

**NATIONAL BENEFIT SERVICES, INC.**  
**BENEFIT BRIEFING**  
**December 2006**

---

---

***FOR BUSINESS OWNERS AND THEIR ADVISORS***

**Questions and Answers about  
412(i) Fully Insured Defined Benefit Plans  
Updated for the Pension Protection Act of 2006**

---

---

**Introduction**

---

The Pension Protection Act of 2006 enacted on August 17, 2006 moved the provisions of Section 412(i) of the Internal Revenue Code to new Code Section 412(e)(3). But for historical context, we will continue to refer to these plans as 412(i) plans.

**Background**

---

**What is a 412(i) defined benefit pension plan?**

A 412(i) defined benefit pension plan, referred to in IRS regulations as an "insurance contract plan", is the only defined benefit plan that is exempt from the minimum funding requirements of Section 412 of the Internal Revenue Code. 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 small business.

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

- Larger initial deductions;
- More stability in the contribution level;
- Simpler plan administration; and
- A secure promise of future benefits guaranteed by an insurance company.

**What are the advantages of a 412(i) insurance contract plan over a "traditional" defined benefit plan?**

A 412(i) insurance contract plan:

- Does not require an enrolled actuary;
- Is not subject to the full funding limitation tests of a defined benefit plan;
- Is required to use the contract guarantees as funding assumptions, thus shielding them from IRS attack as unreasonable funding assumptions;
- Can be designed to eliminate the potential of 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 the contracts funding the participant's account;
- Creates larger initial deductions than a traditional plan since the funding assumptions are required to be much more conservative; and
- Provides retirement benefits that are guaranteed by the insurance company and not just the financial strength of the particular employer providing the plan.

**What requirements must be met to qualify as a 412(i) insurance contract plan?**

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

- The plan must be funded exclusively with annuity products, or a combination of life insurance and annuity products, issued by an insurance company.
- The benefits provided to each individual must be equal to the values provided in the contracts and guaranteed by the insurance carrier.

- Life insurance dividends and excess annuity interest must be used to reduce the following year's plan contribution.
- No policy loans are allowed under the contracts.

**Are 412(i) plans new to the retirement planning marketplace?**

No. These plans have been around since ERISA (in 1974) or even before. They were referred to then 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 "grey area" of the law and are, in fact, a very conservative approach to retirement plan funding. All benefits are guaranteed by an insurance company.

**Contributions**

**How much can be contributed to a 412(i) plan?**

Contributions to a 412(i) plan are based on such factors as the participant's age, compensation, projected normal retirement age, and the amount of life insurance coverage.

**How does the initial deductible contribution required in a 412(i) plan compare to a traditional defined benefit plan?**

Generally, a 412(i) defined benefit plan may double the maximum deductions allowed under a traditional plan as show on the following table.

Age	Traditional	412(i)
45	\$74,485	\$172,828
50	\$122,720	\$271,610
55	\$170,267	\$369,318
60	\$168,121	\$369,921

The figures in this chart are the maximum first year contributions based on maximum retirement benefits for 2006. The figures also assume that each participant has a normal retirement age of 62 or five years of participation if later.

**Does the contribution to the 412(i) plan have to be made by the end of the fiscal year?**

No. The contribution has to be made by the tax filing date including extensions.

**Do the contributions remain level forever?**

No. The contributions will gradually decrease since the excess interest earned over the guaranteed rate must be used to reduce the following year's contribution. The dividend payable on the life policy will also 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.

**412(i) Plan Design**

What type of business entities can adopt a 412(i) Plan?

A 412(i) plan can be adopted by a sole proprietor, partnership, C-corporation, S-corporation, or LLC.

**What kinds of business owners should consider adopting a 412(i) plan?**

Generally speaking, a business owner who is 45 years of age or older and typically earns at least \$100,000 per year should consider a 412(i) plan if he or she:

- Wants to contribute more than \$44,000 annually,
- Has few employees, or
- Is self-employed as the primary means of making a living, or

- Is an employee who also receives self-employment income from consulting, directors fees, or has a moonlighting business, or
- Has a spouse who has a business in which the second income is not required to live on.

**What counts as “earnings” for purposes of contributing to a 412(i) plan?**

Pension law limits your earnings for retirement plan purposes to a maximum of \$220,000 in 2006 and \$225,000 in 2007. Your legal form of business entity determines what income can be counted for retirement plan purposes. If you are a:

- Sole proprietor compensation, it is Earned Income
- Partnership, it is also Earned Income which must also be calculated
- C-compensation, it is W-2 income
- S-corporation, it is also W-2 income (dividends can not be included)
- LLC, it depends on how it is taxed (partnership or corporation rules apply)

**Who has to be included in a 412(i) Plan?**

Employees who are work at least 1,000 hours or more a year and have attained age 21.

**Multiple Retirement Plans**

**Can an employer also maintain a defined contribution plan in addition to a 412(i) plan?**

Yes. The new Pension Protection Act of 2006 increases the amount an employer can deduct under both a defined benefit pension plan and a defined contribution plan.

**How much more can be contributed?**

Depending on the facts and circumstances, a business owner may be able to deduct an additional \$33,300 to a profit sharing/401(k) plan.

**Life Insurance**

**What happens to the 412(i) plan’s death benefit?**

The owner and beneficiary of the life insurance policy is the 412(i) plan trustee to which the proceeds are paid. The participant’s named beneficiary under the plan then receives the proceeds. A spousal beneficiary can rollover the benefit tax free to an IRA. In addition, the new Pension Protection Act of 2006 makes that same tax treatment available to a beneficiary other than a spouse effective in 2007.

**What happens to the life insurance policy if the 412(i) plan is terminated or at retirement?**

There are several options:

- You can purchase the life insurance policy with no taxable consequences if it bought at fair market value. The cash you pay for the policy becomes a plan asset, and if the plan is terminated or you retire can be rollover over to an IRA or other qualified retirement plan tax free.
- A trust can also purchase the life insurance policy owned by the 412(i) plan provided that certain requirements are met.

**What happens when the life insurance policy is distributed or purchased from the 412(i) plan?**

If the policy is personally owned by the former participant outside the 412(i) plan, the death benefit will be tax free to the named beneficiary. It may also be estate tax free based on proper advance planning.

**Plan Administration**

**Do you have to retire on the plan’ s specified retirement date?**

No. The plan’s retirement date is one of the assumptions we use to calculate the amount of money you need to fund each year.

You can amend the plan to change the retirement date or keep working and take your benefits later. It is important that you let us know as your plans change and we can make the appropriate amendments.

### **When can you retire?**

You can stop the plan at any age and take your benefits in a number of ways including rolling them over to an IRA or other employer sponsored retirement plan. Generally, however, 412(i) plans go for a minimum of five years and the earliest retirement date is age 55.

### **What happens if you close your business and stop working before the plan's retirement date?**

The plan can be terminated at any time subject to IRS rules, and you can take your benefits as described above. And also as mentioned above, it is important to let us know as your plans change since early planning is best.

### **Is the 412(i) plan approved by the IRS?**

Our plan documents have been approved by the IRS through the volume submitter program.

### **How is a 412(i) plan administered?**

The company is listed as the Plan Administrator, and the Trustee is generally one or more officers of the company that has adopted the 412(i) plan. Our firm assists the company and the Trustee by providing plan administration services as the third party administrator.

\* \* \*

## **About National Benefit Services, Inc.**

Founded in 1978, National Benefit Services, Inc. provides retirement plan consulting and administrative services for a wide range of privately held and publicly traded employers.

Clients include business owners and employers in a wide range of industries in the United States, Canada, and overseas.

Our activities are focused on the design and administration of qualified retirement plans using innovative plan design techniques to accomplish the plan sponsor's objectives.

For further information contact:

Jerry Kalish, President

National Benefit Services, Inc.

300 West Adams, Suite 326

Chicago, IL 60606

Phone: 312-419-9080

Fax: 312-419-9099

Email: [jerry@nationalbenefit.com](mailto:jerry@nationalbenefit.com)

Subscribe to our blog:

[www.retirementplanblog.com](http://www.retirementplanblog.com)

*This explanation of 412(i) defined benefit pension plans is provided for general information purposes only and should not be considered tax or legal advice. Always check with a qualified tax advisor for the application of the tax laws to your specific situation.*