

In Defense of 412(i) Plans

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***Abstract:** A 412(i) plan is a defined-benefit plan that is funded exclusively with life insurance or annuity contracts. This type of plan offers a low-cost and low-risk alternative to more traditional plans funded with securities that are subject to a fluctuating stock market. Although the advantages of a fully insured plan seem obvious, 412(i) plans are continuously besieged by critics who assert that the plans are either not qualified or result in various other adverse tax consequences. This article responds to those critics.*

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ONCE UPON A TIME THERE WERE THREE LITTLE PIGS. THE FIRST LITTLE PIG OWNED A COMPANY THAT BUILT HOUSES OUT OF STRAW AND SPONSORED A PENSION PLAN THAT INVESTED IN A DIVERSE PORTFOLIO OF CONSERVATIVE BLUE CHIP STOCKS. THE SECOND LITTLE PIG OWNED A COMPANY THAT BUILT HOUSES OUT OF STICKS AND SPONSORED A PENSION PLAN THAT INVESTED IN A BALANCED PORTFOLIO OF GROWTH AND INCOME STOCKS. THE THIRD LITTLE PIG OWNED A COMPANY THAT BUILT HOUSES OUT OF BRICKS AND SPONSORED A PENSION PLAN THAT INVESTED EXCLUSIVELY IN INSURANCE CONTRACTS THAT PROVIDED A GUARANTEED RATE OF RETURN. IN THE 1990S, THE FIRST TWO LITTLE PIGS BRAGGED RELENTLESSLY ABOUT THE PERFORMANCE OF THE INVESTMENTS IN THEIR PENSION PLANS. THE THIRD LITTLE PIG REMAINED CONFIDENTLY SILENT. SUDDENLY, THE BIG BAD STOCK MARKET HUFFED AND PUFFED AND BLEW DOWN THE PLAN INVESTMENTS OF THE FIRST TWO LITTLE PIGS. A FEW YEARS LATER, THE FIRST TWO LITTLE PIGS RETIRED PENNILESS AND MOVED INTO A BRICK HOUSE GENEROUSLY GIVEN TO THEM BY THE THIRD LITTLE PIG, WHO LIVED COMFORTABLY ON HIS RETIREMENT INCOME HAPPILY EVER AFTER.

From the vantage point of 2003, how many pension plan sponsors would like to go back in time and fund their plans with fully insured investments having a guaranteed rate of return? The probable answer is all but those who were very smart or very lucky. Because of the precipitous drop in the stock market in recent years, together with the

surprising failure of some of the country's largest and most respected companies, the desirability of a 412(i) plan, which is fully insured with guaranteed benefits and low administrative costs, could not be greater. It is not surprising, therefore, that 412(i) plans are becoming increasingly popular. What is surprising is that these plans are continuously besieged by critics who assert that the plans are either not qualified under Section 401 of the Internal Revenue Code of 1986 (the Code) or result in various adverse tax consequences. Many of these critics may be disingenuous because they market competing pension plan products, yet others may honestly believe their assertions. This article begins with a brief description of 412(i) plans and then responds to their critics.

Background

A 412(i) plan is a defined-benefit pension plan that is funded exclusively by either life insurance or annuity contracts, or a combination thereof. As a defined-benefit plan, a 412(i) plan promises an employee a retirement benefit in a specified dollar amount based upon a formula that takes into account the employee's level of compensation and years of service. The plan derives its unique status from Section 412(i) of the Code, which exempts qualifying plans from the minimum funding requirements contained in other provisions of Section 412. A 412(i) plan is, in general, subject to all other requirements applicable to defined-benefit plans.

Section 412 of the Code requires a plan to establish and maintain a funding standard account to which annual contributions must be made that are actuarially calculated to fund projected future benefits payable by the plan. These requirements, however, do not apply to plans described in Section 412(i).¹ To qualify under Section 412(i), a plan must meet the following requirements:

1. The plan must be funded exclusively by the purchase of individual annuity or insurance contracts, or a combination thereof.²
2. The insurance contracts under the plan must provide for level annual, or more frequent, premium payments for the period commencing with the date each individual in the plan became a participant

and ending not later than the normal retirement age for that individual (or, in the case of an increase in benefits, commencing at the time such increase becomes effective). For this purpose, premium payments may be considered level even though items such as experience gains and dividends are applied against future premiums.

3. The benefits provided by the plan must be equal to the benefits provided under each contract at normal retirement age under the plan.
4. The benefits provided by the plan must be guaranteed by an insurance carrier licensed to do business in the state of the plan to the extent that premiums have been paid.
5. Premiums paid for the plan year, and all prior plan years, must have been paid before lapse, or there must have been a reinstatement of the policy.
6. No rights under the insurance contracts may be subject to a security interest at any time during the plan year.
7. No policy loans may be outstanding at any time during the plan year.³

A plan's failure to satisfy any of the above requirements for a plan year will not result in the plan being disqualified under Section 401(a) of the Code. Such failure, however, will cause the plan to be subject to the minimum funding requirements of Section 412 since it will no longer qualify for the exception contained in Section 412(i).

Response to Various Criticisms

Funding Exclusively with Life Insurance

Some 412(i) plans are funded exclusively by life insurance contracts. Critics argue, however, that life insurance may not be used to fund 100% of plan benefits. This is a surprising argument considering the language of Section 412(i) and the regulations thereunder. Section 412(i) requires that a plan be funded exclusively by the purchase of insurance contracts. The regulations provide further that the plan must be funded exclusively by "individual annuity or individual insurance contracts, or a combination thereof."⁴ By the use of the conjunction "or," this language leaves little doubt that the drafters of the regulations contemplated that plans could be funded exclusively by (1) annuity con-

tracts, (2) life insurance contracts, or (3) a combination of annuity contracts and life insurance contracts.

Ignoring the regulatory language, some critics have asserted that Revenue Ruling 81-162⁵ supports the argument that a pension plan cannot be funded exclusively by life insurance contracts. That ruling is a restatement of Revenue Ruling 54-67⁶ that was issued before the enactment of Section 412(i) and more than 25 years before Section 1.412(i)-1 of the regulations was issued in 1980.⁷ Thus, if it were proper to read Revenue Ruling 54-67 (and Revenue Ruling 81-162) as preventing a plan from being funded 100% by life insurance contracts, the language in Section 1.412(i)-1(b)(2) contemplating plans funded exclusively by such contracts would make no sense.

Moreover, Revenue Rulings 54-67 and 81-162 are clearly distinguishable from a typical 412(i) plan funded by life insurance. In those rulings, the Internal Revenue Service (the Service) held that a plan, in which the retirement benefits provided by the employer were limited to whatever amounts were available through the purchase of ordinary life insurance contracts and which were to be converted to life annuities at retirement, did not qualify as a pension plan. The benefits under the arrangement in the ruling were not “definitely determinable” as required under Section 1.401-1(b)(1) of the regulations because the employees were provided with “only such benefits as are afforded” by the insurance contracts. Thus, the rulings stand for the proposition that an arrangement by which an employer does nothing more than purchase life insurance policies for its employees does not constitute a pension plan within the meaning of Section 401(a) of the Code simply because the life insurance policies can be converted to life annuities at retirement. In contrast to the arrangements in the rulings, a typical 412(i) plan that invests exclusively in life insurance contracts provides a defined benefit to employees in the same manner as other qualified defined-benefit plans, but happens to use life insurance as its funding vehicle.

Incidental Death Benefits

The regulations provide that a pension plan, in addition to providing pension benefits, may provide for the payment of death benefits through insurance or otherwise as

long as such benefits are considered to be “incidental.”⁸ The incidental death benefit limitation does not limit the type of investments a qualified plan can make, but rather simply limits the amount of death benefits the plan can pay. The regulatory concern is that a plan be established primarily to provide retirement benefits rather than death or other benefits not customarily included in a pension plan.⁹

A death benefit equal to 100 times a participant’s monthly retirement benefit (often referred to as the 100-to-1 ratio) is generally accepted as being an incidental death benefit for this purpose.¹⁰ When life insurance is the exclusive investment in a 412(i) plan, however, the death benefit payable to the plan under an individual insurance policy may exceed the 100-to-1 ratio with respect to the participant whose life is insured. This is because of the amount of insurance coverage that is needed in order for the cash surrender value (CSV) of the policy to build up to a sufficient amount to fund projected retirement benefits. However, as long as the death benefit payable to the participant under the plan does not exceed the 100-to-1 ratio, the death benefit should be considered incidental regardless of the amount of death benefit payable to the plan under the insurance policy.¹¹ In short, the determination of whether the plan is a pension plan, as opposed to a plan to provide benefits not customarily included in a pension plan, necessarily depends upon the benefits that are payable to the participants. The investments that are acquired in order to fund those benefits are irrelevant to that determination.

Thus, a plan that purchases more life insurance coverage than the amount that would be permitted under the incidental benefit limitation should retain its tax-qualified status as long as the plan documents expressly provide that the death benefit payable to a beneficiary will not exceed the 100-to-1 ratio and that any insurance proceeds in excess of that limitation will be retained by the plan.¹²

Permanency

Critics of 412(i) plans often claim that the plans fail to satisfy the “permanency” requirement of Section 1.401-1(b)(2) of the regulations. That section provides in relevant part:

The term “plan” implies a permanent as distin-

guished from a temporary program. Thus, *although the employer may reserve the right to change or terminate the plan*, and to discontinue contributions thereunder, the abandonment of the plan for any reason other than business necessity within a few years after it has taken effect will be evidence that the plan from its inception was not a bona fide program for the exclusive benefit of employees in general.

The italicized language makes clear that a plan does not lack permanency merely because it can be changed or terminated by the employer. In fact, all pension plans, whether funded by insurance contracts or not, contain termination provisions. Moreover, even the abandonment of a plan within a few years of its inception will not necessarily disqualify a plan, although early abandonment does serve as evidence that the plan was never bona fide. But such evidence may be overcome by a showing of business necessity, which has been defined broadly by both the courts and the Service as being synonymous with “the existence of a valid reason for the termination.”¹³ For example, in *Kane Chevrolet Co. v. Commissioner*,¹⁴ the qualification of a plan was upheld despite the fact that it had only been in effect for one year. The Tax Court found that the employer’s dissatisfaction with the plan because it failed to accomplish its purpose of preventing employee turnover was a valid reason for terminating the plan and did not disqualify the plan for the one year of its existence.

Critics argue that certain 412(i) plans that are funded exclusively by life insurance fail to satisfy the permanency requirement. This is a curious argument because the regulations make clear that the permanency of a plan “will be indicated by all the surrounding facts and circumstances.”¹⁵ There is nothing inherent in funding a 412(i) plan with life insurance that suggests that it is anything other than a permanent plan established to provide retirement benefits for employees. Unless a specific plan expressly contemplates a temporary or short-term program, the permanency issue arises, if at all, only in hindsight after a particular plan is terminated within a few years without a valid business reason.¹⁶

Section 412(i) requires that the insurance contracts

funding the plan provide for level annual premiums based upon rates guaranteed by the insurance carrier.¹⁷ What if projected (as opposed to guaranteed) returns on life insurance policies funding a 412(i) plan suggest that the plan may be fully funded in, for example, seven years? Should that be enough to jump to the conclusion that an employer may consider it advantageous to terminate the plan before the retirement age of the participants? Some critics think so, but that seems to be an enormous leap, particularly in today’s economy and in light of the fact that there are many reasons why an employer would want to keep a fully funded pension plan in place for its employees. Certainly there is nothing wrong with an employer, before adopting any type of qualified plan, looking at the consequences that would be projected to occur if the plan were to be terminated at different points in time after its adoption.

Moreover, the fact that a plan may be terminated in the future is not grounds for invalidating the plan. For example, the Service has found that a plan does not lack permanency even if it is contemplated at its inception that the plan may only be in effect for five years. In a series of rulings dealing with union-negotiated pension plans, the Service considered a plan to be permanent even though it was created pursuant to a collective bargaining agreement that terminated at the end of five years, at which time the plan might be changed or terminated.¹⁸ The Service reasoned that the possibility of the plan terminating at the end of five years was “similar to plans generally in which provision is made for amendment and discontinuance.”¹⁹

The drafters of the permanency requirement in the regulations seemed to be more concerned with an employer failing to continue making contributions to a plan than the employer terminating a plan that became fully funded sooner than anticipated.²⁰ In Revenue Ruling 72-239,²¹ for example, the Service held that no business reason was necessary to terminate a plan that was fully funded prior to normal retirement age due to erroneous actuarial assumptions. The Service explained that the lack of business necessity was relevant if a plan had only been in effect for a few years and noted that the plan at issue had been in existence for “many” years. The Service did not

state how many years the plan had been in existence in the ruling but, as discussed above, the regulations speak of the abandonment of a plan within a “few” years.²²

A 412(i) plan cannot be overfunded due to actuarial error since funding must be based upon the rates guaranteed by the insurance contracts. Overfunding may occur, however, if actual interest rates exceed guaranteed rates. It cannot be predicted, however, if or at what point in time such overfunding will occur. If an employer chooses to terminate an overfunded plan after “many” years, Revenue Ruling 72-239 would support the termination of the plan without adverse tax consequences. Moreover, the expense of continuing a fully funded plan without a corresponding annual deduction may serve as a business reason for terminating a plan.

Exclusive Benefit Rule

A qualified plan of an employer must be established for the exclusive benefit of its employees or their beneficiaries.²³ Thus, no part of the assets of the plan may be used for, or diverted to, purposes other than the exclusive benefit of the employees or beneficiaries.²⁴

Critics of 412(i) plans that invest exclusively in life insurance contracts assert that the plans violate the exclusive benefit requirement because it is not appropriate for life insurance to be the sole investment of a plan. That assertion is difficult to sustain, however, since the drafters of Section 1.412-(i)-1(b)(2) of the regulations clearly contemplated that 412(i) plans may be funded exclusively with life insurance contracts (see “Funding Exclusively with Life Insurance” section).

Moreover, the regulations expressly provide that there are no specific limitations with respect to investments that may be made by a plan and that, generally, any investments permitted by the trust agreement may be made to the extent allowed by local law.²⁵

The exclusive benefit requirement has at times been applied to limit the types of investments that are permitted to be made by a plan; however, except for rare circumstances, this limitation has been applied only when it is clear that the employer or another related party is enjoying a benefit from the investment at the expense of the plan partici-

pants.²⁶ Thus, even when the employer or another party arguably does benefit from an investment, such as in the case of an investment in the stock or obligation of the employer, the investment is generally permitted as long as the primary purpose of the investment is to benefit employees or their beneficiaries and the purchase price for the stock or other investment does not exceed its fair market value.²⁷

The Service has generally not been successful in challenging investments on the ground that the exclusive benefit requirement was violated. In *Shedco, Inc. v. Commissioner*,²⁸ for example, the Tax Court refused to sustain the Service’s assertion that a pension plan’s loan of 90% of its assets on an unsecured basis to a partnership in which the employer was a general partner violated the exclusive benefit rule. The Tax Court agreed that the loan was not a prudent investment for the plan because the loan was unsecured, was used for working capital rather than to invest in assets, did not comply with the diversity requirements of the trust, and did not provide a rate of return commensurate with the high degree of risk to which it exposed the plan. The Tax Court held, however, that although the related party circumstances required greater scrutiny, the plan’s investment in the loan did not violate the exclusive benefit rule because the trustee in fact intended that the plan, and thereby the participants, would benefit from the loan. In so holding, the court noted that the loan proceeds did not flow back to the employer, nor were they diverted for the personal benefit of the shareholders of the employer or any other related party.

Life insurance contracts acquired by 412(i) plans are arm’s-length policies. The life insurance business is a competitive industry and it can be assumed that the policies are not sold for less than their fair market value. A life insurance contract is a low-risk investment that provides a guaranteed rate of return. The fact that another investment might provide a greater rate of return does not make an investment in a life insurance contract imprudent. Section 412(i) requires that investments in life insurance contracts be calculated actuarially to provide projected retirement benefits to employees at normal retirement age. The investments provide nothing more and nothing less. Furthermore, the policies do not provide benefits to any party other than the employees and

their beneficiaries. Thus, there is no support for the assertion that a plan that invests exclusively in life insurance contracts violates the exclusive benefit requirement.

Springing Cash Value Policies

Critics of 412(i) plans also argue that the plans are often funded by “springing cash value” insurance policies. As discussed below, the Service’s concerns with the springing cash value issue did not arise in the 412(i) plan context,²⁹ and there is nothing in the design of a 412(i) plan itself that would encourage such a plan to invest in that type of policy. Although the determination of whether any policy falls within this category depends upon the unique characteristics of that policy, the limited guidance provided by the Service for making that determination is discussed below.

In general, when a plan either sells or distributes an individual insurance contract to the individual who is the insured under the policy, the CSV determines the appropriate purchase price or the value of the amount distributed. The first situation, a sale of the insurance contract to the plan participant who is the insured, would generally be a prohibited transaction under the rules of ERISA and the Code. Such a sale is allowed, however, under a Department of Labor prohibited transaction class exemption that provides that a plan may sell an insurance contract to the plan participant whose life is insured if, among other things:

The amount received by the plan as consideration for the sale is at least equal to the amount necessary to put the plan in the same cash position as it would have been had it retained the contract, surrendered it, and made any distribution owing to the participant on his vested interest under the plan.³⁰

Thus, a purchase price equal to the CSV of the policy is sufficient to qualify for the class exemption from the prohibited transaction rules.³¹

CSV is also the relevant valuation amount in the second situation, a distribution of the insurance contract to a plan participant. The regulations provide the general rule that a distribution of property from a plan is included in the income of the distributee at its fair market value.³² In the case of a distribution of an insurance contract, however, the regulations provide the more spe-

cific rule that the amount included in the income of the distributee is equal to the CSV of the policy.³³

This regulatory language could not be more clear. Nonetheless, the Service has indicated informally by announcement and notice that the CSV of an insurance policy may not represent its fair market value when a plan distributes an insurance contract to a plan participant. In 1988, the Service announced that it was studying certain types of insurance contracts that have “artificially low” CSVs, and referred to these policies as springing cash value contracts.³⁴

The next year, in Question and Answer 10 of Notice 89-25,³⁵ the Service addressed the following question: “What amount is included in a plan participant’s gross income when the participant receives a distribution from a qualified plan that includes a policy issued by an insurance company with a value substantially higher than the cash surrender value stated in the policy?” The Notice concluded that although individuals should generally use the CSV as the amount to be includible in their income, that practice is not appropriate when the reserves under the policy represent a much more accurate approximation of the fair market value of the policy than the CSV.

The Notice then set forth an example illustrating the circumstances under which the use of CSV was not appropriate. The plan in the example acquired a single-premium insurance policy for \$400,000 and distributed it to a participant two years later. The policy’s CSVs and accumulated reserves were as follows:

Year	CSV	Reserves
1	\$106,000	\$406,949
2	\$112,360	\$426,596
3	\$119,109	\$447,052
4	\$126,248	\$468,178
5	\$489,908	\$489,908

As can be seen from the above, the CSV of the policy almost quadruples between the fourth and fifth years (the increase is approximately 388%). Moreover, in the first four years, the CSV is equal to only 26-27% of the amount of the reserves, whereas in the fifth year the percentage jumps to 100%. These significant one-year increases illustrate the situation that the Service was con-

cerned about because the nominal value of the policy “springs up” in one year. Notice 89-25 concluded that a distribution of the policy to the participant two years after its purchase resulted in an income inclusion to the participant equal to the amount of the reserves (\$426,596) rather than the amount of the CSV (\$112,360).

The guidance provided by the Notice is fairly limited: In the case of a single premium policy in which the CSV is equal to 26-27% of the reserves, and that provides for a CSV increase of 388% in a later year, the reserves represent a better approximation of the fair market value of the policy than the CSV. The Notice does not provide any other guidance except to state that the differential between CSVs and reserves must be “substantial” to overcome the general rule that the CSV is to be used in determining the amount of income inclusion.

The only other guidance provided by the Service was in Announcement 94-101,³⁶ in which the Service announced certain examination guidelines that later became a part of the IRS Manual. The guidelines set forth certain principles relating to the springing cash value issue, but indicated that the principles applied only to specific abuse situations and did not “apply to valuing insurance contracts in general.” Thus, in a nonabusive situation, the general rule of including a distributed insurance policy in income at its CSV would continue to apply. The guidelines illustrate the “specific abuse situations” to which the special rule is to apply by using the same example that was set forth in Notice 89-25, which does not specifically relate to 412(i) plans.

The Service has failed to provide any further guidance to taxpayers since 1994, nor has it amended the regulations to indicate that a distribution of an insurance policy should not be taken into account at its CSV. Neither Notice 89-25 nor Announcement 94-101 disputed that the general rule in the regulations was to apply in most cases, even if the actual fair market value of a policy was higher than the policy’s CSV. The only time that CSV is not to be used is if the actual fair market value is “substantially” higher than the CSV, according to Notice 89-25, or in “specific abuse situations,” according to Announcement 94-101. Both of these situations were illustrated by an insurance policy in which the CSV was equal to approximately 26-27% of the reserves and whose

value sprung up 388% in one year. Thus, without further guidance, a taxpayer is left to conclude that a significantly lesser differential between CSVs and reserves will not result in a policy constituting a springing cash value policy.

Most insurance policies provide for surrender charges in the early years. These charges are necessary to allow the insurance company to earn a profit and to compensate it for the expenses of setting up the policy, paying sales commissions, and paying other costs that are fixed regardless of the length of the policy. Since it is typical for CSVs to reflect a surrender charge in the early years, these CSVs should not be considered “artificially low” within the meaning of Announcement 88-51.³⁷ Thus, the distribution of a policy whose CSVs increase steadily in each of the first five or more years to compensate for the costs to the insurance company for an early surrender should still be taken into account at CSV even though the fair market value of the policy may, arguably, be a somewhat greater amount.

Discrimination

All qualified plans, including 412(i) plans, must comply with the nondiscrimination provisions of Section 401(a)(4) of the Code. In order to comply with those provisions, a plan cannot discriminate in favor of highly compensated employees. There is nothing inherent in a 412(i) plan that raises any discrimination issues. In a typical 412(i) plan, the retirement and death benefits for all employees are determined according to the same formula.

When a 412(i) plan invests exclusively in life insurance contracts, however, the investments underlying the benefits for highly and non-highly compensated employees may differ because there may be times when the plan’s insurable interest in a non-highly compensated employee will not allow the purchase of a large enough policy to provide a sufficient CSV to fund projected retirement benefits. In such a case, the plan may purchase an annuity for the non-highly compensated employee to fund a portion of the projected retirement benefit in addition to the life insurance policy. But the life insurance policies used for both highly and non-highly compensated employees would typically be the same, and in both cases the death benefit payable under the plan would be no less than 100 times the anticipated monthly retirement ben-

efit. Moreover, the annuity policies would typically provide all the same features available in the life insurance policy. In many plans, the CSVs under the annuity contracts are greater than in the life insurance contracts, so the plans discriminate, if at all, against the highly compensated employees, which does not violate Section 401(a)(4) of the Code.

Recent Developments

At a recent benefits conference that was cosponsored by the American Society of Pension Actuaries and the Tax Exempt/Government Entities Division of the Service (TE/GE Division), Richard J. Wickersham and certain other representatives of the TE/GE Division made several informal remarks in a panel discussion that appeared to have been intended to serve as a warning to sponsors and administrators of 412(i) plans. Among other things, the panelists stated that the Service has assigned a very high priority to providing guidance on “abusive” insurance-funded defined-benefit plans that “misuse” Section 412(i) of the Code. Rather than being offended by this name-calling, most plan sponsors and administrators will welcome additional guidance from the Service in this area. Legitimate plans have lived in the shadow of informal pronouncements and a general lack of guidance for too long. ■

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(1) IRC § 412(h)(2).

(2) A plan may also be funded exclusively by the purchase of group insurance contracts that are determined under the regulations to have the same characteristics as individual contracts described in Section 412(i) of

the Code. IRC § 412(i) (flush language).

(3) IRC § 412(i); Treas. Reg. § 1.412(i)-1(b)(2).

(4) Treas. Reg. § 1.412(i)-1(b)(2).

(5) 1981-1 C.B. 169.

(6) 1954-1 C.B. 149.

(7) T.D. 7706 (July 15, 1980).

(8) Treas. Reg. § 1.401-1(b)(1)(i).

(9) Treas. Reg. § 1.401-1(b)(1).

(10) *See e.g.*, Rev. Rul. 74-307, 1974-2 C.B. 126; Rev. Rul. 68-453, 1968-2 C.B. 163; Rev. Rul. 61-121, 1961-2 C.B. 65. Death benefits under a plan will also be considered incidental if less than 50% of the employer contribution credited to each participant’s account is used to purchase life insurance on the participant’s life (applicable to defined contribution plans). *See* Rev. Rul. 74-307, 1974-2 C.B. 126. Moreover, if an employer makes contributions to an auxiliary fund that is not invested exclusively in insurance contracts, the death benefit under certain circumstances may exceed the 100-to-1 ratio. *Id.* However, such plans would not qualify under Section 412(i) and therefore are not relevant to this discussion.

(11) Payment of excess death benefits to the plan under the insurance contract, however, will cause the plan to lose its Section 412(i) status because its funds will no longer be invested exclusively in insurance contracts. This will cause the plan to become subject to the minimum funding requirements of Section 412.

(12) Once a death benefit in excess of the 100-to-1 ratio is paid to a plan, the plan will no longer satisfy the requirements of Section 412(i) of the Code because its funds will not be invested exclusively in insurance contracts. This will cause the plan to become subject to the minimum funding requirements of Section 412 but will not affect the qualified status of the plan.

(13) *Kane Chevrolet Co. v. Commissioner*, 32 T.C. 596 (1959); Rev. Rul. 57-163, 1957-1 C.B. 128.

(14) 32 T.C. 596 (1959).

(15) Treas. Reg. § 1.401-1(b)(2).

(16) Business necessity is not required to terminate a longstanding plan. This is clear from the language in the regulations that simply states that abandonment of a plan without business necessity *within the first few years* is evidence that the plan is a temporary program. In Revenue Ruling 72-239, 1972-1 C.B. 107, the Service confirmed that the termination of a plan that had been in effect for “many years” would not affect the prior qualification of the plan even though there was no business necessity for the termination.

(17) IRC § 412(i)(2) & (3).

(18) Rev. Rul. 83-83, 1983-1 C.B. 86; Rev. Rul. 70-257, 1970-1 C.B. 90; Rev. Rul. 55-681, 1955-2 C.B. 585.

(19) Rev. Rul. 83-83, 1983-1 C.B. 86.

(20) The permanency requirement was in part a reaction to *Lincoln Electric Co. Employee’s Profit Sharing Trust v. Commissioner*, 190 F.2d 326 (6th Cir. 1951), which had allowed an employer to establish a profit-sharing plan by making a single contribution. It is instructive that the regulations focus on the abandonment of a plan rather than its termination. In addi-

tion, the regulations state: "The permanency of the plan will be indicated by all the surrounding facts and circumstances, including the likelihood of the employer's ability to continue contributions as provided under the plan." Treas. Reg. § 1.401-1(b)(2). The regulations then go on to state that an employer does not have to make a contribution every year but that a single or occasional contribution will not establish a plan of profit sharing. *Id.* (21) 1972-1 C.B. 107.

(22) A "few" is generally interpreted as meaning a small number, or approximately three or four. This interpretation is consistent with the rulings that upheld union-sponsored plans even though it was contemplated at the inception of the plans that they may be terminated after five years.

(23) IRC § 401(a); Treas. Reg. § 1.401-1(a)(3)(ii).

(24) IRC § 401(a)(2); Treas. Reg. § 1.401-1(a)(3)(iv).

(25) Treas. Reg. § 1.401-1(b)(5).

(26) An example of a rare circumstance in which the exclusive benefit requirement was found to limit plan investments even though it was not clear that the employer or another related party would benefit from the transaction can be found in Revenue Ruling 73-532, 1973-2 C.B. 128. In that ruling the Service held that a trust providing the trustee with complete power to invest trust funds without regard to whether the investments were "new, speculative, hazardous, adventurous, or productive of

income" violated the exclusive benefit requirement.

(27) *See e.g.*, Rev. Rul. 69-494, 1969-2 C.B. 88.

(28) 76 T.C.M. (CCH) 267 (1998).

(29) The primary concern of the Service with respect to springing cash value policies appears to have been with single-premium policies purchased for an employee who is about to retire or when the plan is about to terminate. *See* Announcement 94-101, 1994-35 I.R.B. 1. For a plan to qualify under Section 412(i), the insurance contracts must provide for level annual premium payments that do not present the same potential for abuse as single-premium contracts.

(30) DOL PTE 92-6, 57 Fed. Reg. 5189 (Feb. 12, 1992), amended, 67 Fed. Reg. 56,313 (Sept. 3, 2002).

(31) The Service has never expressly disputed this conclusion even in its springing cash value pronouncements, which specifically deal solely with distributions rather than sales of insurance contracts.

(32) Treas. Reg. § 1.402(a)-1(a)(1)(iii).

(33) Treas. Reg. § 1.402(a)-1(a)(2).

(34) Announcement 88-51, 1988-13 I.R.B. 34.

(35) 1989-1 C.B. 661.

(36) 1994-35 I.R.B. 1.

(37) 1988-13 I.R.B. 34.