ADVANCED MARKETING

ACTIVATOR

MAY 2003

412(i) PLANS: THE GOOD, THE BAD, AND THE UGLY!

What Is A 412(I) Plan?

A 412(i) plan is a form of defined benefit plan. A defined benefit plan is an employer-sponsored retirement plan. It promises an employee that, upon retirement, he or she will receive a specific benefit amount annually (or more frequently) based on a formula that considers compensation, years of service, or both.

A 412(i) plan (a/k/a a fully insured plan) is a form of defined benefit pension plan funded exclusively by life insurance or annuity contracts, and which meets relevant Internal Revenue Code sections, Treasury Regulations, Department of Labor Regulations, as well as ERISA requirements..

Fully insured plans receive special treatment under Code Section 412(i) – which is why they are called "412(i) plans."

Why Are Defined Benefit Pension Plans Becoming So Popular?

There are at least nine reasons for the increasing popularity of 412(i) plans:

First, tax law reflects real life. There's a pendulum which swings back and fourth – in synchronization with the economy and stock market. It is currently swinging away from the all-out optimistic "go-go" or "everyone's getting rich and you can't lose on stocks" mind set, and toward a more conservative thinking that emphasizes certainty and guarantees. What people want most of all right now is not a return on their investments as much as a return of their investments.

412(i) plans provide that security – since – by design and definition – they are fully insured. Risks are shifted from employers to state licensed and well-financed insurers.

COPYRIGHT ©2003 STEPHAN R. LEIMBERG / REPRODUCTION PROHIBITED WITHOUT EXPRESS PERMISSION / FOR INTERNAL USE ONLY. NOT FOR USE WITH THE GENERAL PUBLIC.

ADVANCED MARKETING ACTIVATOR

Prudential Financial

The internal investment return rates of insurance contracts used to fund 412(i) plans are competitive with the returns on similar risk investments. Rates of 4-6% are fairly common, and even an assumed lower rate such as 2% is not unattractive when compared to rates available through diversified funding vehicles in today's poorly performing investment environment.

Second, aging baby-boomer business owners are finding that "age-weighted" formulas favor them as older and long-service employees.

Third, Code Section 415 generally limits the total annual addition to any participant's account (employer plus participant contributions) to $40,000. However, a very important exception is made for older individuals in defined benefit plans. Although the threshold age varies depending on actuarial assumptions, it is usually crossed in the late forties. For these plan participants, the maximum amount that can be contributed annually can be significantly greater than $40,000. The older the participant at entry age, the higher the permissible contribution amount. For instance, if a participant enters the plan at age 55, the maximum contribution level for a regular defined benefit plan would generally be around $100,000. That is more than twice the $40,000 limit for a defined contribution plan!

Fourth, a 412(i) plan allows even greater contribution levels than a normal defined benefit plan. For instance, for the age-55 entrant, it is possible under some 412(i) plan designs to provide for annual contributions of $200,000 or even more.

These last few points highlight the really important advantages of a 412(i) plan: the time value of money and tax leveraging. All qualified plans involve significant tax deferral benefits, well beyond those of nonqualified plans, because employer contributions to the plan are currently deductible in the year made, even though the participant's benefits are not taxed until they are received. A 412(i) plan can amplify these advantages by providing a heavy front-end contribution pattern which accelerates employer deductions and, thus, magnifies the economics possible through tax deferrals. Because of the time value of money, for a given amount of tax to be deferred for a given number of years, the greatest benefit comes if the maximum portion of the total amount can be deferred in the early years.

In a fully-insured plan a level-funding approach must be used. This requirement maximizes the deductible contributions (premiums) in the early plan years. In addition, investment assumptions for insured funding vehicles are by nature conservative. These elements typically result in relatively high initial contributions. In later years, good investment results (or dividends from participating contracts in some cases) can reduce the costs. Add the impact of low assumed guaranteed annuity payouts to conservative but realistic investment assumptions, add the deductibility of the entire insurance premium and compute the utility of the present value of lower corporate tax obligations, then the 412(i) plan becomes much more attractive.

COPYRIGHT ©2003 STEPHAN R. LEIMBERG / REPRODUCTION PROHIBITED WITHOUT EXPRESS PERMISSION / FOR INTERNAL USE ONLY. NOT FOR USE WITH THE GENERAL PUBLIC.

ADVANCED MARKETING ACTIVATOR

Prudential Financial

Fifth, 412(i) plans minimize risks. Because a third party, the insurer, guarantees all benefits, assuming premiums are paid when due, the employer's investment risks are minimized.

Sixth, employers are attracted to these plans because they are generally easier and less expensive to administer than many other types of retirement plans. Administration costs can be significantly lower in a 412(i) plan because there are no direct actuarial fees. 412(i) plans are exempt from the general Code Section 412 funding requirements such as minimum funding standard account, the full funding limit, quarterly contributions, and the Schedule B Enrolled Actuary Requirement.

Seventh, it is relatively easy to calculate and explain the benefits.

Eighth, fully insured plans avoid excise taxes and income taxes on reversions, since by design they can (assuming continued compliance with Section 412(i) requirements) be neither over- nor under-funded.

Ninth, balance sheet liabilities under FASB 87 should be eliminated due to the fully funded nature of 412(i) plans.

What Are The Pitfalls, Cost, And Downsides Of 412(i) Plans?

Marketers of 412(i) plans have developed attractive packages and products for the fully insured pension market. Some products have been designed solely to exploit the legitimate advantages of the 412(i) concept to, and (unfortunately in some cases) beyond, their limits, thereby raising some unresolved and potentially harmful legal issues.

Planners should not venture far beyond the basic fully insured pension plan concept with its inherent advantages. Clients and their advisors should be made aware of the pitfalls, costs, and downsides of 412(i) plans such as:

First, compared to certain other alternatives, a 412(i) plan is more conservative and provides less upside potential for growth.

Second, compared to certain other alternatives, the 412(i) plan provides less investment and plan design flexibility.

Third, a 412(i) plan is not permitted to make loans to plan participants.

Fourth, initial costs may be higher than for noninsured defined benefit plans.

So the clear "upsides" are the use of 412(i) as a tool for maximizing contributions and guarantees as well as the simplicity and relative safety. The clear downsides are limited investment growth potential and plan design flexibility.

COPYRIGHT ©2003 STEPHAN R. LEIMBERG / REPRODUCTION PROHIBITED WITHOUT EXPRESS PERMISSION / FOR INTERNAL USE ONLY. NOT FOR USE WITH THE GENERAL PUBLIC.

ADVANCED MARKETING ACTIVATOR

Prudential Financial

Last but not least, planners should alert clients and their advisors to some of the very cloudy and unresolved (but potentially litigious) issues in connection with overly aggressive plan design and insurance product features (to be discussed below).

When Should A 412 (i) Plan Be Considered – And By Whom?

- the employer wants to maximize its initial rate of contribution,
- the employer is in a good current financial condition,
- substantial early funding is preferable for any reason,
- a significant portion or most of the benefits will go to owner-employees and key employees, and
- contributions to an employer's existing, conventionally funded defined-benefit plan have been severely reduced by the restrictions on actuarial assumptions or by the full funding limitation.

What Are The 412(i) Qualification Requirements?

Generally, 412(i) plans must meet the same participation, vesting, and benefit provisions as regular defined benefit plans. Additionally, they must meet the following six requirements:

First, the plan must be funded exclusively by the purchase of individual insurance contracts. These contracts can be either individual or group, and can be life insurance or annuity contracts or a combination.

Second, the contracts must provide for level annual (or more frequent) premiums extending to retirement age (as defined in the plan's documents) for each individual. (When these plans were first developed, special retirement income or retirement annuity contracts were used. Those contracts were designed specifically to provide the proper ratio of insurance face amount to income to generate the cash value needed to provide a specific monthly income as of any given retirement age.) However, the employer's outlay need not be level, since the regulations permit experience gains and dividends to reduce premiums.

Third, plan benefits must be equated to, and based solely on, the contract benefits and must be guaranteed by a state licensed insurance company. In other words, to the extent premiums have been paid, the benefits promised under the plan must be guaranteed by the insurer.

Fourth, premiums must have been paid without lapse (or the policy must be reinstated after a lapse).

Fifth, no rights under the contracts may be subject to a security interest during the plan year.

COPYRIGHT ©2003 STEPHAN R. LEIMBERG / REPRODUCTION PROHIBITED WITHOUT EXPRESS PERMISSION / FOR INTERNAL USE ONLY. NOT FOR USE WITH THE GENERAL PUBLIC.

ADVANCED MARKETING ACTIVATOR

Prudential Financial

Sixth, no policy loans may be made or outstanding at any time during the plan year. It is, however, permissible to utilize the APL (automatic premium loan) feature, if any loans made from internal policy values to pay premiums are in fact repaid before the end of the plan year.

What Are The Coverage Requirements For 412(i) Plans?

The same nondiscrimination requirements that apply to other qualified plans must be met by 412(i) plans. However, the current nondiscrimination regulations provide a safe harbor for fully insured plans meeting certain requirements; the benefit formulas of plans satisfying the safe harbor and specified uniformity requirements will be considered to be nondiscriminatory.

Generally, as for all qualified plans, the plan cannot cover only a limited group of highly compensated executives. However, fully insured plans have the same inherent age-weighting aspect as do other defined benefit plans, and costs for younger rank-and-file employees can often be minimized. The plan also can utilize the permissible ERISA vesting rules (3- to7-year or 5-year cliff vesting) to minimize costs for high-turnover employees. Also, plan benefit formulas can be integrated with social security to weight benefits in favor of higher-paid employees.

What Is The Cost Of Failure To Comply?

Upon the failure of a fully insured defined benefit plan to comply with one or more of the provisions of Section 412(i), Section 412 becomes operative. This does not mean the plan is automatically disqualified and loses its tax exempt status. But, because of the method used by the insurer to calculate premium costs for guaranteeing benefits under the plan, it may result in an over-funding of the plan and the consequent loss of deductions.

Why Purchase Life Insurance?

Although a fully insured plan does not have to provide death benefits, most do. Guaranteed or simplified life insurance coverage programs provide simplicity for the employer and an important additional benefit for the covered employees. (Some insurers also offer waiver of premium feature. So if a participant becomes disabled, the retirement program will "self-complete.") This, of course, is an additional taxable benefit which must be reported by the insured participant under Code Section 72(m).

COPYRIGHT ©2003 STEPHAN R. LEIMBERG / REPRODUCTION PROHIBITED WITHOUT EXPRESS PERMISSION / FOR INTERNAL USE ONLY. NOT FOR USE WITH THE GENERAL PUBLIC.

ADVANCED MARKETING ACTIVATOR

Prudential Financial

What Are The 412(i) Life Insurance Safe Harbor Tests?

Life insurance can be used to provide an "incidental" death benefit to participants in a qualified retirement plan, including a 412(i) plan. The IRS considers any non-retirement benefit in a qualified plan to be incidental so long as the cost of that benefit is less than 25 percent of the total cost of the plan. Since this standard by itself is difficult to apply, the IRS has developed two practical tests or "safe harbors" for life insurance in a qualified plan. If the amount of insurance meets either of the following tests, it is considered incidental:

1. The participant's insured death benefit must be no more than 100 times the expected monthly benefit, or
2. The aggregate premiums paid (premiums paid over the entire life of the plan) for a participant's insured death benefit are at all times less than the following percentages of the plan cost for that participant:

"ordinary life" insurance	50%
term insurance	25%
universal life	25%

Defined benefit plans have typically used the "100 times" limit. Other tests can be used within the plan if it can be demonstrated that the underlying 25% rule is satisfied. Currently, 412(i) plans typically use the 50 percent test to determine the amount of incidental insurance since this generates a higher life insurance premium (and therefore higher deduction) than the 100 times test, albeit at the cost of a more complex calculation to "back into" the proper amount of insurance. Some plans use even more complex actuarial equivalents to this test.

Life insurance is particularly advantageous in a defined benefit plan (such as a 412(i) plan) because it adds to the limit on deductible contributions. This add-on feature allows greater tax-deferred funding of the plan. That is, a defined benefit plan can be funded to provide the maximum tax-deductible contribution for retirement benefits for each participant. The cost for life insurance can then be added to this amount and further deducted.

The advantage is clear when compared with the deductions for defined contribution plans which are limited by the Section 415 annual additions limit of $40,000, whether or not life insurance is included in the plan.

How Does A 412(i) Plan Work?

Fully insured funding can be used either with a new plan or an existing plan. The employer can be a corporation or an unincorporated business such as a general or family limited partnership or LLC. Typically, an individual policy (and in some cases a group type of contract such as a group annuity

COPYRIGHT ©2003 STEPHAN R. LEIMBERG / REPRODUCTION PROHIBITED WITHOUT EXPRESS PERMISSION / FOR INTERNAL USE ONLY. NOT FOR USE WITH THE GENERAL PUBLIC.

ADVANCED MARKETING ACTIVATOR

Prudential Financial

with individual accounts for each participant) is used. All benefits are guaranteed by the insurance company. Life insurance is provided within the limits of the incidental tests discussed above.

The participant has the right to name the beneficiary(ies) of the insured death benefit. The premium is based on the guaranteed interest and annuity rates, which are typically conservative, resulting in larger initial annual deposits than in a typical uninsured plan. However, excess earnings beyond the guaranteed level are used to reduce future premiums and may not be recovered by the employer.

BEWARE: If any of the Section 412(i) requirements are not met for a plan year, the plan ceases to be a fully insured plan and must meet the minimum funding requirements for that year. For instance, the failure to make a regular premium payment will terminate fully insured status. Therefore, a fully insured plan is not appropriate for an employer if there is any doubt about its financial ability to make regular premium payments now and in the foreseeable future. A stable business, rather than a boom and bust or start-up enterprise, is the best prospective client for fully insured funding.

Employers are likely to wonder if the accelerated tax deduction permitted under fully insured plans is outweighed by an increased overall cost for the plan over the years in which it is in effect. This is not an easy question to answer. In theory, the excess earnings credited to the employer under the contract could provide as good a return on investment as the employer might obtain in a trusteed plan. However, there is no reliable method to predict future earnings, either under the contract or in a trust. Selling a fully insured plan requires "selling the insurer" so that the employer has confidence that the rate of return will be reasonable. The guaranteed features of the contract must be "paid for." This implies a lower rate of return in the contract.

In other words, the trade-off for a 412(i) plan (as opposed to alternative retirement plan vehicles) is forgoing (potentially) higher investment returns in return for lower investment risks, lower plan administrative costs, greater guarantees, and larger tax deductions.

The Problem – The Attempt At Tax Alchemy!

Some promoters competing in an increasingly crowded 412(i) market are not content with a good thing. Some of them feel that to make the sale, they have to make the tax and economic advantages of 412(i) plans "better." I repeat: The basic 412(i) plan described above has clear advantages as well as downsides. But it is legitimate and will not result in painful and expensive litigation.

Unfortunately, some promoters insist on tax magic that purports to increase the front-end tax leverage, or generate benefits for owner-employee and key (and/or highly compensated) employee participants well beyond what their competition can offer. Some of these "enhancements" (in terms of plan design and/or product features) increase the complexity of the plan and, more importantly, may trigger serious tax and legal issues.

COPYRIGHT ©2003 STEPHAN R. LEIMBERG / REPRODUCTION PROHIBITED WITHOUT EXPRESS PERMISSION / FOR INTERNAL USE ONLY. NOT FOR USE WITH THE GENERAL PUBLIC.

ADVANCED MARKETING ACTIVATOR

Prudential Financial

Back To Basics

It is essential to recognize that the law relating to qualified plans is a complex and seamless "web" of statutes, regulations, and rules, the most important of which have been in effect for decades, organized around the following principles (among others):

- The plan must be permanent (rather than temporary);
- The plan must be a "retirement" (and not an insurance) plan;
- The plan must be for the "exclusive benefit" of employees and their beneficiaries (rather than a personal planning tool for the corporation and/or its owners); and
- The plan must not discriminate in any way in favor of "highly compensated employees."

When determining the viability of a plan, the planner (and the client's advisors) should avoid a hyper-technical reading of the law. It is essential to go beyond mere emphasis on the literal interpretation of a single provision or phrase found somewhere in the voluminous bodies of law that pertain to pension plans.

Reliable, experienced, knowledgeable, and ethical planners and advisors who specialize in qualified plans realize that it is also necessary to realistically examine the overall effect of the plan, in its actual operation. That is, any analysis of the plan's viability and success should be based on not just what the plan (document) says – but what it actually does!

With this in mind, let us consider some of the "enhancement" features that are often proposed and aggressively marketed for 412(i) plans.

The Use Of Insurance Contracts Which Do Not Require Level Premiums

For investment reasons, it might be desirable to use interest-sensitive products in the plan, such as variable universal life polices. These policies do not provide for a level premium; instead they generally allow premium payments to vary from year to year. This raises the question of whether the plan meets the "level premium" requirement of Section 412(i).

Some authorities believe that, if the plan documents do not permit annual funding greater than the level premium amount (as if level premium contracts were actually used), then the "level premium" requirement can be met -- even though the insurance contracts are not actual level premium contracts. Although there is no legal authority on this issue, the reasoning is logical. But a positive private letter ruling is necessary to provide comfort.

COPYRIGHT ©2003 STEPHAN R. LEIMBERG / REPRODUCTION PROHIBITED WITHOUT EXPRESS PERMISSION / FOR INTERNAL USE ONLY. NOT FOR USE WITH THE GENERAL PUBLIC.

ADVANCED MARKETING ACTIVATOR

Prudential Financial

Excessive Death Benefit

If whole life (rather than the classic retirement income or endowment-type) contracts are used and the life insurance in the plan is no more than the "incidental" limit, life insurance cash values at retirement will probably be insufficient to fund the full pension benefit. That means the plan will be forced to use a supplementary insured vehicle (annuities) to fund the benefit. Since the life insurance level premium is the primary reason for the upfront leveraging of the deductible funding, it would be desirable to use more insurance.

The question is: Can this be done without violating the incidental rules and thereby disqualifying the plan?

Some practitioners have posited that, if the plan document limits the amount of life insurance benefit (insurance for which the participant can name the beneficiary) to the incidental amount (50 percent test or equivalent), then the plan can use additional life insurance as a funding vehicle. However, at a certain point, excessive life insurance will totally disqualify the plan and cost the loss of all its tax benefits. That point is reached when it becomes an insurance plan rather than a "retirement plan."

If the participant dies, the excess death benefit from this extra insurance cannot be paid to the participant's beneficiary, so the excess remains within the plan. This presents a problem, since, under the Section 72 Regulations, a qualified plan death benefit loses its tax-exempt status to the beneficiary if "the trust has a right under any circumstances to retain any part of the proceeds of the life insurance contract."

Based on the fact that the regulations refer to the "contract," not the insurance benefit as such, a possible solution to this problem would be to use a separate contract for the excess insurance. The contract under which the death benefits would be paid would be designed to comply with the regulations and would provide no benefit to the plan. There appears to be no legal authority on this point beyond the regulation itself. It is difficult to evaluate this issue since the specific purpose of this Section 72 regulation is not entirely clear. If it is simply intended to identify the part of the insurance for which the participant can name a beneficiary, then the use of the separate contract for the excess insurance does not appear to contravene the purpose of the regulation.

However, note that when excess insurance proceeds are paid to the plan, it will no longer qualify as a 412(i) plan, since the death proceeds must be invested and the plan's funding will no longer be exclusively insured investments.

COPYRIGHT ©2003 STEPHAN R. LEIMBERG / REPRODUCTION PROHIBITED WITHOUT EXPRESS PERMISSION / FOR INTERNAL USE ONLY. NOT FOR USE WITH THE GENERAL PUBLIC.

ADVANCED MARKETING ACTIVATOR

Prudential Financial

Premature Plan Termination

Would it be possible to terminate the plan so that the excess death proceeds would not cause plan disqualification? It is not advisable to design a plan with the express purpose to terminate it upon this occurrence, since such an advance intention to terminate the plan would probably be considered a violation of the "permanent plan" requirement. This requirement generally means that plans can be terminated within a few years of inception only for unforeseen business necessity. Any other termination could disqualify the plan -- retroactively to the inception of the plan. This danger is particularly acute if the termination occurs "soon after pensions have been fully funded for [highly compensated employees]."

Lowered Guaranbtee Rates And Excessive Premiums

Generally, the lower the guaranteed rates of the life insurance contracts are, the greater the initial deductible premiums. Thus, within reason, low guaranteed rates can be used to enhance upfront deductions and tax leveraging. Excess earnings in the early plan years can probably be used to reduce future premiums without violating the "level premium" requirement.

If, by design, unrealistically low rates are used in determining premiums, the technique could be problematic. Although Section 412(i) technically exempts fully insured plan from the requirements of the funding standards relating to reasonableness of actuarial assumptions (and the use of lowered guarantee rates do not directly conflict with 412(i) per se), qualified plan investments must have a fair return under the "exclusive benefit" principle, as a separate issue.

Also, 412(i) plans are generally subject to fiduciary provisions of ERISA. It is probable that a claim could be made by a plan participant or by the Department of Labor that an artificially structured unrealistically low guaranteed rate is a violation of ERISA. The DOL had shown some concern about the use of high cost, low-return life insurance vehicles for funding employee benefit plans in the past and, although there has been little recent DOL interest in this issue, it could be revived. Finally, the IRS could also question the deductibility of excessive premiums as a "reasonable" business expense.

Policy Incubation/Pre-Mature Distribution/Withdrawal

A planning technique often discussed when life insurance is purchased by qualified plans is the possibility of withdrawing the policy from the plan before the participant's retirement. This is a legitimate and natural concern for a participant who, under current law (and under any circumstances in the next few years) faces federal estate tax liability and wants to keep the policy proceeds out of the estate so the full death proceeds will be available for estate liquidity. As long as the policy remains in the qualified plan, the participant has the right to name the beneficiary, and this incident of ownership is enough to include the proceeds in the estate.

COPYRIGHT ©2003 STEPHAN R. LEIMBERG / REPRODUCTION PROHIBITED WITHOUT EXPRESS PERMISSION / FOR INTERNAL USE ONLY. NOT FOR USE WITH THE GENERAL PUBLIC.

ADVANCED MARKETING ACTIVATOR

Prudential Financial

But planned policy incubation and premature distribution present some major problems that are often overlooked and/or not fully appreciated. The issues generally stem from the interplay of various planning strategies and laws (especially those pertaining to life insurance that are seemingly irrelevant to qualified plans) such as:

- **Prohibited transaction exemption**. Normally, the distribution of a plan asset to a participant (except as a regular benefit payment) would be a prohibited transaction under Code Sec. 4975 and ERISA Sec. 406(a). However, Prohibited Transaction Exemption (PTE) 92-6 allows a sale of an insurance policy to the plan participant, a trust for the participant or relatives, and certain others – but only if specific conditions set out in the PTE are met. These conditions are often either overlooked or misunderstood – or selectively read or hypertechnical interpreted.

- **Transfer for value rule**. Briefly, to retain the income-tax exempt status of the insurance proceeds, the transfer of a policy must come within one of the safe harbor exemptions to the "transfer for value" rule. A transfer to the insured is exempt. A transfer to a grantor trust (such as an "intentionally defective" life insurance trust) may also be exempt.

- **Valuation issues**. When property (such as an insurance policy) is distributed from a qualified plan, the distributee (generally the participant) must include the fair market value of the property in his/her income as stipulated by the relevant regulations. Where a policy is sold by the plan rather than distributed, this provision does not apply as such. However, the prohibited transaction exemption (PTE 92-6, discussed above) requires that the plan must be in the "same cash position" as if it had retained the contract and surrendered it. Is this a "fair market value" requirement? Some point out that this is not clear. But cautious practitioners would conclude that it is – and that neither the IRS nor the DOL (or the courts) are bound by any interpretation that would allow a sale of a pension trust asset at more or less than its fair market value.

Valuation of an insurance policy (in the context of qualified plans) raises the "springing cash value" issue. That is: Can the policy be designed with an artificially low cash value to allow the sale to the insured participant at a low price based on the cash value, which increases (or "springs" up) dramatically shortly or a few years after the sale? The IRS stated in Notice 89-25 that the use of the cash surrender value is "not appropriate" where policy reserves "represent a much more accurate approximation of the fair market value of the policy than does the policy's stated cash surrender value."

IRS Notice 89-25 discusses this issue without providing any bright-line test, except to suggest that the value of the policy reserves as calculated under Code Section 807(d) would provide an accurate representation of fair market value. This provision of the Code provides a means of calculating reserves for purposes of determining the insurance company's income tax liability. In some cases the gift-tax provision for valuation using the "interpolated terminal reserve" method of Reg. Sec. 25.2512-6(a) could be useful in establishing a value, since traditionally gift-tax valuation of a life insurance contract is supposed to be the same as income-tax valuation.

COPYRIGHT ©2003 STEPHAN R. LEIMBERG / REPRODUCTION PROHIBITED WITHOUT EXPRESS PERMISSION / FOR INTERNAL USE ONLY. NOT FOR USE WITH THE GENERAL PUBLIC.

ADVANCED MARKETING ACTIVATOR

Prudential Financial

Generally, if policies with artificially depressed cash values, or have built-in early year loads (that disappear shortly after the policy is intended to be rolled out) are used to facilitate policy withdrawal, the issue of "springing cash value" policy needs to be considered closely by the client's advisors.

One indication of potential abuse is emphasis on a premature rolling out of the policies or a prescheduled termination of the plan. Beware of:

• artificially depressed cash surrender values,
• waiver of surrender charges on face amount reductions,
• automatic conversion privileges to a VUL (variable universal life) contract and other ploys which in essence shuffle potential abuses "downstream" or "off the books," and
• any promotional materials that suggest the use of special policies with cash values that are low at rollout.

In short, it is prudent to determine if the insurance policy is expected to be rolled out before retirement, and if the cash values used for rollout purposes show any deviation from the normal pattern expected from a life insurance policy. Do not rely solely on assurances from the marketer and/or the insurer that the policy does not involve a "springing cash value" arrangement – either by product design or contract provisions.

At a minimum, insist on a legal opinion letter by the client's independent tax counsel and the insurer involved stating explicitly that the cash values of the policy comply with the letter and spirit of IRS standards on policy valuation, including IRS Announcement 88-51, Notice 89-25, IRS Announcement 92-182, and IRS Announcement 94-101. This independent review may protect the client from a negligence penalty, but it may not preclude an IRS challenge. The IRS is clearly interested in this issue, and current rules such as Notice 89-25 are inadequate and are likely to be revised in the near future, probably without any protective "grandfathering" of existing policies.

Discrimination is yet another problem. If the financial advantages of withdrawing a policy by paying the plan an amount equal to the low cash value (which shortly thereafter increases significantly) are effectively available only to highly compensated employees, then the plan can be disqualified as being discriminatory. This result would follow even if the policy cash value meets the somewhat murky rules of Notice 89-25.

Transactions that involve life insurance and qualified plans are often not as simple as represented in marketing materials. For instance, there is a requirement in the PTE that "the plan, but for the sale, would have surrendered the contract." Why would a plan purchase and pay premiums on a policy – if it is not a good investment? If it is a good investment, why would a plan trustee surrender a contract that – only a few years later – would be worth significantly more than it is currently worth?

COPYRIGHT ©2003 STEPHAN R. LEIMBERG / REPRODUCTION PROHIBITED WITHOUT EXPRESS PERMISSION / FOR INTERNAL USE ONLY. NOT FOR USE WITH THE GENERAL PUBLIC.

ADVANCED MARKETING ACTIVATOR

Prudential Financial

Keep in mind that the plan fiduciary is required to invest and conduct plan transactions solely in the interest of the plan and its beneficiaries. Mere compliance with the PTE is not tantamount to satisfying prudent investment rules. Finally, the IRS is not bound by DOL Advisory Opinions or rulings. Yet another issue raised by distributions of insurance contracts involves possible plan termination. Where the plan is fully insured, distribution of insurance contracts (i.e., plan investments) could result in "plan termination" by definition. Consequently, the termination would also violate the "permanent plan" requirement discussed above. The problem is twofold: first, the plan is no longer "fully insured" when the contracts are distributed, and second, the "termination" is not due to necessary business purposes.

The Bottom Line

412(i) plans are legitimate, economically viable, and highly useful tools when applied in the proper circumstances and backed (and administered) by reputable insurers willing to stand behind their promises and make their claims in writing. 412(i) plans are appealing to risk adverse employers who have the financial stability to maximize contributions, where substantial early funding will (incidently) result in a significant portion of the plan's benefits inuring to owners and key employees, and where contributions to an employer's existing, conventionally funded defined-benefit plan have been severely reduced by the restrictions on actuarial assumptions or by the full funding limitation.

COPYRIGHT ©2003 STEPHAN R. LEIMBERG / REPRODUCTION PROHIBITED WITHOUT EXPRESS PERMISSION / FOR INTERNAL USE ONLY. NOT FOR USE WITH THE GENERAL PUBLIC.

ADVANCED MARKETING ACTIVATOR

Prudential Financial

What The IRS And Treasury Are Saying About Abuses In This Area?

In general, the IRS is only concerned about the abuses and overreaching, since 412(i) is a section of the Code and there are, of course, a number of insurers and agents setting up perfectly legitimate 412(i) plans. Of course, the obvious question is: At what point has the line been crossed? The answer is usually apparent when the requirements, limitations and restrictions stipulated in the Code are studied and the purposes behind them pondered.

Comments made by senior Treasury Department and IRS officials (reported in the Daily Tax Report (DTR) on Monday, Feb. 3, 2003) pertaining to abusive 412(i) fully insured defined benefit qualified retirement plans (as well as abusive Sections 419A(f)(6) and 419(A)(f)(5) plans, and ESOPs) give an indication of how aware the IRS and Treasury are of potential abuses – and how strongly they are likely to react.
It is wise to remember the scene from NETWORK, in which Howard, the just fired newscaster, leans out the window and says,

"I'M MAD AS HELL AND I'M NOT GOING TO TAKE THIS ANYMORE!"

Those words describe the attitude of the Service toward abusive versions of these plans. Here's a quick summary of some of the more notable comments and quotes from senior IRS officials reported in The Daily Tax Report on Section 412(i) plans:

"Very high priority has been assigned to providing guidance for employee plan sponsors and administrators on abusive insurance-funded defined benefit plans that misuse Code Section 412(i)."

"The IRS will "not be gentle" when it retroactively examines illegal Section 412(i) schemes."

"No one should take comfort in the fact that there is no guidance yet."

"There is a criminal side to such schemes, beyond any eventual tax penalties or fines."

"Courts have not looked favorably on arguments that rely on the legal opinions put out by the promoters of such schemes."

"More than one piece of guidance may be issued on Section 412(i) plans, perhaps starting with a notice warning practitioners of the concerns with such plans and then later something more substantive."

Planner should be very conscious of the pitfalls and draconian costs inherent in attempts to over-aggressively increase the front-end tax leverage, or enhance benefits to plan participants, particularly owner-employees and other members of the prohibited group. More importantly, planners must assume their responsibility in alerting clients and their advisors to the same pitfalls and costs in connection with planning strategies that are "too good to be true."

COPYRIGHT ©2003 STEPHAN R. LEIMBERG / REPRODUCTION PROHIBITED WITHOUT EXPRESS PERMISSION / FOR INTERNAL USE ONLY. NOT FOR USE WITH THE GENERAL PUBLIC.

ADVANCED MARKETING ACTIVATOR

Prudential Financial

How Will They Find Out – And What Could Happen?

Plan promoters and clients often ask questions such as: How will they catch me? What's the worst that can happen if they do?

Techniques such as purchasing excessive insurance coverage, manipulating the valuation of policy for pre-scheduled buy-out from the plan, and over-funding through artificially conservative actuarial assumptions can result in what my sergeant in the army often described as "a world of hurt."

Plan sponsors must file IRS Form 5500. This makes it easy for the IRS to examine the funding aspects of the plan. Now that they've discovered what is happening – from a document signed by the client, and the plan fiduciary -- under penalty of perjury – what can they do? Consider these questions (albeit rhetorical):

- Will the IRS disallow some of the deductions? Will it impose interest and accuracy-related penalties?
- Will the Department of Labor treat the purchase of the life insurance policy as a Prohibited Transaction?
- Will the IRS treat the excess contributions as constructive dividends (which would trigger a tax at both the corporate and personal levels)?
- Will the purchase of excess life insurance be considered a Prohibited Transaction and thus trigger a 15% excise tax?
- Will the IRS disqualify the plan?

"Please note that Prudential is a mere product provider and does not administer 412(i) plans. Please also note that the IRS has indicated that it will be issuing guidance shortly on 412(i) plans that do not meet the requirements of the tax law. For example, if a heavily funded plan is terminated within a few years of establishment, the life insurance policies are distributed with relatively little cash value, and the cash value of the policies increase dramatically after the plan termination and distribution, it is likely that the IRS would take the position that the plan does not qualify under 412(i). You should encourage your clients to consult with their tax and legal advisors to determine whether the structure of the proposed 412(i) plan complies with the tax law."

This material is for internal use only and is provided courtesy of The Prudential Insurance Company of America. The discussion of planning techniques does not imply that a recommendation that a specific planning concept should be implemented. References to legal and tax considerations are made but are not meant to provide advice in this regard. Please remind clients that legal and tax advice, including the preparation of legal and tax documents, should come from an attorney and/or a tax advisor such as an accountant. These advisors can determine how best to utilize such product or technique.

Prudential Financial Planners can prepare financial plans incorporating many of the planning techniques discussed above. Financial Services Associates and producers can work as knowledgeable members of clients' professional teams to provide suitable products.

This author is not affiliated with Prudential and Prudential makes no representation as to the accuracy of the cites.

Prudential Financial is a service mark of The Prudential Insurance Company of America, Newark, NJ, and its affiliates.

The Prudential Insurance Company of America
751 Broad Street
Newark, NJ 07102-3777

COPYRIGHT ©2003 STEPHAN R. LEIMBERG / REPRODUCTION PROHIBITED WITHOUT EXPRESS PERMISSION / FOR INTERNAL USE ONLY. NOT FOR USE WITH THE GENERAL PUBLIC.