

PENTEGRA RETIREMENT SERVICES

412(e)(3) DEFINED BENEFIT PLAN



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THE FULLY INSURED 412(e)(3) DEFINED BENEFIT PLAN

A Fully Insured 412(e)(3) Defined Benefit plan is a defined benefit retirement plan that meets the requirements of Section 412(e)(3) of the Internal Revenue Code (the "IRC"). When a plan meets the requirements of this subsection it is exempt from the funding rules of IRC Section 412 applicable to other defined benefit plans. IRC Section 412(e)(3) requires the plan be funded exclusively with qualifying annuity and life insurance contracts.

REQUIREMENTS

In order for a plan to be exempt under IRC Section 412(e)(3), specific requirements must be satisfied.

- The plan must be funded solely by individual or group whole life insurance and fixed annuity contracts that are part of the same series, and that include the same mortality tables and rate assumptions for all participants.
- The contracts must fund benefits using level premiums for all benefits. Premiums begin when a participant enters the plan and may extend no later than the retirement date specified under the plan.
- The plan benefits must be provided only by the contracts and be guaranteed* by an insurance company.
- Participants may not take loans.

ADVANTAGES

- A Fully Insured 412(e)(3) Defined Benefit plan can provide substantial retirement benefits without market risk.
- Because benefits are funded based on the contract guarantees, the Fully Insured 412(e)(3) Defined Benefit plan can provide a maximum current tax-deductible contribution for the business.
- No full-funding limitation under IRC Section 404 (a)(1)(A).
- No quarterly contributions are required.
- There can be no under-funding. Contributions are based solely on the guaranteed provisions of the level premium contracts.
- No actuarial certification required.
- The accrued benefits for participants are always the cash surrender values of the insurance contracts.
- Generates larger contributions for workers who are older and higher paid.
- Contributions are structured to be tax deductible to the business and are not currently taxable to the participants.

DISADVANTAGES

- Requires large contributions that must be made each year.
- No policy loans are available.
- No flexibility in contribution allocations.
- Must be funded exclusively through annuity and life insurance contracts.

HOW FULLY INSURED 412(E)(3) DEFINED BENEFIT PLANS WORK

Each participant is provided with a guaranteed,* predetermined benefit amount that is defined by the plan document and fully insured by the purchase of fixed annuity or life insurance and annuity contracts. Because plan benefits are guaranteed*, 412(e)(3) plans are exempt from the funding requirements of IRC Section 41. Any "excess" interest earnings (or dividends, if paid) over and above the life and annuity contract guarantees* are used to reduce the next year's plan contribution.

Fully Insured 412(e)(3) Defined Benefit plans may generate larger employer deductible contributions than traditional defined benefit plans because the assumptions used in determining 412(e)(3) plan costs are those mandated by IRC Section 412(e)(3) to be the guaranteed life and annuity rates – assumptions that are typically lower than those used in a traditional defined benefit plan.

BENEFITS

The Internal Revenue Code (IRC) section that limits the overall plan benefit is Section 415. Section 415 applies to all defined benefit plans in the same way:

- The maximum annual benefit is the lesser of 100% of the highest consecutive three years of average compensation, up to \$360,000 (2026) or the dollar limit of \$290,000 (2026). The dollar limit is reduced if the actual retirement age is less than age 62
- Individuals may receive the maximum amount available when they reach normal retirement age. This amount is reduced if it is received prior to that date.
- If the benefit is received in the form of a lump sum, IRC Section 417(e) limits apply. This limit is basically the lesser of the limit calculated using the plan actuarial assumptions or the Section 417(e) prescribed interest and mortality. If a fully insured plan funds for a maximum benefit payable as an annuity, and then pays out benefits as a lump sum, there will be excess funds in the plan. Therefore the maximum benefits under a fully insured plan are usually limited to what can be distributed as a lump sum, in order to prevent excess assets in the plan at normal retirement date.

* Guarantees are dependent upon the claims-paying ability of the issuing company.

TOP HEAVY RULES

A 412(e)(3) plan must satisfy the top-heavy requirements of IRC Section 416. A plan is considered "top-heavy" if more than 60 percent of the accrued benefits belong to the "key" employees. A key employee is any employee who at any time during the plan year is:

- A more than 5% owner of the business;
- A more than 1% owner of the business with compensation in excess of \$150,000; or
- When top-heavy a 412(e)(3) plan must normally provide a minimum benefit of 2% of compensation per year of service up to 10 years. A Defined Benefit plan is considered "super top-heavy" when key employees have accrued benefits that exceed 90% of the present value of all accrued benefits. There is no additional penalty for "super top-heavy" plans provided that the employer maintains only one plan.

LIFE INSURANCE

Whole life insurance may be included in a 412(e)(3) plan. Life insurance in all qualified retirement plans must comply with the "incidental insurance" rules discussed in Treasury Reg. Section 1.401-1(b)(1)(i). These provisions place a limit on the amount of life insurance that may be purchased under the plan. Generally, a 412(e)(3) plan can provide no more than 100 times the projected monthly retirement income as a pre-retirement survivor benefit. An alternative provision available under IRS Rev. Rul. 74-307 allows up to two-thirds of the theoretical plan contribution to be used to purchase whole life insurance. This calculation will result in approximately one half of the plan contribution being available to pay for life insurance.

While life insurance is not required to be included in a 412(e)(3) plan, this feature does provide additional death benefits for the participant on a pre-tax basis. Including life insurance in the plan will lead to a higher required plan contribution than a 412(e)(3) plan funded solely with a fixed annuity.

Taxable "Economic Benefit"

When life insurance is included inside a pension plan, participants must recognize as taxable income the "current economic benefit" of the insurance provided by the plan (Notice 2002-8, 2002-1 CB 398, Treas. Reg. § 1.72-16(b)). Each participant is currently taxed on the "taxable term cost" of the "pure" life insurance benefit. The "taxable term cost" that is reported by the insurance company will be either the Table 2001 cost or a cost based on the company's alternate term rates.

BENEFIT TAXATION

A participant will be taxed on any distributions received as cash under a retirement plan upon retirement, termination or separation from service (IRC Section 402). If the participant is under age 59½, a 10% early distribution penalty will be assessed, in addition to regular income taxes. The premature distribution penalty may not apply if one of the allowable exceptions in IRC Section 72(t) applies. Taxation on distributions rolled into an IRA is deferred until minimum required distributions commence. If a plan participant has a life insurance contract under the plan, the insurance can be continued and owned on an individual basis outside of the plan. The policy can be distributed to the participant and the participant will pay tax on the market value of the policy, less any economic benefit costs paid over the years the policy was in the qualified plan. Alternatively, the participant can purchase the life insurance out of the plan for its market value. There is no tax payable on this transaction. If the plan participant does not wish to keep the life insurance, the policy can be surrendered inside the qualified plan. The cash value will roll to the annuity. The annuity can then be rolled into an IRA.

COMPLIANCE

Should a Fully Insured 412(e)(3) Defined Benefit plan later fail to comply with IRC Section 412(e)(3), it does not automatically become disqualified. It may be converted into a traditional defined benefit plan under Section 412. Due to the large contribution and conservative assumptions, conversion will most likely result in the plan becoming fully funded.

ADMINISTRATION

A 412(e)(3) plan is subject to the testing and reporting requirements of other defined benefit plans. The services of a Third Party Administrator are required to keep the plan in compliance.

CONCLUSION

A Fully Insured 412(e)(3) Defined Benefit plan may be a plan solution for the owner of a small business or professional enterprise who desires a large current tax deduction and secure guaranteed* retirement income. The contributions are by design quite large in the early years of the plan and may be less appealing as the number of plan participants increases. Introducing life insurance to fund a portion of the benefit will provide increased initial contributions and a current life insurance benefit for each participant.

CODE SECTION 412(e)(3)

A plan is described in this paragraph if—

- (A) the plan is funded exclusively by the purchase of individual insurance contracts,
- (B) such contracts provide for level annual premium payments to be paid extending not later than the retirement age for each individual participating in the plan, and commencing with the date the individual became a participant in the plan (or, in the case of an increase in benefits, commencing at the time such increase becomes effective),
- (C) benefits provided by the plan are equal to the benefits provided under each contract at normal retirement age under the plan and are guaranteed by an insurance carrier (licensed under the laws of a State to do business with the plan) to the extent premiums have been paid,
- (D) premiums payable for the plan year, and all prior plan years, under such contracts have been paid before lapse or there is reinstatement of the policy,
- (E) no rights under such contracts have been subject to a security interest at any time during the plan year, and
- (F) no policy loans are outstanding at any time during the plan year.

A plan funded exclusively by the purchase of group insurance contracts which is determined under regulations prescribed by the Secretary to have the same characteristics as contracts described in the preceding sentence shall be treated as a plan described in this paragraph.

REGULATIONS SEC. 1.412(e)(3)-1. CERTAIN INSURANCE CONTRACT PLANS:

- (a) In general. Under section 412(h)(2) of the Internal Revenue Code of 1954, as added by Section 1013(a) of the Employee Retirement Income Security Act of 1974 (88 Stat. 914) (hereinafter referred to as "the Act"), an insurance contract plan described in section 412(e)(3) for a plan year is not subject to the minimum funding requirements of Section 412 for the plan year. Consequently, if an individual or group insurance contract plan satisfies all of the requirements of paragraph (b)(2) or (c)(2) of this section, whichever are applicable, for the plan year, the plan is not subject to the requirements of Section 412 for that plan year. The effective date for Section 412 of the Code is determined under section 1017 of the Act. In general, in the case of a plan which was not in existence on January 1, 1974, this section applies for plan years beginning after September 2, 1974 and in the case of a plan in existence on January 1, 1974, to plan years beginning after December 31, 1975.
- (b) Individual insurance contract plans.
 - 1) An individual insurance contract plan is described in section 412(e)(3) during a plan year if the plan satisfies the requirements of paragraph (b)(2) of this section for the plan year.
 - 2) The requirements of this paragraph are:

(i) The plan must be funded exclusively by the purchase from an insurance company or companies (licensed under the law of a state or the District of Columbia to do business with the plan) of individual annuity or individual insurance contracts, or a combination thereof. The purchase may be made either directly by the employer or through the use of a custodial account or trust. A plan shall not be considered to be funded otherwise than exclusively by the purchase of individual annuity or individual insurance contracts merely because the employer makes a payment necessary to comply with the provisions of Section 411(c)(2) (relating to accrued benefit from employee contributions).

Under the Pension Protection Act of 2006, 412(e)(3) Defined Benefit plans will be re-designated under new IRC Section 412(e)(3) effective 01/01/2008.

(ii) The individual annuity or individual insurance contracts issued under the plan must provide for level annual, or more frequent, premium payments to be paid under the plan for the period commencing with the date each individual participating in the plan becomes a participant and ending no later than the normal retirement age for that individual or, if earlier, the date the individual ceases his participation in the plan. Premium payments may be considered to be level even though items such as experience gains and dividends are applied against premiums. In the case of an increase in benefits, the contracts must provide for level payments with respect to such increase to be paid for the period commencing at the time the increase becomes effective. If payment commences on the first payment date under the contract occurring after the date an individual becomes a participant or after the effective date of an increase in benefits, the requirements of this subdivision will be satisfied even though payment does not commence on the date on which the individual's participation commenced or on the effective date of the benefit increase, whichever is applicable. If an individual accrues benefits after his normal retirement age, the requirements of this subdivision are satisfied if payment is made at the time such benefits accrue. If the provisions required by this subdivision are set forth in a separate agreement with the issuer of the individual contracts, they need not be included in the individual contracts.

(iii) The benefits provided by the plan for each individual participant must be equal to the benefits provided under his individual contracts at his normal retirement age under the plan provisions.

(iv) The benefits provided by the plan for each individual participant must be guaranteed by the life insurance company, described in paragraph (b)(2)(i) of this section, issuing the individual contracts to the extent premiums have been paid.

(v) Except as provided in the following sentence, all premiums payable for the plan year, and for all prior plan years, under the insurance or annuity contracts must have been paid before lapse. If the lapse has occurred during the plan year, the requirements of

this subdivision will be considered to have been met if reinstatement of the insurance policy, under which the individual insurance contracts are issued, occurs during the year of the lapse

and before distribution is made or benefits commence to any participant whose benefits are reduced because of the lapse.

- (vi) No rights under the individual contracts may have been subject to a security interest at any time during the plan year. This subdivision shall not apply to contracts which have been distributed to participants if the security interest is created after the date of distribution.
- (vii) No policy loans, including loans to individual participants, on any of the individual contracts may be outstanding at any time during the plan year. This subdivision shall not apply to contracts which have been distributed to participants if the loan is made after the date of distribution. An application of funds by the issuer to pay premiums due under the contracts shall be deemed not to be a policy loan if the amount of the funds so applied, and interest thereon, is repaid during the plan year in which the funds are applied and before distribution is made or benefits commence to any participant whose benefits are reduced because of such application.

(c) Group insurance contract plans.

1) A group insurance contract plan is described in section 412(e)(3) during a plan year if the plan satisfies the requirements of subparagraph (2) for the plan year.

2) The requirements of this subparagraph are:

(i) The plan must be funded exclusively by the purchase from an insurance company or companies, described in paragraph (b)(2)

(i) of this section, of group annuity or group insurance contracts, or a combination thereof. The purchase may be made either directly by the employer or through the use of a custodial account or trust. A plan shall not be considered to be funded otherwise than exclusively by the purchase of group annuity or group insurance contracts merely because the employer makes a payment necessary to comply with the provisions of section 411(c)(2) (*relating to accrued benefit derived from employee contributions*).

(ii) In the case of a plan funded by a group insurance contract or a group annuity contract the requirements of paragraph (b)(2)(ii) of this section must be satisfied by the group contract issued under the plan. Thus, for example, each individual participant's benefits under the group contract must be provided for by level annual, or more frequent payments equivalent to the payments required to satisfy such paragraph. The requirements of this subdivision will not be satisfied if benefits for any individual are not provided for by level payments made on his behalf under the group contract.

(iii) The group annuity or group insurance contract must satisfy the requirements of clauses (iii), (iv), (v), (vi), and (vii) of paragraph (b)(2). Thus, for example, each participant's benefits provided by the plan must be equal to his benefits provided under the group contract at his normal retirement age.

(iv) (A) If the plan is funded by a group annuity contract, the value of the benefits guaranteed by the insurance company issuing the contract under the plan with respect to each participant under the contract must not be less than the value of such benefits which the cash surrender value would provide for that participant under any individual annuity contract plan satisfying the requirements of paragraph (b) and approved for sale in the state where the principal office of the plan is located.

(B) If the plan is funded by a group insurance contract, the value of the benefits guaranteed by the insurance company issuing the contract under the plan with respect to each participant under the contract must not be less than the value of such benefits which the cash surrender value would provide for that participant under any individual insurance contract plan satisfying the requirements of paragraph (b) and approved for sale in the State where the principal office of the plan is located. (v) Under the group annuity or group insurance contract, premiums or other consideration received by the insurance company (*and, if a custodial account or trust is used, the custodian or trustee thereof*) must be allocated to purchase individual benefits for participants under the plan. A plan which maintains unallocated funds in an auxiliary trust fund or which provides that an insurance company will maintain unallocated funds in a separate account, such as a group deposit administration contract, does not satisfy the requirements of this subdivision.

(d) A plan which is funded by a combination of individual contracts and a group contract shall be treated as a plan described in section 412(e)(3) for the plan year if the combination, in the aggregate, satisfies the requirements of this section for the plan year. [Reg. Sec. 1.412(e)(3)-1.]

* Guarantees are dependent upon the claims-paying ability of the issuing company.