412(e)(3) Fully Insured Pension Plans

Mark R. Zingle, FSA, MAAA, EA, MBA
President, Zingle & Associates, Inc.
2013

ZINGLE
AND
ASSOCIATES, INC.

412(e)(3) Fully Insured Pension Plans

Welcome to Zingle and Associates, Inc. Management Series, offering insights on a number of current topics. Additional information on our services and other subjects can be obtained through our web site. We would be pleased to receive feedback from any of our readers. Feel free to contact us by mail, phone, or e-mail.

You've never heard of a 412(e)(3) plan? Don't worry, you're not alone. Although they have been authorized by the Internal Revenue Service for more than 30 years, even many practitioners don't know about them. These are fully insured, defined benefit pension plans, known before 2008 as "412(i) plans". They are well suited to meet the need for tax leverage present in many profitable small businesses. 412(e)(3) plans began to blossom after 1999, when key sections of the Internal Revenue Code were relaxed. Although the following pages will not turn you into an expert, we trust this report will reveal the tremendous opportunities inherent in 412(e)(3) plans. If you are interested in learning more about this evolving subject, we would like to hear from you.

Included in this topic are the following parts:

1. The Basics Page 3
2. What is a 412(e)(3) Plan, and How Does It Work? Page 4
3. Sample Profile Page 5
4. Legal Principles and Administration Page 6
5. Advantages Page 8
6. Disadvantages Page 10
7. Funding and Benefits Page 10
8. A Place for Life Insurance Page 12
9. Comparison: The 412(e)(3) Advantage Page 13
10. The IRS Shuts Down Abusive 412(e)(3) Plans Page 14
11. How to Begin? Page 18
12. Our Services Page 19
13. Important Reminder Page 21
14. Technical Appendix Page 22

1. THE BASICS

To appreciate 412(e)(3) plans, it is necessary to start with the basics. Retirement plans fall into two very broad categories: tax qualified and nonqualified.

Tax Qualified Plans

Qualified plans must be designed and maintained according to rules required primarily by the Internal Revenue Service and U.S. Department of Labor. Over the years, a number of important pieces of federal legislation have shaped tax qualified retirement plans as they are known today:

- Employee Retirement Income Security Act of 1974 (ERISA)
- Omnibus Budget Reconciliation Act of 1987 (OBRA ’87),
- Omnibus Budget Reconciliation Act of 1990 (OBRA ’90),
- Retirement Protection Act of 1994 (RPA ’94),
- General Agreement on Tariffs and Trade (GATT),
- Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA),
- Pension Funding Equity Act of 2004,
- Pension Protection Act of 2006,
- Heroes Earnings Assistance and Relief Tax Act of 2008,
- Worker, Retiree and Employer Recovery Act of 2008,
- Internal Revenue Code, and
- Related statutes, regulations and rulings.

If maintained properly, qualified plans can supply valuable tax deductions to the employer and tax deferrals to the participants. What’s more, they can make sure retirement dollars are available when needed.

Defined Benefit Plans

Within qualified plans, there is a further split between defined contribution plans (“DC”) and defined benefit plans (“DB”). DC plans are defined in terms of the amount of money which can be deposited within a given year. (Think of DC plans as “input” oriented.) Examples include 401(k) and profit sharing plans, where the accumulation uncertainty is borne by the participant. DB plans, on the other hand, are defined in terms of the eventual benefits they pay. (Think of DB plans as “outcome” oriented.)

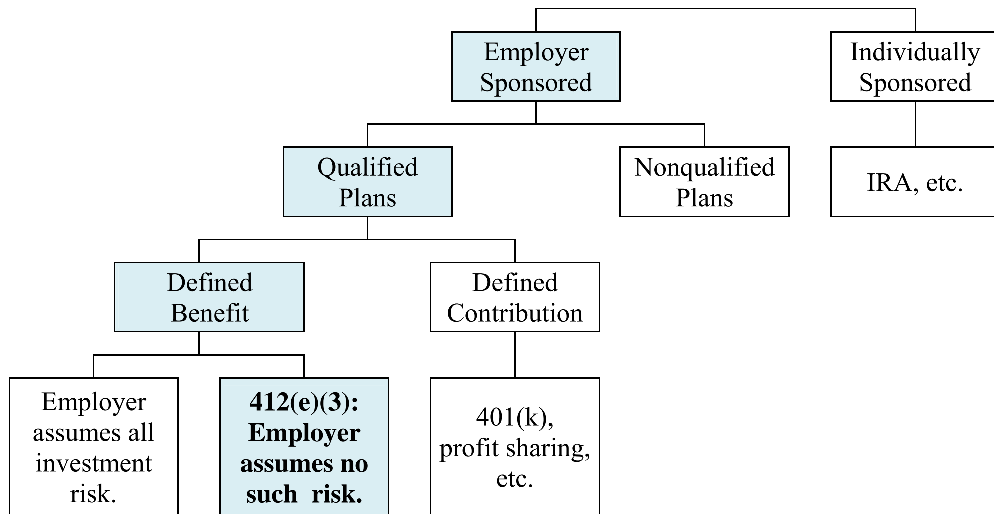
412(e)(3) Plans

Finally, DB plans come in two varieties – trusteed plans (where the funding uncertainty is borne by the employer) and 412(e)(3) plans (where the funding uncertainty is transferred to an insurer).

This “family tree” of retirement plans is illustrated graphically on the following page.

© 2013 Zingle and Associates, Inc. • 4627 Parkridge Dr., Eagan, MN 55123 • Tel: (651) 405-6887 • Fax: (651) 454-0019
www.zingleandassociates.com • *contact@zingleandassociates.com*

OVERVIEW OF RETIREMENT PLANS



2. WHAT IS A 412(E)(3) PLAN, AND HOW DOES IT WORK?

Fully Insured

412(e)(3) plans are named for a section of the Internal Revenue Code. Sometimes they are called “fully insured pension plans”, since funding is accomplished through products available exclusively from insurance companies.

Think of them as a customized, specialty within a specialty. They are defined benefit pension plans in their own right, but are special types best suited for small business owners *with sufficient, sustainable cash flow*. They were first legally recognized at the beginning of ERISA (1974), but didn’t gain popularity until about 2000. The Pension Protection Act of 2006 changed their Internal Revenue Code section from 412(i) to 412(e)(3).

Uncommon Distinction

Why haven’t employers and financial planners heard about them before? For two reasons:

- First, although they have been possible in theory, they were impractical while certain federal requirements were present. For example, Family Aggregation which limited benefits in a family business. Also Internal Revenue Code Section 415(e) which severely limited contributions if the sponsor also maintained another type of plan. All the while, 401(k) plans became “hot” for their investment potential and the possibility for employers to decrease their

funding commitment. However, these stumbling blocks have been repealed, so that higher limits and accelerated funding are at last appealing for baby boomers whose needs for such tools are becoming critical.

- Second, too often business owners have purchased programs in vogue rather than plan types best suited to meet their business needs.

How Does It Work?

412(e)(3) plans typically enjoy larger annual contributions than are possible with trusteed DB plans, profit sharing plans, and 401(k) plans. This can mean larger tax deductions for the employer and larger tax deferrals for the employee. (For an example, refer to Section 9.)

The plan document is designed to establish a retirement benefit formula, usually expressed as a percentage of salary. Each year, the plan administrator calculates the benefit's lump sum equivalent and annual funding amount. Based on that calculation, the employer makes annual premium payments into an annuity (and perhaps a life insurance policy) to accumulate sufficient plan assets with which to finance the deferred benefit.

412(e)(3) plans are required by law to use the conservative ("guaranteed") assumptions of life insurance policies and annuity contracts as their funding targets. In comparison, trusteed DB plans use higher ("non-guaranteed") funding assumptions. The more conservative the funding target, the greater the value to the employer and employee, alike.

The result can be accelerated funding and higher deductions during critical business years.

3. SAMPLE PROFILE

Suitability

412(e)(3) plans are not for everyone. However, when they fit, they can be extremely effective.

- *Tax Strategy*: They are ideally suited to profitable small businesses, including an owner age 30+ with significant earned income, a need for income tax relief, and available positive cash flow. C-Corporations can find them helpful as a "release valve" when significant retained earnings issues are present.

- *Retirement Strategy*: Some business owners have put off saving for retirement while the financial realities of business and family came first. Consequently, there doesn't seem to be sufficient time left to accumulate enough retirement value under common techniques. The good news is that the accelerated contributions of 412(e)(3) plans can be ideally suited to them without taking on short term investment risk.

- *Business Strategy*: Business owners intending to sell their companies with extended payments may wish to integrate 412(e)(3) plans into their planning.

Supplement and Conversion

For those small businesses already in profit sharing, 401(k), SEP or SIMPLE plans, the investment setbacks of recent memory have delayed their retirement horizons. Present market uncertainties often make employers timid about those program types, as well. On the other hand, 412(e)(3) plans can be structured to provide guaranteed retirement income beginning at a designed age.

Another possible use of 412(e)(3) plans is as a conversion vehicle for conventional defined benefit plans which have become fully funded (and hence unable to legally accept additional contributions). Conversion needs to follow methodology prescribed by the Internal Revenue Service, but it may be possible for additional deductions to be designated through conversion or restatement.

Rule-of-Thumb

Although a detailed proposal is needed to measure the 412(e)(3) advantages, the following simple rule-of-thumb can help pinpoint opportunities.

- Step 1: Multiply each employee's age by his or her salary in thousands (limited to $255,000 in 2013 by statute).
- Step 2: Subtract the total for the non-owner employees from the total for the owner employees.
- Step 3: Compare the result to the following "barometer":

8,000 and above:	Excellent results likely
5,000 to 8,000:	Good results likely
Below 5,000:	Fair results likely

For example, consider the following three person employer:

- 50-year old owner ($300,000 salary), plus
- 40 year old assistant ($40,000 salary), plus
- 30 year old assistant ($30,000 salary)

This could be an excellent fit, since: 50x255 minus 40x40 minus 30x30 equals 10,250. Of course, an actual design would need to be undertaken to tell for sure.

4. LEGAL PRINCIPLES AND ADMINISTRATION

According to the Internal Revenue Code, 412(e)(3) plans must continually meet numerous requirements, including the following.

Exclusive

The plan must be funded solely through an annuity contract, or a combination of life insurance policies and annuity contracts. All benefits provided by the plan must be equal to the benefits provided by the insurance and annuity products.

© 2013 Zingle and Associates, Inc. • 4627 Parkridge Dr., Eagan, MN 55123 • Tel: (651) 405-6887 • Fax: (651) 454-0019
www.zingleandassociates.com • *contact@zingleandassociates.com*

- Because insurance company guarantees are used, the plans are called “fully insured”.
- This means that before benefits can be paid or a distribution taken, all policies must be in force and premiums paid to date.
- Both individual and allocated group products are acceptable if they meet the rest of the requirements.

Nondiscriminatory

The policies or contracts must be part of the same series and must be based on identical mortality tables and rate assumptions for all participants. However, Treasury regulations indicate that a combination is acceptable as long as the funding meets the requirements in the aggregate.

With numerous insurers revising products as interest rates have fallen, the “same series” requirement can become an issue and a gray area. Scrutiny of it may rest on employer intent and on the letter of the law vs. the spirit of the law.

Methodology

Funding must be calculated by assuming level premiums to retirement age. Funding must begin when a participant enters the plan and must be complete by the time the participant arrives at the plan’s specified retirement date. (The choice of specified retirement age has met with increased IRS regulation in recent years.)

Loans

Participants may not take policy loans. Exception: automatic premium loans to avoid lapse are not violations as long as the loan and interest on it are repaid within the same plan year and before any benefit distribution occurs.

Ownership

The policies and contracts may not be assigned or pledged as collateral in any transaction.

Legal Administration

412(e)(3) legal requirements can be satisfied through a combination of:

- an IRS-approved plan document, plus
- funding through insurance / annuity products tailored to this market, plus
- an experienced administrator / actuary to monitor ongoing events.

Disclosure

Additionally, as required by the Internal Revenue Service, before insurance policies are issued a funding agreement needs to be entered into between the plan’s trustee (typically the employer) and the insurer. This normally takes the form of a Pension Plan Disclosure Statement, signed by the trustee and submitted to the insurer at the same time as policy applications are sent to the Home Office.

Safety Net

Nevertheless, should such a plan fail to comply with Internal Revenue Code Section 412(e)(3), the plan does not automatically become disqualified. Instead, typically it is deemed equivalent to a trusteed DB plan for that particular year. In that event, an Enrolled Actuary will need to certify to the plan's finances, and additional administration will be necessary. For that reason, as a fail-safe measure, employers should select 412(e)(3) administrators who are also currently certified as Enrolled Actuaries under the Joint Board for Enrollment of Actuaries..

To assist an employer's tax counsel, accountant, and financial planner, the Technical Appendix to this report provides a breakdown of typical day-to-day responsibilities and technical documentation.

5. ADVANTAGES

Income Taxation

- Leverage: Like other forms of tax qualified retirement plans, contributions can be tax deductible to the business. Additionally, once committed to the plan, the funds grow tax-free to the business and tax deferred to the participants.
- Size: Depending on participant age(s), the plan can provide (a) much larger current tax deductions for the business and (b) much larger tax deferments for participants than other forms of tax qualified retirement plans. For example, it may be possible to deduct / defer more than 100% of salary. This can be an amount several times greater than the limits under a 401(k) or profit sharing design.
- Resumption: It may be possible to resume contributions (and tax deductions and deferments) by converting a frozen trusteed DB plan.

Amount of Benefits

- Optimal: A 412(e)(3) plan is capable of providing significant retirement benefits in a short amount of time, typically larger than any other form of qualified plan. This often is well-suited to professionals whose earned income may peak long before formal retirement. Because benefits usually are based on the highest three year average compensation, wages which decline in later years may not decrease pension benefits.
- Communication: The value of a participant's accrued benefit is the cash surrender value of all policies / contracts, thereby simplifying participant communication and understanding.
- Ages: 412(e)(3) plans typically appeal to ages 30 and above, compared with roughly 50 and above under trusteed DB plans.
- Insurance: Life insurance protection, within limits and on a non-

discriminatory basis, can be included on a pretax basis, such as to help with owner buyouts or for other purposes. Insurance can be portable as well, by using the IRS's Safe Harbor approach.

Funding

- Relaxed Rules: 412(e)(3) plans are exempt from minimum funding requirements which can complicate trusteed DB plans.
- Downside Protection: As long as contributions are made as scheduled, underfunding is not possible. This can be a sizeable advantage during times of soft financial markets.
- Upside Protection: 412(e)(3) plans can be designed to eliminate potential overfunding which can occur in trusteed DB plans, thus avoiding costly excise taxes.
- Eliminated Adjustments: There is no requirement for quarterly contributions or interest additions, compared with trusteed DB plans.

Risk Management

- Safety: 412(e)(3) plans are simple, secure, and stable, since the investment risk is passed to an insurance company. Unlike trusteed DB plans where an investment loss can produce large subsequent funding increases, there is no possibility of investment loss with 412(e)(3) plans.
- Acceptable: The IRS is unlikely to challenge the funding assumptions, since they are based on the terms of the insurance or annuity policy. This reduces the risk of IRS objection based on unreasonable funding assumptions.
- Protection: Unlike IRAs and nonqualified plans, assets can be protected from the claims of creditors, an advantage all qualified plans enjoy. (However, exceptions have existed within the authority of certain circuit courts.)

Administration

- Straight Forward: No certification is required by an Enrolled Actuary.
- PBGC: 412(e)(3) plans are exempt from Pension Benefit Guaranty Corporation annual variable premium payments (and administration). Instead, protection is derived from the insurer of record. Note: PBGC annual fixed premium payments are still required from many plan sponsors.
- Portable: 412(e)(3) plans are portable in the sense that they can provide lump sum equivalencies, subject to IRS limits. In order to determine the optimal point to accomplish this, it is important to monitor the funding annually. There is a tremendous amount of incorrect or incomplete information appearing in advertisements on this subject, so it is important for the plan administrator to incorporate the services of an experienced pension actuary.

© 2013 Zingle and Associates, Inc.

6. DISADVANTAGES

Income Taxation

- Pattern: The size of deductions and deferrals tends to decrease slightly over time, since any excess interest must decrease the next year's deposit calculation. Unlike trusteed DB plans, 412(e)(3) plans do not enjoy a range of possible contributions each year.

- Cost of Insurance: Participants' current taxable income is increased by the amount of "pure" death protection in the event life insurance is included within the plan. (However, trusteed DB plans are identical in this respect. The additional tax is small compared with the tax deduction and tax deferral advantages.)

Amount of Benefits

- Other Employees: 412(e)(3) plans do not work well in companies which employ many nonowner employees. (However, trusteed DB plans are identical in this respect, and 412(e)(3) plans actually have broader appeal, since they are attractive for younger ages than trusteed DB plans.)

- Earned Income: 412(e)(3) plans are not necessarily attractive to owners whose compensation comes largely from investment income instead of earned income.

Funding

- Recurring: Contributions are required each year, meaning that the business must be financially healthy with profitable cash flow, ideally for at least five future years. *Contributions are in addition to earned salary, not as a reduction of it.* Unlike 401(k)s, there is no salary reduction with 412(e)(3) plans. Unlike profit sharing plans, 412(e)(3) funding does not enjoy the same level of flexibility from year to year.

- Products: Financing is limited to certain life insurance and annuity products. Mutual funds and variable policies are not permitted. Although some financial planners oppose the use of annuities inside qualified plans, a significant value of 412(e)(3) plans often is tax leverage rather than long term investment income.

Administration

- Loans: No participant loans may be taken, or else the plan will default to a trusteed DB plan for that year.

7. FUNDING AND BENEFITS

High Early Deductions

Excess interest credits or dividends are likely to occur. When they do, they must be used as a dollar-for-dollar offset against the following year's contribution. (That is, they are treated as having been funded in advance.) As the plan's assets increase, these offsetting credits tend to increase as well, resulting in an employer cost expected to decrease over time.

© 2013 Zingle and Associates, Inc.
• 4627 Parkridge Dr., Eagan, MN 55123 • Tel: (651) 405-6887 • Fax: (651) 454-0019
www.zingleandassociates.com • *contact@zingleandassociates.com*

For that reason, and everything else being equal, tax deductions may be greatest in the initial years of a plan. (In contrast, the opposite usually occurs among trusteed DB plans, particularly now that the Pension Protection Act of 2006 has taken effect.) This pattern of high short-term deductions is why 412(e)(3) plans often are ideally suited to high income professionals in mid-career, or beyond. (For an example, refer to Section 9.)

Additionally, unlike trusteed plans where costs can vary widely due to investment experience, the pattern of contributions in 412(e)(3) plans is more predictable.

Maximum Benefits

Top-heavy provisions and maximum benefit limitations affect both trusteed DB and 412(e)(3) plans. That portion of the Internal Revenue Code limiting overall plan benefits is Section 415. For plan years beginning in 2013, this limit is the lower of the following:

- 100% of pre-retirement compensation, defined as the highest three consecutive years of earned income, and
- $205,000

This is not a direct limit on funding. Rather, this is a limit on the amount of annual retirement benefits, subject to adjustment for a targeted retirement age outside the safe harbor design corridor of ages 62-65.

Lump Sums versus Monthly Benefits

Although monthly benefits are the "default" form under the plan, it is common for participants to elect a lump sum equivalent for rollover into an IRA (or other company plan). However, tax law specifies the assumptions for determining the maximum lump sum distribution. These assumptions are usually not as conservative as the insurance policy or annuity contract guarantees that have served as the basis for actual funding. For that reason, participants planning to elect lump sums will need to rely on careful monitoring by the plan's actuary, so that the optimal point can be anticipated without inadvertently "leaving dollars on the table".

Other techniques are available to avoid or minimize this problem. For example, setting the plan benefit formula below the Section 415 maximum from the outset, or electing to receive monthly retirement income rather than a lump sum (called "annuitization").

A word of caution is in order. Some plans have been designed with only a monthly retirement income option available. When participants expect a lump sum option as well, the communication "disconnect" can become a significant disappointment at retirement. Modifying such an existing plan by adding a lump sum option usually is possible. However, doing so may trigger overfunding if benefits were structured originally with no intent to pay lump sums.

© 2013 Zingle and Associates, Inc. • 4627 Parkridge Dr., Eagan, MN 55123 • Tel: (651) 405-6887 • Fax: (651) 454-0019
www.zingleandassociates.com • *contact@zingleandassociates.com*

8. A PLACE FOR LIFE INSURANCE

Incidental Test

To maximize the available benefits of a 412(e)(3) plan, life insurance can serve as one of the funding vehicles under the plan. Either Whole Life or Fixed Premium Universal Life can provide such accumulations, although variable products are not permitted (since guaranteed rates are required for funding purposes.)

According to IRS requirements, however, life insurance being used to accumulate plan equity must be held below a maximum amount:

- *Method #1*: Amount of life insurance protection at the date of issue ≤ 100 times the projected monthly retirement benefit.

- *Method #2*: Amount of life insurance premium < 2/3 times the theoretical "would have been" level annuity premium in the absence of life insurance.

Occasionally life insurance policies and annuity contracts incorporate guaranteed settlement factors different from each other. Therefore, 412(e)(3) plans are best served by emphasizing the more conservative of the two. Often this will be the annuity, in which case greater retirement funding may be accomplished by emphasizing that product. (Also refer to the "Nondiscriminatory" section under Part 4.)

However, even in this event life insurance can be included in the plan, as long as it complies with the "incidental insurance rules" found in Treasury Regulation Section 1.401(b)(1)(i). These provisions limit the amount of life insurance that can be purchased (pre-tax) under the plan, as indicated above.

For example, a participant qualifying for the Year 2013 maximum retirement benefit ($205,000 / year) may be able to finance up to $205,000 / 12 x 100 = $1,708,333 of death benefit, as long as the other limitations are met. (Assumes the 100x Method is use.)

While life insurance does not have to be offered under a 412(e)(3) plan, this feature can provide important additional pre-tax benefits if desired. For highly profitable, closely held businesses, there often exists a substantial insurance need for the owner. A "fully insured" retirement plan can simultaneously fund such protection while maximizing current deductions.

Current Economic Benefits

When life insurance is included inside a pension plan, participants annually must recognize this "current economic benefit" provided by the plan as taxable income. (Internal Revenue Code Section 72(m)(3)(B), and Reg. Section 1.72-16(b).)

Each participant is taxed on the cost of the "pure" life insurance benefit. This cost presently is based on Mortality Table 2001 (formerly the "PS58 Cost"),

according to Notice 2001-10, Notice 2002-8 and others. Its amount is calculated by using the one year term insurance rates from such table, or the insurer's own rates if lower and available to all standard risks.

Once determined for a participant, the resulting amount is communicated by the plan's administrator to the participant by means of a 1099-R form, for inclusion in the participant's gross income for the year. The year's personal tax on this amount usually is small compared with the large deduction taken by the business.

9. COMPARISON: THE 412(E)(3) ADVANTAGE

Any comparison is only as valid as the actual facts and circumstances. Nevertheless, the following example may be typical of certain small businesses. It is based on a one-person plan with the owner's earned income of $255,000 (or more) per year, a plan benefit subject to the 2013 statutory maximum ($205,000 per year), and other assumptions as follows:

- Current age 50
- Retirement age 62
- 412(e)(3) funding assumptions: 1.0% pre-retirement interest and 1.5% post-retirement interest (annuity), 5.25% pre-retirement interest and 5.25% post-retirement interest (insurance), 2000a Table post-retirement mortality (all guaranteed). Actual experience: 1.0% annuity, 5.25% life insurance. Insurance proportion: 40%, Standard Non-Smoker underwriting.
- Alternative funding (trusteed) assumptions: 5.09% pre- and post-retirement equivalent discount rate (IRC §430 segment rates for November 2012), and 2013 Applicable Mortality Table (male non-annuitant, non-guaranteed, post-retirement). Actual investment experience: 5.09% investment income.
- For the three alternatives other than Profit Sharing, each benefit formula is set equal to 51.92% of average compensation.

Plan Year	Resulting Contributions for Four Plan Types (Yrs 1-5)			
	Profit Sharing	**Trusteed Defined Ben.***	**412(e)(3) Plan w/o Ins.****	**412(e)(3) Plan w/ Ins.****
2013	$51,000	$77,480	$181,725	$245,245
2014	51,000	82,826	181,725	245,245
2015	51,000	88,289	181,725	245,245
2016	51,000	93,884	181,725	245,245
2017	51,000	99,607	181,725	245,245
Totals	$255,000	$442,086	$908,625	$1,226,225

* Under the Pension Protection Act of 2006, larger lump sum funding may be possible. However, doing so will tend to reduce future contributions. Hence, this column is based on the prescribed minimum funding.

** When insurance companies are able to credit more than the product guaranteed interest rates, the funding patterns under these alternatives will tend to decrease in renewal years.

For this particular example, an employer may consider establishing a conventional Defined Benefit Plan since its tax deductible funding exceeds the Profit Sharing alternative. However, over the same time period a 412(e)(3) plan can provide deductions significantly greater than both the Profit Sharing and traditional Defined Benefit plans. *What's more, it can do so with lower investment risk.*

Actual results will vary depending on case design, crediting rates, and securities or insurance products chosen. Ages older than this example may produce even greater funding results.

10. The IRS Shuts Down Abusive 412(e)(3) Plans (2005 and Later)

"Again and again, we've uncovered abusive tax avoidance transactions that game the system to the detriment of those who play by the rules… Today's action sends a strong signal to those taking advantage of certain insurance policies that these abusive schemes must stop."

-- Mark W. Everson, IRS Commissioner

Friday the 13th of February 2004 was, indeed, unlucky for some 412(e)(3) practitioners. That was the day when the IRS issued long-awaited guidance designed to shut down certain abusive approaches. At last – a level playing field! As stated by Assistant Secretary for Tax Policy, Pam Olson, "There are many legitimate Section 412(e)(3) plans, but some push the envelope, claiming tax results for employees and employers that do not reflect the underlying economics of the arrangements." Public comments were accepted until May 2004 (in writing) and June 2004 (public hearing). Resulting from this feedback, further refinements were made in April 2005 in the form of Revenue Procedure 2005-25. This was very welcome relief after nearly 30 years without material guidance on the subject of 412(e)(3) plans.

The major issues addressed by the IRS are summarized below. To review the actual text, refer to our web site.

Issue #1: Fair Market Value

- The Problem: For many years, Internal Revenue Code §402 and related regulations have contained the tax requirements for policy buy-outs from qualified retirement plans. However, certain terms initially were not adequately defined, leading some practitioners to interpret them in unintended ways. As well, "in kind" distribution of the actual life insurance policy was not adequately addressed.

Before 2004, some 412(e)(3) sales relied on life insurance products with exceptionally low cash values in their early years. This created an artificial incentive for the plan participant to purchase the ownership rights of the policy from the plan during its low cash value period. In this way, the tax deduction claimed by the employer would be significantly greater than the income recognized by the employee. Such transactions can be timed so that the policy cash value increases rapidly thereafter. A related issue is when such arrangements are made available only to highly compensated employees.

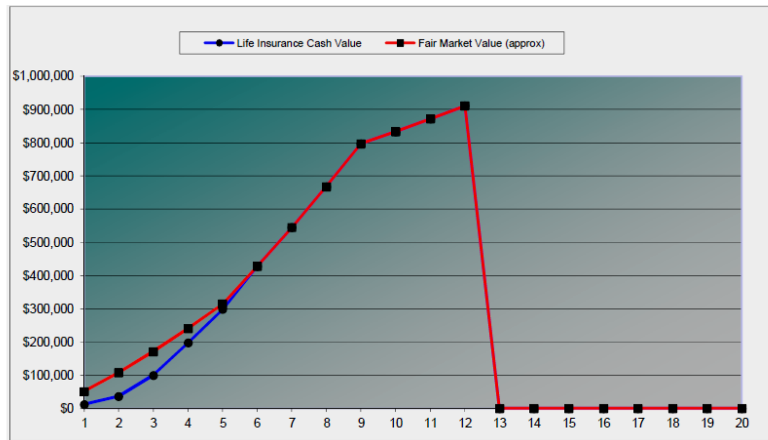
- The IRS Solution: The IRS began studying artificially low cash value insurance products in 1988, at which time it coined the phrase "springing cash values". It now has clarified earlier ambiguities: future 412(e)(3) distributions and/or buy-outs of life insurance policies by employees are taxable at full fair market value. (This also applies to transfers from employers in other kinds of tax-qualified plans.)

  As defined by the IRS, fair market value will rarely be the policy cash surrender value. It usually will be closer to the account value (before surrender charge) for unbundled products, or to the interpolated terminal reserve for traditional dividend-paying products. Additionally, it is possible for the fair market value to be even higher, depending on facts and circumstances. [Amendments to Treasury Regulations §1.79-1, §1.83-3, and §1.402(a)-1]

  In 2004, the IRS proposed a safe harbor for determining fair market value for buy-out purposes. Its formula was based on the accumulation of premiums, adjusted for interest, expected mortality, and policy expenses. Since 2005, the IRS has permitted a reduction in this accumulation by removing an *average* surrender charge. In this way, the fair market value typically falls between the account value and cash value, but usually closer to the former. (For "bundled" insurance products, interpolated terminal reserve is used.) [Revenue Procedure 2005-25, superseding and replacing Revenue Procedure 2004-16]

  > *Caution: if the buy-out price is set lower than the fair market value, the participant's current taxable income will increase in an amount equal to the difference between the two values.*

© 2013 Zingle and Associates, Inc. • 4627 Parkridge Dr., Eagan, MN 55123 • Tel: (651) 405-6887 • Fax: (651) 454-0019
www.zingleandassociates.com • *contact@zingleandassociates.com*



Life Insurance Cash Value: Illustrates possible insurance surrender values, assuming the insurer's current rates continue. **Fair Market Value**: Based on IRS safe harbor, and applicable in the event of policy buy-out or policy rollover.

All values are expressed as of the end of the plan year. Account Value is before surrender charges, Cash Value is after surrender charges, and Fair Market Value is approximated from the safe harbor of Revenue Procedure 2005-25. All values are based on current factors and therefore are not guaranteed. Where applicable, fair market value may need to be based on the insurer's interpolated terminal reserve, instead.

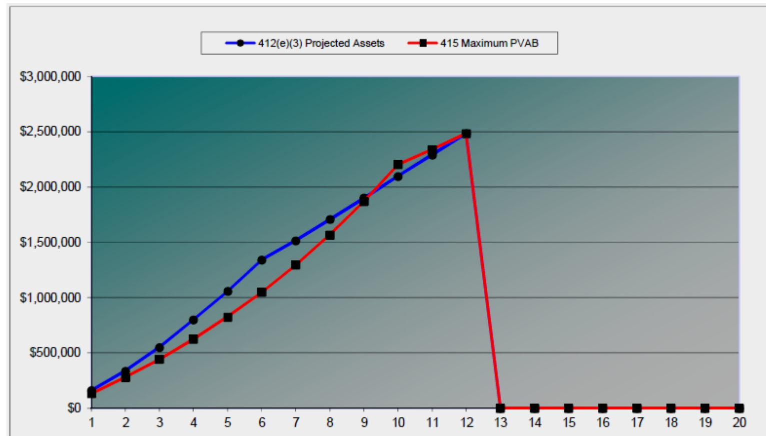
The graph shown above is derived from a popular insurer's rates and values, together with the resulting fair market value under the IRS's 2005 safe harbor. (Assumes design for issue age 50, retirement age 62, 40% life insurance funding blend, and other assumptions taken from the example in Section 9.)

But that is not the end of the story. Often, the fair market value is greater than the corresponding cash surrender value. That means that a buy-out for the full fair market value will tend to create a temporary surplus within the remaining annuity policy. As a result, the following year's employer funding will decrease. (By statute, a 412(e)(3) "gain" must be used to reduce the following year's premium.)

In this way, an employer who personally buys out his/her own life insurance policy is funding in advance for the next year, although with non-deductible dollars. That is, the plan's funding is roughly the same as it otherwise would have been, if you consider both years together.

This sort of effect should be discussed during the design of the plan, assuming the proposal system is able to project it. From the beginning of our 412(e)(3) practice, Zingle & Associates, Inc. has developed such a tool. (Refer to the graph below, illustrating the effect on the funding of such a buy-out at the end of the fifth year. (Same example as illustrated, above.)

© 2013 Zingle and Associates, Inc. • 4627 Parkridge Dr., Eagan, MN 55123 • Tel: (651) 405-6887 • Fax: (651) 454-0019
www.zingleandassociates.com • *contact@zingleandassociates.com*



412(e)(3) Projected Assets: Illustrates possible policy cash values, based on the design parameters outlined in Section 9. **415 Maximum PVAB**: Estimated lump sum accrued benefit limit, assuming continuation of current (nonguaranteed) IRS discount rates.

- Who is Impacted? Employees purchasing a policy from the plan or from the employer, and participants rolling life insurance policies in-kind as part of a plan distribution.

- When Effective? Distributions, sales, and transfers made on and after February 13, 2004. (Taxpayers were able to rely on the requirements proposed under Revenue Procedure 2004-16 until May 1, 2005.)

- For Additional Review: Refer to Revenue Procedure 2005-25, which superseded and replaced Revenue Procedure 2004-16

Issue #2: Deductible Premiums / Excessive Benefits

- The Problem: 412(e)(3) plans pay death benefits as well as retirement benefits, and for risk management reasons many purchase life insurance policies to help manage that risk. However, some plans have purchased higher amounts of protection than they are legally able to remit to the beneficiaries of the plan participants. Such an insurance purchase was not a violation per se, although it certainly inflated the tax deduction claimed by an employer. Proponents of this approach argued unsuccessfully that the worst case scenario would be for the plan to enjoy a large windfall in the event of an actual death claim.

- The IRS Solution: The solution comes in two pieces. First, a qualified pension plan is not a 412(e)(3) plan if the funding contracts provide benefits at normal retirement age which exceed those provided under the terms of the plan document. Second, the employer's current tax deduction is limited to that portion of the life insurance premium represented by the plan's death benefit under the terms of its legal document.

  In other words, assuming the plan is still a 412(e)(3), premiums for excess coverage are no longer currently deductible by the employer. They are considered advance payments against future years' costs following a death in

the plan; at that future time they would be deductible on a carryover basis. (Amends Revenue Ruling 55-748, where this same position has been held by the Service for nearly 50 years.) Additionally, most of these “excess” arrangements now are considered “listed transactions” for tax-shelter reporting purposes. [Revenue Ruling 2004-20]

As required by Treasury Regulation §1.6011-4, abusive tax shelters ("listed transactions") now must be disclosed by participating corporations, individuals, partnerships and trusts. This is done by attaching Form 8886 (disclosure statement) to the entity’s tax return. A listed transaction is one that is the same or substantially similar to one published by the IRS as tax avoidance. Entities engaging in listed transactions may be required to disclose the transaction, register it with the IRS, or maintain lists of such investors and furnish the list to the IRS on request.

To obtain a copy of IRS Form 8886, refer to:
www.irs.gov/pub/irs-pdf/f8886.pdf

For the IRS web site on listed transactions, refer to:
www.irs.gov/Businesses/Corporations/Listed-Transactions---LB&I-Tier-I-Issues#27

- Who is Impacted? Plans purchasing insurance in excess of the IRS incidental limits.
- When Effective? February 13, 2004.
- For Additional Review: Refer to Revenue Ruling 2004-20

Issue #3: Nondiscrimination Rules

- The Problem: Some 412(e)(3) plans have permitted highly compensated plan participants to purchase from the plan their life insurance policies based on cash value, without extending the equivalent opportunity to non-highly compensated participants. In some cases the difference in purchase opportunity is subtle – for example, in the features of the policies, themselves.
- The IRS Solution: 412(e)(3) plans may not use differences in life insurance policy forms to discriminate in favor of highly paid employees. This applies to all “benefits, rights, and features” offered under the plan. Only in this way will a plan demonstrate compliance with anti-discrimination requirements. Especially problematic are differences in the terms of cash value growth or different exchange features, even if the buy-out procedure is identical for the two groups of participants. On the bright side, the IRS is not requiring uniformity in insurance policy buy-outs by participants – only that what is offered and the terms under which it is offered do not discriminate in favor of the highly compensated. [Revenue Ruling 2004-21]
- Who is Impacted? Plans differentiating either policy distributions or buy-out rights / benefits between highly compensated and non-highly compensated participants.
- When Effective? February 13, 2004.

- For Additional Review: Refer to Revenue Ruling 2004-21

11. How to Begin?

An employer is only five steps away from enjoying the benefits of a 412(e)(3) plan:

Step 1: Communication

First, contact us for answers to any questions not addressed in this material. If you prefer, we will be happy to work with the employer's insurance agent or financial planner. Your tax and legal advisors also should provide input to the decision making process.

Step 2: Data

Second, request a no-obligation 412(e)(3) Feasibility Study from us. For that, we will need to receive certain confidential information. We make it straight-forward by minimizing the input we need.

To obtain a hard copy of our "fact finder", refer to our web site at: www.zingleandassociates.com/knowledge-center/defined-benefit-data-submission-form/

Step 3: Request

Third, return the information to us. There is no charge for our proposals.

Step 4: Proposal

Fourth, once complete, we will furnish the financial advisor with our written report, outlining our conclusions, recommended design and level of funding. We also are available to answer questions and discuss alternatives.

Step 5: Approval

Fifth, we receive the employer's approval to begin plan implementation.

12. Our Services

Typically, there are four types of stakeholders in a 412(e)(3) plan, in addition to non-owner participants:

- Employer: Responsible for financing, fiduciary matters, and day-to-day plan compliance decisions and actions.

© 2013 Zingle and Associates, Inc.
• 4627 Parkridge Dr., Eagan, MN 55123 • Tel: (651) 405-6887 • Fax: (651) 454-0019
www.zingleandassociates.com • *contact@zingleandassociates.com*

- Insurer: Responsible for risk management, policy compliance, policy issue / administration, and policy communication.

- Financial Advisor (Agent / Broker): Responsible for client needs-analysis, policy application(s), ongoing policy transactions, product-related assistance, and general communication.

- Consultant (Administrator and Actuary): Responsible for plan design, plan administration, advisory services, plan compliance issues, and prompting necessary action in advance.

As the remodeling pro and television personality, Mike Holmes, has said, "There are the good, the bad, and the ugly [home contractors]. Everyone knows who the ugly are, and everyone stays away from them. But then there is the bad. They either don't know enough or don't care enough to do the job right for you." *Holmes on Homes*, aired January 22, 2011.

The same can be true of benefit consultants. As independent, third party administrator, Zingle & Associates, Inc. provides turn-key administrative services for 412(e)(3) plans and the small employers who sponsor them. Over the years we have served clients in 35 states, and we encourage you to compare our experience with that of other TPAs. We work as a team with employers, insurers and financial professionals to coordinate the various steps detailed more completely in the Appendix.

Our services can be broken down as follows:

Beginning

- Design / conversion
- Sample Board resolution, Notice to Employees, and Beneficiary forms
- Installation
- Summary Plan Description and other required disclosure

Maintaining

- Annual valuation and premium calculation
- Annual actuarial projection (early warning system)
- Annual participant certificates
- Annual preparation of Form 5500 and related schedules
- Annual preparation of PBGC premium form (if required)
- Annual compliance check / monitoring
- Annual 1099-R preparation as needed

Changing

- Employment termination calculations, as needed
- Sample plan amendments as needed
- Plan termination (eventually)

13. IMPORTANT REMINDER

A 412(e)(3) plan is a legal pension instrument. It must comply with the Internal Revenue Code, Department of Labor regulations, and all ERISA governing rules.

The plan document, implementation, and the plan's ongoing administration must be in continuous compliance with these rules. Even when a valid plan document and IRS initial approval letter are in place, improper implementation or day-to-day conduct can result in significant penalties – namely, the disallowance of the various tax advantages granted to qualified plans. 412(e)(3) plans must also comply at all times with the insurance and annuity policies which are regulated primarily by state law – for example, suitability standards in some states. For these reasons, it is very important for employers to seek advice from a knowledgeable attorney or tax advisor when establishing and administering a 412(e)(3) plan.

Zingle & Associates, Inc. does not offer legal, tax, or investment advice for our clients. Therefore, this report and any discussions or calculations which follow from it are not intended to constitute such advice and should not be construed as such.

The material included in this report is based on our understanding of the marketplace and regulations pertaining to 412(e)(3) plans as of January 2010. No anticipated change in such laws has been assumed. Additionally, this report has been prepared for 412(e)(3) plan purposes exclusively. Therefore, its details and conclusions may not be relevant or suitable for other purposes. Finally, the opinions and suggestions contained in this report are not intended to be used, and cannot be used, to avoid penalties imposed under the Internal Revenue Code.

14. 412(e)(3) Fully Insured Pension Plans: Technical Appendix

Phase	Reference	Description	Trigger	Impact	Responsibility
Plan Design		Furnish Feasibility request form to employer or agent	Upon inquiry or in advance		Consultant
		Employer or agent sends (mail, e-mail, or fax) necessary information on preformatted form to consultant, requesting feasibility study / plan design.	Upon request		Employer or agent
	State Ins Code	Consumer suitability issues, if any, by state		Continued policy compliance	Agent and Insurer
	Rev. Rul. 81-196, Rev. Rul. 94-75	Conversion issues, if any, from trusteed DB plan. Note: conversion of overfunded trusteed DB plan may require excise tax(es) by employer	Feasibility request	412(h) exemption from minimum funding	Consultant
	IRC §401(a), Reg 1.401-1(b)(1)(i), Rev. Rul. 78-56	Verify compliance with Definitely Determinable rules	Feasibility request		Consultant
	Treasury Reg. 1.412(i)-1(b), IRC §416	Project early year accruals of minimum benefit for rank and file employees in plans which are Top Heavy; increase plan design if necessary	Feasibility request		Consultant
	IRC §415	Anticipate regulatory limitations on lump sums; disclose as needed	Feasibility request		Consultant
	Rev. Proc. 2005-25	Anticipate additional cash into the plan due to policy buy-out at Fair Market Value. May prompt reduction in benefit design, lower emphasis on insurance funding, or both.	Feasibility request		Consultant
	Rev. Rul. 2004-20	Include demonstration at Normal Retirement Date that value of plan benefits = guaranteed policy Cash Surrender Value.	Feasibility request		Consultant
	Rev. Rul. 2004-21	Product suitability issues, if any, concerning springing Cash Surrender Values and related issues.		Continued policy compliance	Insurer
		Preparation of written feasibility report	Feasibility request		Consultant
	Rev. Rul. 2004-21	Ensure that equivalent benefits, rights and features as designed are offered to each enrolling plan participant.	Feasibility request		Employer or agent

© 2013 Zingle and Associates, Inc.
4627 Parkridge Dr., Eagan, MN 55123 • Tel: (651) 405-6887 • Fax: (651) 454-0019
www.zingleandassociates.com • *contact@zingleandassociates.com*

Phase	Reference	Description	Trigger	Impact	Responsibility
Plan Installation		Consultant receives go-ahead and final participant data.			Employer or agent
		Applications are submitted to Insurer			Agent
		Consultant prepares sample Board resolution, plan document, Summary Plan Description, administrative package (including participant applications) for owner signature, as well as summary of first year funding requirements (subject to actual issue). Also sends administrative services agreement to employer for signature.	Once completed forms are returned to consultant with one-time set-up fee		Consultant
Policy Issue		Policies are issued, preferably with policy date identical to plan anniversary date.	Once plan document is signed		Insurer / agent
		If needed, agent contacts consultant, and the (revised) first year funding calculations are repeated.	If policy not taken, or rated, or issued in different risk category than designed		Agent
		Insurer confirms policy issue to consultant, including amount and dates of premiums received.			Insurer
Valuation Process and Yearly Updates		Provide consultant with annual business updates	Beginning of each plan year, prompted by consultant		Employer
		Send consultant duplicate copy of year end policy report for each policy (prior year beginning of year CV, prior year end of year CV, prior year transactions)	Beginning of each plan year		Insurer
	IRC 412(e)(3), Reg 1.412(i)-1	Verify that the plan is funded exclusively with annuities / combination of life insurance and annuities	Each plan year anniversary / valuation	Continued 412(e)(3) status preserved	Consultant
	IRC 412(e)(3) Reg 1.412(i)-1 Rev. Rul. 2004-20	Verify for each participant that the value of benefits under the plan equals the guaranteed values provided under the annuity contracts / life insurance policies (to the extent premiums have been paid).	Each plan year anniversary / valuation	Continued 412(e)(3) status preserved	Consultant

Phase	Reference	Description	Trigger	Impact	Responsibility
Valuation Process and Yearly Updates, continued	IRC 412(e)(3) Reg 1.412(i)-1	Verify that all policy dividends / excess interest credits have been used to reduce the required plan contribution for the subsequent year	Each plan year anniversary / valuation	Continued 412(e)(3) status preserved	Consultant
	IRC 412(e)(3) Reg 1.412(i)-1	Verify that the policies have not been loaned, assigned, or otherwise pledged as collateral in any transaction during the years.	Each plan year anniversary / valuation	Continued 412(e)(3) status preserved	Consultant
	IRC 412(e)(3) Reg 1.412(i)-1	Verify for each participant that level annual premiums have been paid under the terms of the policy / contract forms, and that no such premiums have been paid beyond the participant's retirement age.	Each plan year anniversary / valuation	Continued 412(e)(3) status preserved	Consultant
	IRC 412(e)(3) Reg 1.412(i)-1	Verify as a condition for payment of benefits to a participant that all policies / contracts are in force and premiums have been paid to date.	At retirement, death, disability, termination of employment, and annually thereafter	Continued 412(e)(3) status preserved	Consultant
	IRC 412(e)(3) Reg 1.412(i)-1	Verify that all policies and contracts are of the same series (consistent basis of valuation)	Each plan year anniversary / valuation	Continued 412(e)(3) status preserved	Consultant
	Reg 1.412(i)-1, IRC Sec. 416	Check for Top Heavy issues; communicate problems as necessary	Each plan year anniversary / valuation	Continued plan qualification	Consultant
	IRC 415	Check for 415 limits: (1) maximum salary, (2) maximum benefit, (3) maximum value of benefit	Each plan year anniversary / valuation		Consultant
	IRC 72(m)	Administer waiver of premium, as needed			Insurer
	IRC 412	Reconcile plan assets for prior year; prepare valuation of liabilities for current year; determine premiums and amounts of insurance for current year	Beginning of each plan year	Continued 412(e)(3) status preserved	Consultant
		Prepare valuation; send results as a written report to client, with copies to agent and insurer. This serves as the action plan for the current year's funding.	Completion of preliminary valuation tasks, above		Consultant

Phase	Reference	Description	Trigger	Impact	Responsibility
Renewal Year Policies		Issue new policies in the amounts and with premiums determined by the annual valuation	Once year's valuation has been completed		Insurer
		If needed, contact consultant to run revised first year funding calculations	If policy not taken, or rated, or issued in different risk category than designed		Agent
		Confirm policy issue to consultant, including amount and dates of premiums received.			Insurer
Administration		Prepare Form 5500 package for employer's signature. May include one or more Schedule As, which the insurer either prepares or furnishes sufficient data to consultant to prepare.	Employer completes Q&A package from consultant	Meets annual reporting requirement	Consultant, with input from Insurer
		Prepare PBGC Form 1-EZ (fixed premium portion only), if required.	Employer completes Q&A package from consultant	Meets annual reporting requirement	Consultant
	IRC 72(m)3(B), 1.72-16(b), Rev. Rul 55-747, Rev. Rul. 66-110, IRS Notice 2001-10	Determine Table 2001 Cost (formerly PS58 cost) for each participant (using insurer's YRT rates if lower); communicate to employer	End of each calendar year	Imputed taxable income for participants with insurance	Consultant
Employment Changes		Calculate benefit and provide options to employer, including J&S notification, etc; also communicate timing of the former employee's notification.	As requested by employer		Consultant
		Select distribution option by completing and returning package to consultant	Consultant package	Benefit distribution	Employee
		Notify insurer of distribution selection, provisions, and limitations	Return of signed forms		Consultant
		Complete policy changes and implement distribution	Receipt of notification		Insurer

Phase	Reference	Description	Trigger	Impact	Responsibility
Employment Changes, continued		Identify recipients of distributions during prior year; communicate to consultant	Prior to end of calendar year, as prompted by consultant	Taxable income to certain participants	Employer
		As needed, prepare Forms 1099-R and 1096 (regarding distributions, insurance) and Form 945 for distribution by employer to participants and submission to IRS	Annually by Jan. 31 (employee copy) and Feb. 28 (employer copy)	Taxable income to certain participants	Consultant
Special handling		Plan takeovers	As notified by employer or agent		Consultant
		FASB calculations	As notified by employer or agent		Consultant
		Assist with training of agents and H.O. personnel	As requested by insurer		Consultant
		Employer's personnel meetings and plan explanation	As requested by employer		Consultant

We would be pleased to hear from you by contacting us as shown below.