

Executive Benefits Design Group

What is a 412(i)/412(e)3 Fully Defined Benefit Pension Plan?

For Top Professionals

A 412(e)3 fully 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(e)3 insurance contract plan over a traditional defined benefit plan?

A 412(e)3 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 participants 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 products are for these plans?

Whole Life product which was modified to fit this market and we have both an individual and group fixed annuity for this marketplace.

What requirements must be met to qualify as a 412(e)3 insurance contract plan?

The major requirements under Section 412(e)3 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 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 years plan contribution.

No policy loans are allowed under the contracts.

How does the initial deductible contribution required in a Fully Insured 412(e)3 plan compare to a traditional defined benefit plan?

These contribution levels are shown from ages 45 to 65. Comparisons are made for plans funded entirely with a combination of annuity and the maximum amount of life insurance available under the incidental insurance rules for qualified plans. A plan funded with both annuity and the maximum life insurance allowed may TRIPLE the deduction allowed in a traditional defined benefit plan.

Are 412(e)3 plans new to the retirement planning marketplace?

No. These plans have been around since ERISA (in 1974) or even before. They were referred to 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 a highly rated insurance company.

Where do you go to find a 412(e)3 plan?

Generally, you will go to an insurance company that sells these types of plans. The funding must be in insurance company products and the company must guarantee the benefits. There are very few insurance companies who market and administer small business retirement plans so there are very few companies that market 412(e)3 plans. That is why it is a plan that is somewhat unfamiliar to most CPA's and small business owners.

We believe it is a market that is under-served. We specialize in the small business retirement plan market place. It is, therefore, natural that we market 412(e)3 plans. These are specialized plans that create large deductions. In the right situation, there is no other plan that will meet the needs of the small business owner. If a traditional defined benefit plan does not create sufficient deductions, there is nowhere else to turn but to a 412(e)3 fully insured plan.

Do the contributions remain level forever?

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.