

Answers to your questions on 412(i) Defined Benefit plans



Q. WHAT IS A DEFINED BENEFIT PENSION PLAN?

A. A qualified defined benefit pension plan is a pension plan that guarantees a specific retirement benefit. Instead of contributing a specified amount for each participant, the employer contributes whatever amount is necessary to fund this guaranteed retirement benefit. This requires a larger contribution for older, higher paid plan participants.

- larger tax-deductible contributions in early years
- more stability in the contribution level
- simpler plan implementation and management
- a secure promise of future plan benefits based upon the guarantees in the life insurance policies and/or annuity contracts, assuming scheduled premiums are paid by the employer*

Q. WHAT IS A 412(i) DEFINED BENEFIT PENSION PLAN?

A. A 412(i) defined benefit pension plan, referred to in IRS regulations as an “insurance contract plan,” is the only qualified defined benefit plan that is exempt from the minimum funding requirements of Section 412 of the Internal Revenue Code (IRC). This type of plan, therefore, enjoys certain advantages over the traditional defined benefit plan and is worth exploring if you are the owner of a growing business.

These advantages create a plan that, compared to a traditional defined benefit plan, will produce:

Q. HOW DO RECENT CHANGES IN QUALIFIED PLAN LEGISLATION BENEFIT ME?

A. Recent changes in the law have made the 412(i) plan more popular and more powerful as a tax and retirement planning tool. With the repeal of IRC 415(e), a 412(i) plan may now be funded with sufficient assets to provide a retirement benefit of up to \$160,000 annually for the rest of your life. This makes it a far more powerful technique than IRAs, 401(k)s, or profit-sharing plans for a business owner to plan aggressively for retirement while enjoying large current income tax deductions.

The most dramatic change in 412(i) planning opportunities, is that Congress has handed you, via the Economic Growth Taxpayer Relief Act of 2001 (effective January 1, 2002), the ability to receive an income tax deduction of up to \$300,000 or more annually when funding your 412(i) plan. In order to receive this substantial income tax deduction you may be required to make small annual contributions on behalf of your non-highly compensated employees, if they meet the definition of “eligible employee.”

Q. WHAT ARE THE ADVANTAGES OF A 412(i) DEFINED BENEFIT PLAN OVER A “TRADITIONAL” DEFINED BENEFIT PLAN?

A. A 412(i) insurance contract plan:

- does not require an enrolled actuary
- is not subject to the full funding limitation tests of a traditional defined benefit plan
- is required to use the insurance policy or annuity contract guarantees as funding assumptions
- can be designed to eliminate the potential for excess plan assets, that, in a traditional plan, would be subject to taxes and penalties of 80% or more upon termination of the plan
- produces an understandable accrued benefit since it is simply the cash value of life insurance and/or annuity products funding each participant’s account
- creates larger initial deductions than a traditional defined benefit plan since the funding assumptions are required to be much more conservative
- provides retirement benefits that are based on the guarantees in the life insurance policies and/or annuity contracts and not just the financial strength of the particular employer/plan sponsor providing the plan

Q. WHAT REQUIREMENTS MUST BE MET TO QUALIFY AS A 412(i) DEFINED BENEFIT PLAN?

A. The major requirements under Section 412(i) of the Internal Revenue Code are:

- The plan must be funded exclusively with annuity contracts, or a combination of life insurance and annuity products, issued as “same series” by an insurance company.
- The benefits provided each individual must be equal to the values provided in the insurance/annuity products.
- Life insurance dividends and excess annuity interest must be used to reduce the following year’s plan contribution.
- No policy loans are allowed while part of a 412(i) plan.
- The products must provide all benefits stated in the plan using guaranteed values at normal retirement age.
- The life insurance products must provide for level annual premiums payable to normal retirement age.
- Forfeited benefits must reduce future contributions. Forfeited benefits occur when employees leave before becoming fully vested in the plan. The unvested portion of the terminated employee’s benefit must stay in the plan trust, which means that a lower contribution will be required to fund the remaining employees’ benefits.
- Benefits must be guaranteed as long as premiums are paid when required.
- Policies cannot be assigned while they are part of the plan.

Q. HOW DOES THE INITIAL DEDUCTIBLE CONTRIBUTION REQUIRED IN A 412(i) PLAN COMPARE TO A TRADITIONAL DEFINED BENEFIT PLAN?

A. A plan funded with annuity contracts may **double** the deductions allowed under a traditional plan. A plan funded with both annuity and the maximum life insurance allowed may **triple** the deduction allowed under a traditional defined benefit plan.

Comparisons are made for plans funded entirely with annuity contracts and those funded with a combination of annuity and the maximum amount of life insurance available under the incidental benefits rules for qualified plans.

Q. ARE 412(i) PLANS NEW TO THE RETIREMENT PLANNING MARKETPLACE?

A. No, these plans have been around since before ERISA (1974). They are referred to as “fully insured defined benefit plans.” In past years, before the demise of retirement endowment contracts, they were fully funded with a retirement endowment contract issued with a face amount equal to 100 times the normal retirement benefit. They are not a “gray area” of the law and are, in fact, a very conservative approach to retirement plan funding. All benefits are based on the life insurance policy and/or annuity contract guarantees.*

Q. WHERE DO YOU GO TO FIND A 412(i) PLAN?

A. Generally, you will go to a financial professional who sells these types of plans. The funding must be in insurance company products and be based on the guarantees under the products. However, because of the recent renewed interest in these plans, it may be somewhat unfamiliar to most CPAs and owners of growing businesses.

Q. HOW ARE 412(i) PLANS DESIGNED?

A. 412(i) plans are designed by determining how much annual income you will need at retirement and then calculating the annual contributions required to reach that goal by the time the

participant reaches normal retirement age. The U.S. government allows you to plan for substantial annual retirement income of up to \$160,000 annually (2003) with the 412(i) plan and permits a tax deduction for the required contributions made to the plan to meet this retirement goal.

Q. HOW MUCH CAN I CONTRIBUTE?

A. How much you can contribute depends on the amount of the retirement benefits and the amount of time remaining until each participant reaches retirement age as specified in the plan. Because there is flexibility in specifying the benefits and the retirement age at which benefits will be paid, a plan can usually be designed with your budget in mind. The maximum annual benefit is the lesser of \$160,000 or 100% of the average of the highest three consecutive years of compensation as a plan participant.

Q. DO THE CONTRIBUTIONS REMAIN LEVEL FOREVER?

A. The contributions will gradually decrease since dividends and/or excess interest earned over the guaranteed rate must be used to reduce the following year's contribution. However, if the deduction decrease becomes a problem, it is likely the plan benefit can be increased to compensate for that since the maximum benefit levels are subject to annual cost of living increases declared each year.

Q. DOES IT MAKE GOOD ECONOMIC SENSE TO USE LIFE INSURANCE AS PART OF THE FUNDING OF MY DEFINED BENEFIT PLAN?

A. Yes, because:

- It can assure your estate of needed liquidity on a tax deductible basis. In fact, it is one of the safest ways to use pre-tax dollars.
- It can reduce your cost of providing needed life insurance benefits to your family and/or your business.
- It helps guarantee your retirement benefit and helps eliminate the uncertainties of a down market.

- It guarantees you and your eligible employees a benefit if they die before reaching retirement age.
- The life insurance portion of your plan may be continued after retirement.
- The higher tax deduction allowed by your defined benefit plan split funded with insurance can substantially reduce “Retained Earnings.”
- The difference between the policy face amount and the cash value would be paid out income tax free to your heirs.
- Your retirement security is represented in the cash and annuity values in the insurance products funding your 412(i) plan. Therefore, you never have to be concerned with not having exactly the retirement income for which you have planned.

Q. SO, ALL OF MY CONTRIBUTIONS ARE TAX DEDUCTIBLE, RIGHT?

A. Yes, all employer contributions required to fund benefits are currently tax deductible, as they are with any qualified pension plan.

Q. DO I HAVE TO PAY TAXES ON ANY EARNINGS IN THE PLAN?

A. No, earnings in the plan accumulate tax deferred. If life insurance is used to fund any of the benefits, a relatively small amount of income must be recognized each year by each participant covered by life insurance. This amount is known as the “economic benefit.” Other than this, there is no tax incurred by participants until distribution, when the benefits become subject to taxation, unless the assets are rolled over to another qualified plan or IRA.

Q. WHAT FINANCIAL PRODUCTS CAN I USE TO FUND A 412(i) PLAN?

A. 412(i) plans can invest in any insurance product that meets IRS guidelines with guaranteed interest and annuity purchase rates. This includes cash value life insurance and deferred annuities filed as being of the “same series.”

Q. WHO DO I HAVE TO INCLUDE?

A. Employers must offer participation in the plan to employees who are over age 21, and have worked at least 1,000 hours. It may exclude non-resident aliens and those employees participating in a union plan. Waiting periods, vesting schedules and benefit accrual formulas can be used to make sure that the plan rewards those employees who you value the most.

Q. HOW DOES A 412(i) PLAN AFFECT MY EMPLOYEES?

A. Employee benefits are determined by a variety of factors. For example:

1. Employees must be over 21 to participate.
2. Employees must stay with the company for a period of 3 years or 6 years (depending upon the vesting schedule) to become 100% vested in their benefits.
3. Employees might have most of their benefits offset by Social Security. Effective January 1, 2002, an employer’s contribution of up to 7½% of employees’ pay may be necessary to pass the new “minimum gateway” rules.
4. Employees must work over 1,000 hours each year.
5. Employees must not benefit from a union plan.

Q. ARE MY 412(i) PLAN CONTRIBUTIONS SUBJECT TO THE ALTERNATIVE MINIMUM TAX (AMT)?

A. No, contributions to your 412(i) plan are not subject to AMT and might lower your overall exposure to AMT. This is a powerful tax-saving opportunity.

Q. ARE THE ASSETS IN MY 412(i) PLAN PROTECTED FROM LAWSUITS AND CREDITORS?

A. Yes, your plan is creditor-protected. A properly drafted 412(i) plan is an ERISA defined benefit pension plan. As such, its assets are fully immune from the claims of creditors.

Q. CAN I AMEND MY 412(i) PLAN?

A. Yes, your plan may be amended. If a plan amendment will result in a significant reduction in the rate of future benefit accruals, the plan administrator must notify all participants and certain beneficiaries. The required written notice is often referred to as the 204(h) notice. For example, if your plan changes the definition of compensation in a way that would lower benefits, a 204(h) notice is required.

Q. CAN I TERMINATE MY 412(i) PLAN?

A. Yes. As plan sponsor, you may terminate your 412(i) plan as long as the plan document provides for termination. In general, a plan must be fully funded and there must be a bona fide business reason for the plan termination, including: a change of ownership of the business by merger; the liquidation or dissolution of the employer; a change in ownership through sale or transfer; the existence of adverse business conditions; and/or the adoption of a new plan. Upon termination, plan proceeds may be rolled over into an IRA, or some other qualified plan income tax-free.

Q. DO I HAVE TO DO ANYTHING AFTER THE PLAN IS IN PLACE?

A. There are a number of things that must be done periodically to ensure that the plan stays compliant with IRS and Department of Labor (DOL) regulations. Contributions must be recalculated each year to account for any excess interest which may be credited and for forfeitures. Summary plan descriptions must be provided to plan participants. New participants must be enrolled when they become eligible. A Form 5500 must be filed each year. Terminated participants must be paid any amounts due them. The plan may also require periodic amendments as necessitated by changes in tax law or DOL regulations. A Form 1099R must be given to each participant who is required to recognize taxable income from the plan.

Q. WHY SHOULD I CONSIDER A 412(i) PLAN?

A. A 412(i) plan guarantees retirement benefits. It usually allows higher tax-deductible contributions than other types of pension plans. And, very importantly, a 412(i) plan can usually be structured to favor older, more highly compensated employees.

Q. WHO IS THE BEST PROSPECT FOR THIS TYPE OF PLAN?

A. Generally, it will be a business with 10 or fewer employees where the owner is at least age 50 and the business experiences very high, consistent cash flow. The ideal prospect is an independent contractor with no employees. Other favorable profiles include medical professionals with few or no employees; S-Corp owners with few employees and consistent profits.

Q. WHAT DO I HAVE TO DO TO START A 412(i)?

A. First you should consult with your tax and/or legal advisors to be certain that a 412(i) plan is right for you. Once you've established that a 412(i) plan is the right solution for your business, the following forms and documents must be completed:

- Census/Request for Information
- Adoption Agreement
- Summary Plan Description (for employees)
- Plan trust instrument
- IRS Tax Determination Letter or use IRS approved prototype plan documents

Q. I ALREADY HAVE A PENSION PLAN. CAN I KEEP THAT AND GET A 412(i) PLAN, TOO?

A. Yes, you can. There are several ways to do this:

- The existing plan can be “frozen” and all future contributions made to the 412(i) plan.

- The 412(i) plan can be “superimposed” on top of your present plan and contributions made to both.
- Your present plan may be able to be rolled into the 412(i) plan.

As part of the plan design process, your Principal Life financial representative will work with their third party administrator (TPA) to determine which of these options is best suited to your goals and budget.

Q. IF I ESTABLISH A 412(i) PLAN, DOES THAT MEAN I CAN'T HAVE A NONQUALIFIED PLAN?

A. No. You can set up a qualified 412(i) plan and a nonqualified executive benefit plan simultaneously.

Q. I ALREADY HAVE A DEFINED BENEFIT PLAN AND MY PLAN ADMINISTRATOR TELLS ME THAT IT IS FULLY FUNDED AND I CAN'T MAKE ANY MORE CONTRIBUTIONS. CAN A 412(i) PLAN STILL WORK FOR ME?

A. A 412(i) plan can often “unfreeze” a fully funded traditional defined benefit plan. Because insurance company guarantees are more conservative than those used by the IRS to determine contributions, 412(i) plans usually require higher contributions to fund the same level of benefits. Because of this, many fully funded defined benefit plans can allow additional contributions to be made when they are amended to comply with the requirements of Section 412(i).

* Guarantees are based on the claims-paying ability of Principal Life Insurance Company, assuming scheduled premiums are paid by the employer

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