412(i) and 419A(f)(6)

Over the past few years we have reviewed a number of 412(i), and before that 419A(f)(6), proposals that were brought to us by insurance agents. Luckily for the client, and insurance agent, we were able to "convert" the 412(i) plans to regular Defined Benefit Plans, with or without insurance, in such a manner that no deductions were lost. Regarding 419A(f)(6) we advised the client that getting an IRS approval letter would not happen and that this type of plan should be implemented only after exhausting all efforts in obtaining a qualified plan where the deductions would stand.

"412(i) PLANS

Section 412(i) of the IRC says that if you have a fully insured plan (all assets are in life insurance and or annuities with a commercial carrier) you can rely on the issuing insurance company guaranteed interest rates for purposes of developing the contributions.

During the period of the Small Plan Actuarial Audit Program wherein the IRS was attempting to require the use of interest rates of not less than 8% and retirement ages of not less than 65, the prospect of a fully insured 412(i) plan looked enticing. A 4% interest assumption for a 45 year old retiring at 65 compared to an 8% interest assumption meant a contribution increase of 60%. However, when the IRS lost its case in Tax Court (12 out of 13 Tax court judges ruled against the IRS. One of the judges abstained because he "didn't know enough about the subject"), actuaries routinely began to use a 5% interest assumption (or 4% in special circumstances). A 4% interest assumption generates a contribution in the above example of only 12% more than what is obtainable with a 5% interest assumption. Immediately, the "interest" advantage of a 412(i) plan was minimized.

However, it is important to note that when a 412(i) plan prematurely terminates, the plan suffers a large decrease in the surrender values, which pays for commissions and the cost of medicals and underwriting. Additionally, there can be no investments of the plan other than in insurance products—no mutual funds, stocks, bonds, real estate, collectables, etc. Employee costs can become exorbitant since they too must receive benefits that are comparable and/or non-discriminatory when compared to that of the owners.

We are aware of cases whereby some insurance companies have been promoting 412(i) plans that use Whole Life insurance exclusively. This violates two IRS principles. First, a plan that uses only insurance is not a qualified plan. Second, the maximum amount of insurance is subject to either 100 times the projected monthly pension or if RR74-307 is used the maximum amount of insurance is limited to the Whole Life premium, which is restricted to no more than 2/3 of the Normal Cost. The insurance industries response was "use 5% for annuities and 95% for whole life insurance." This addressed the first principal but the resulting face amount was still far in excess of the incidental death benefit rule. Their next response was, "lets name the trust as beneficiary who will then pay out the appropriate maximum death benefit." What happens to the plan in the event of such a windfall? If, for example, only 2.5 million out of a 6 million dollar death benefit is paid out the plan will become fully funded and be subject to all kinds of problems besides not permitting any future contributions on behalf of the remaining owners.

The IRS has stated that they are fully aware of the abuses in this area (including the usage of policies with jumping cash values) and will be taking steps to correct the problems and revisit those plans that have already been approved to determine if there have been any violations.

There is nothing wrong with including insurance in a qualified Defined Benefit plan. If this is what the client wants and understands the advantage and disadvantages of providing life insurance in a plan, then you can achieve similar results without implementing a 412(i) plan. Our experience shows that we can achieve equal or better results with a Defined Benefit plan that incorporates whole life insurance with far greater flexibility since 412(i) plans can use only one funding method and cannot have any investments outside that of insurance or annuities.

With the passage of TEFRA in 1982 section 419A(f)(6) of the IRC was of interest once again. It appeared to be the answer to the cutbacks imposed by TEFRA except that it could not be used to provide retirement benefits of any kind. It could make available all kinds of ancillary benefits, almost all of them requiring some form of insurance. This plan could provide a "severance" benefit of up to two times the individual's salary. Since this had to be funded by insurance it required a large face amount and premium in order to generate the required cash values.

While a number of prestigious law and accounting firms have issued their own favorable opinion letters on 419A(f)(6) plans, the one opinion letter that truly counts, the one from the IRS, has never been issued.

If you are going to venture down this road, our recommendation has always been to first implement a plan where you can get a favorable IRS Determination Letter. This not only provides added protection for the client, but you as well.