plan design, considered compensation for testing the calculation is limited to $250,000 in 2012.

Based on the data we received, we created this plan design as an initial proposal. This does not include every alternative. It is offered as a place to start our exploration of your goals and concerns.

The actual compensation can exceed this amount. For purposes of this plan design, considered compensation for the benefit calculation is limited to $200,000 in 2012. The maximum compensation is different for benefits and testing purposes.

The actual contribution can exceed this amount. For purposes of this plan design, considered compensation for the benefit calculation is limited to $200,000.

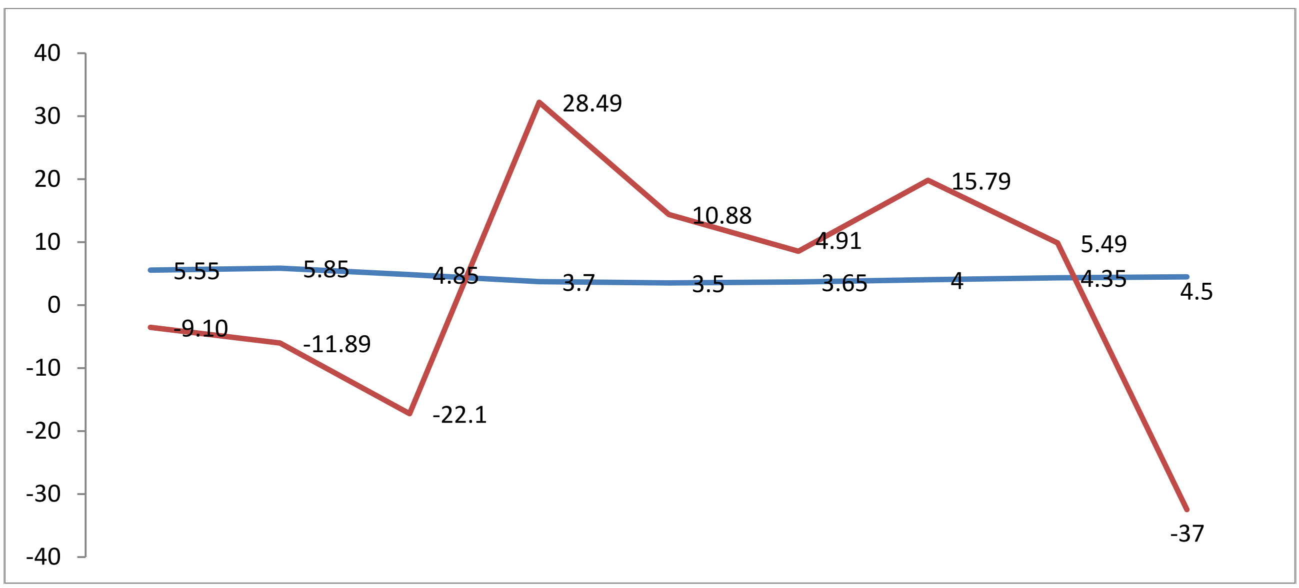
* HCE management discretion.

** If included in the pension plan.

Pension Annuity vs. S&P 500

Comparison of Pension Annuity and the S&P 500 since the year 2000

	Contribution	Running Total Pension Annuity	Rate	Contribution	Running Total S&P 500	Rate
2000	100,000	105,550	5.55	100,000	90,860	-9.10
2001	100,000	217,575	5.85	100,000	168,202	-11.89
2002	100,000	332,997	4.85	100,000	208,130	-22.10
2003	100,000	449,018	3.70	100,000	397,542	28.69
2004	100,000	568,233	3.50	100,000	551,710	10.88
2005	100,000	692,623	3.65	100,000	683,709	4.91
2006	100,000	824,372	4.00	100,000	907,456	15.79
2007	100,000	964,535	4.35	100,000	1,062,745	5.49
2008	100,000	1,112,439	4.50	100,000	669,529	-37
2009	100,000	1,245,812	3.00	100,000	943,606	26.46
2010	100,000	1,386,186	3.00	100,000	1,169,986	12.11
2011	100,000	1,427,777	3.00	100,000	1,169,986	0.00



KEY EMPLOYEE PENSION BENEFITS ONLY
Plan Year Beginning January 1, 2012

Retirement age 65

EMPLOYEE NAME	SALARY	MONTHLY BENEFIT	LUMP SUM	DEATH BENEFIT
Mr. Jones	200,000	16,666	3,400,000	1,666,666
Mrs. Jones	200,000	16,666	3,400,000	1,666,666

Benefits cannot be above the maximum Section 415 limit. Benefits at this level will not increase unless there is a COLA adjustment. Contributions may decrease if the plan earns more than the guaranteed crediting rate. Contributions could also increase if the maximum benefit or considered compensation levels increase. Additional employees may increase employee costs. You must consider the vesting and participation rules carefully.

- Pension contributions may vary in the final plan design. Younger participants have more time to fund. Death benefits follow the IRS guidelines for a QPSA under Revenue Ruling 74-307.
- Disability benefits are based on accruals in the plan at the time of disability.
- Lifetime income is mandatory while the plan is active. A lump sum may be taken at termination.
- Funds within the plan grow at 3% per year, or the crediting/dividend rate (current declared interest or dividend rate) of the insurance company, whichever is greater. A lower crediting rate increases the contribution.
- Death benefits are contingent upon passing a physical.

These benefits do not include benefits you may receive from a 401(k)/Profit Sharing Plan, which are not guaranteed. The plan is funded with annuity and/or life insurance contracts and the assets are protected within limits by the National Organization of Life and Health Guarantee Association. Visit www.nolhga.org The Plan benefits may, within limits, be protected by the Pension Benefit Guarantee Corporation-check with your plan administrator.

Tax savings in a qualified plan can be substantial. In addition, this plan falls under Title One of ERISA and is not subject to bankruptcy, garnishment or attachment.

Your plan is subject to the rules of the Internal Revenue Service, the Department of Labor, the Employee Benefit Security Administration, and the PBGC.

This proposal is for discussion only. The final plan design may vary based on further conversions and the choice of the insurance carrier. The discussions in this handout are for illustrative and educational purposes only and do not reflect the opinions of Northeastern University and cannot be used as tax advice or as a marketable opinion under circular 230. Any use of this material other than for educational purposes is strictly prohibited. Any reproduction without the express written consent of the author is strictly prohibited.

Request for Proposal - RFP

6995 S. Union Park Center, #190
Cottonwood Heights, UT 84074

Telephone: (877)252-1692
Fax(801)676-1505

Business Name:	**Tax Year Month/ Year**	**Date of Incorporation (optional) MM/DD/YY**	**Proposed Year Ending (optional) MM/YY**

Owner:	**Phone:**	**Email:**

Other 401(k) Plan	**Yes** ☐	**No** ☐	**Thrift Savings Plan**
Other Defined Benefit Plan	**Yes** ☐	**No** ☐	**Federal Employee Retirement System (FERS)**
Other Business Ownership Interest	**Yes** ☐	**No** ☐	**None**

Business Entity: Sole Prop. / Partnership / S Corp / PLLC / LLC etc.	**Business Address: (street, city, state, zip)**

Budget: (what the client wants to contribute)	$

CPA's Name:	**CPA's Firm:** (optional)	**CPA's Telephone:**

Financial Advisor's Name:	**Financial Advisor's Address (street, city, state, zip)**

FA's Phone:	**FA's Fax:**	**FA's Email Address:**

Employee Census Data:

Name:	**Birth Date**	**Hire Date**	**Actual W2 Earnings**	**Hours Worked 1000+**	**% Owned**	**Family or Key Empl.**	**Sched. K Income**