

THE TAX ADVISOR

By John Oliver

When 3% Is a Good Return



LATELY, 412(i) PLANS HAVE BEEN GENERATING a lot of buzz—and with the tax benefits these plans provide to small business owners, it’s easy to see why. Many clients may be leery of relying entirely on volatile stock and bond markets to meet all their retirement goals. They would like to have a portion of the income needed at retirement to be guaranteed by a financially strong life insurance company.

A 412(i) plan offers investment guarantees not found in traditional defined benefit plans, along with initially larger income tax deductions than may be available with other types of qualified plans. Using an annuity and life insurance, a 412(i) plan can be an excellent planning strategy to help clients make the most of their qualified retirement plans with guaranteed, tax-deductible benefits.

“But I’ve spent the majority of my career advising clients to stay away from low-interest-earning investments,” you say. “Why would I want to steer them toward a 3% insurance and annuity vehicle?” Good question. Here are the good answers. For the client, the major benefits are the large up-front tax deductions and guaranteed returns on retirement investment. For the advisor, it’s the opportunity for long-term money management.

And while the tax deduction element exists in all qualified plans, what really makes a 412(i) plan shine is that it can help clients build up money for later rollover into a profit-sharing plan or IRA.

A 412(i) fully insured plan is a defined benefit qualified retirement plan funded exclusively with insurance contracts. For a plan to be considered fully insured for the plan year, it must be funded exclusively with annuity contracts or a combination of annuities and whole life insurance policies,

and it must meet several other requirements in order to qualify as fully insured.

Because of the annuity and life insurance policy guarantees, the fully insured plan is exempt from standard minimum funding requirements, so no plan actuary is needed to certify the plan contribution and related income tax deduction.

While not required, a life insurance death benefit can be provided to help protect the client’s family if the client dies while participating in the 412(i) plan. For income tax purposes, the plan participant must recognize the current cost of the life insurance death benefit protection (the death benefit in excess of the policy cash value) as measured by IRS Table 2001. If the plan participant dies, this portion of the death benefit is received by the beneficiary income tax-free, while the cash value is subject to income tax similar to any other distribution from the plan.

Compared to traditional defined benefit plans, a 412(i) defined benefit plan allows for initially higher plan contributions in the early years of the plan. By definition, the 412(i) plan is always fully funded, never over- or under-funded, as can be the case with traditional defined benefit plans.

Finally, with funding of a 412(i) plan extended to the tax-filing deadline (rather than year end), a client can sign plan documents by year-end 2004, but not fund the first contribution until the tax filing deadline in 2005 (including extensions). This flexibility may help a client manage cash flow better than a traditional defined benefit plan, which requires quarterly contributions.

The table below illustrates how a client could maximize his contributions with a 412(i) plan while providing an opportunity for you to manage more assets.

While the mechanics of a 412(i) plan are

Pondering DB plans for clients? Don’t forget the tax and insurance advantages offered by 412(i) plans

not particularly complicated, it does take a team to establish and administer the plan. One of the key players is the third-party administrator (TPA). However, not all TPAs are alike. They charge different fees for services, may share in commissions, and may have various levels of experience administering 412(i) plans. Most insurance carriers have a list of recommended TPAs. The TPA, the financial advisor, and the client’s other professional advisors should review the client’s needs and objectives and develop the 412(i) plan accordingly.

The TPA develops the plan proposal based on the client’s objectives, cash flow, and employee census. Once the client accepts the plan, the TPA works with legal counsel to provide the appropriate plan documents and plan administration annually.

Annual plan administration typically

How They Compare		
	Traditional Defined Benefit Plan	412(i) Plan
Cash at age 65	\$1,471,328	\$2,936,784
Interest Assumption	6% to 8%	3% to 4%
Actuarial Mortality	Current	Guaranteed
Normal Retire. Age	Reasonable	Reasonable

Source: The Heritage Group LLC. Assumes plan participant is 50 years old. Funding for maximum retirement benefit allowed at age 65. Participant’s salary in excess of \$205,000.

includes calculating the required plan contribution and developing reports for the government, employer, and plan participants. The plan administrator will also handle new plan participant additions and plan participant distributions. Should the plan ever terminate, the administrator will prepare all government-related reports and distribute final payout amounts to plan participants.

To show the tax benefits of a 412(i) plan, consider this case study. William Esquire, a 50-year-old lawyer and sole proprietor, establishes a 412(i) plan and bases his contribution on the best three consecutive years of his Schedule C income, which was \$100,000 a year when there was no 412(i) plan. In year 4, he establishes a 412(i) plan and contributes \$100,000 to the plan, realizing \$0 in net taxable income. In subsequent years his 412(i) contributions are reduced because the interest earned on previous contributions exceeded the annuity and life insurance contract guarantees, resulting in greater-than-projected plan funding (see "The Tax Advantages" table).

As business thrives, Esquire can make greater contributions that result in larger deductions and lower taxable income.

But what happens to a 412(i) plan if an employee retires or separates from his or her employer? Depending on terms of the plan, participants may be able to select a lump sum equivalent to the participant's accrued benefit.

Following are various options to invest the lump sum distribution that provide additional money management opportunities for financial advisors

- **When No Life Insurance Protection Is Needed.** If the former plan participant no longer needs life insurance protection, the plan trustee can surrender the life insurance policy, recognizing company-imposed surrender charges if applicable, and then pay a cash lump sum to the plan participant. The annuity contract could be distributed or it could be surrendered, also subject to any applicable company-imposed surrender charges. If the annuity contract is distributed, with the consent of the issuing company, the annuity can be reclassified as an IRA. The plan participant could then roll over the cash from the life policy into the annuity, a separate IRA, or a profit-sharing plan.

- **When Life Insurance Is Needed.** Many

former plan participants may still need the life insurance protection offered by the 412(i) plan. Depending on the plan document, the former participant could:

- *Roll the life insurance policy into a profit-sharing plan.* The individual's employer must sponsor an active profit-sharing plan. Life insurance cannot be the only asset in the participant's plan account, and insurance must be incidental to the plan's purpose.

- *Receive the policy as a plan distribution.* The former plan participant would pay income tax on the fair market value of the policy at the time of distribution. This value is unclear at this time and may be the cash surrender value or the interpolated terminal reserve value, which is typically higher than the cash surrender value. Since the individual had been recognizing the term cost of

suitable. Many carriers, like Transamerica, offer various options, such as an exchange to a variable life policy or a universal life policy. To meet emergencies or to supplement retirement income, the policy owner might access this policy through withdrawals and loans.

The insurance company may also offer to protect the client's insurability by offering a new policy without evidence of good health. This option may be limited to a survivorship policy, which pays a death benefit at the second insured's death. However, evidence of insurability is usually required for the second insured.

The Appropriate Use

Who are the best candidates for a 412(i) plan? They might include the following:

- 1) Highly paid business owners and professionals looking to maximize tax deductions
- 2) Companies with few or no common-law employees
- 3) Business owners who can make a financial commitment to the plan for multiple years
- 4) Clients who prefer security and guarantees in part of their retirement portfolio over a fluctuating stock market

As always, all qualified retirement planning strategies—including the 412(i) plan—should be pursued with the advice of tax and legal counsel.

As an advisor, you might wonder whether a strategy trumpeting a 3% return is valuable. The 412(i) plan has the potential to provide the largest possible contributions and deductions for clients with a short retirement timeframe, while generating long-term opportunities for you. IA

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The Tax Advantages of 412(i)s

Year	Schedule C Income	412(i) Contribution	Net Taxable Income
1	\$100,000	\$0	\$100,000
2	100,000	0	100,000
3	100,000	0	100,000
4	100,000	100,000	0
5	100,000	98,000	2,000
6	100,000	95,000	5,000

Source: The Heritage Group, LLC.

the life insurance protection as income annually, he or she could reclaim these costs as cost basis to the policy.

- *Purchase the policy from the profit-sharing plan.* If the former plan participant is participating in a profit-sharing plan, the policy could be transferred from the 412(i) plan as a tax-free rollover and then sold by the profit-sharing plan to the plan participant. This is normally a prohibited transaction, but Prohibited Transaction Class Exemption 92-6 issued by the Department of Labor allows a plan participant and certain other parties to purchase a life insurance policy from a qualified plan for its cash surrender value if certain conditions are met.

Note that an IRA cannot own a life insurance policy, so if an insurance policy is involved in the distribution, it could not be rolled over into an IRA.

- **Change of Policy to Meet New Needs.** In some situations, while the client still needs life insurance protection, the whole life policy used in the 412(i) plan may no longer be

