

IRC Sec. 412 (i) Requirements :

A defined benefit plan will meet the requirements of IRC Sec. 412 (i) if:

1. The plan is funded exclusively by the purchase of individual insurance contracts.
2. Such contracts provide for level annual premium payments to be paid extending not later than retirement age for each individual participating in the plan, and commencing with the date the individual becomes a participant in the plan.
3. 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 to the extent premiums have been paid.
4. 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.
5. No rights under such contracts have been subject to a security interest at any time during the plan year.
6. No policy loans are outstanding at any time during the plan year.

In a nutshell, if the plan invests entirely in acceptable insurance company contracts and does not allow loans, it can qualify as a 412(i) or fully insured plan, and be exempt from the funding requirements of IRC Sec. 412.

The advantages of being exempt from IRC Sec. 412 funding requirements need to be fully understood. This is the appeal of the fully insured plan. Let's explore these advantages in detail.

Advantages of the Fully Insured 412(i) Defined Benefit Plan

The fully insured plan is not subject to the requirement of making quarterly contributions. In a traditional plan, these contributions are usually a nuisance for the small business. The correct amount of quarterly contribution is not always known soon enough to make the first quarterly contribution. If it is not made, the participants need to be informed or penalties will be incurred. If the contribution is too small, there will be interest penalties. If it is too large, a nondeductible contribution penalty may be incurred. The calculation of the full funding limit may mean no contribution can be made, but that may not be known until later in the year. Generally, quarterly contributions are an undesired complexity to the small business.

The mathematical results of the full funding limitation test may be the biggest problem of all for the small defined benefit plan. These annual calculations can cause the plan costs to fluctuate greatly. There may be little or no deduction in one year and then relatively high cost may be required the following year. Suddenly, the small business loses any handle on what the future cost pattern for the plan may be. Certainly, unknown costs are an undesirable trait for a small business retirement plan. Fully insured plans are not subject to the full funding limitation.

Inadvertent over-funding can occur in a traditional plan for various reasons, including higher than anticipated earnings, new changes in the law limiting benefits, and plan forfeitures. This can create excess plan assets. If the plan is terminated with excess assets that will revert to the employer, the plan will pay a 50 percent excise tax on the excess, in addition to income tax on the reversion to the corporation. The nature of the funding method of a fully insured plan should not create excess assets so there would be no reversion to be taxed and penalized.

Fully insured plans should not have the actuarial assumptions attacked since the assumptions are mandated to be the guaranteed rates in the insurance company products. If the benefits must be guaranteed by the contracts, the funding of the contracts must be based upon the guaranteed rates.

A fully insured plan is not required to file a Schedule B so the service of an enrolled actuary are not necessary for attesting to the funding of the plan.

Additional advantages of the fully insured plan include:

- ✓ It is more understandable since the participant's accrued benefit at any point is simply the amount of funds in the insurance company contracts. Historically, participants find it difficult to understand the pro-rata service or participation accrual definitions of the traditional defined benefit plan.
- ✓ Larger overall deductions are allowable because the funding assumptions are based on the contract guarantees. The lump sum equivalent of the monthly benefit is higher than in a traditional plan and the pre-retirement interest assumption is lower. The plan still benefits from current earnings, however, as the dividends of the insurance company contracts serve to reduce the next year's required contribution. The chart at the end of this article illustrates the initial level of deductions possible in a fully insured plan compared to the traditional defined benefit plan.

In total, these advantages are too important for the small business to ignore. The investment options are more limited but can be worth the trade-off. If the overall objective of the small business is a large deduction, a secure promise of benefits, a reasonable market rate of return on investments, more stability, and less complexity, then the fully insured plan has merit.

The cost of the plan remains a relatively known quantity in a fully insured plan. The traditional defined benefit plan may experience undesirable fluctuations under the full funding limit calculations. This handle on plan costs enjoyed by the fully insured plan can be one of the most important advantages of all for the small business.

Speaking very generally, traditional defined benefit plans have fallen into disfavor for the very small business for the reasons stated above. Unless the owner is at least 45- 50, a defined contribution plan may have more overall advantages – particularly the New Comparability profit sharing plans now allowed under non-discrimination rules.

There is still a need for the defined benefit plan for the very small business. Many times, only a defined benefit plan can meet the objectives of the business owner. In these cases, the advantages of the fully insured plan deserve close consideration.

There are relatively few insurance companies that fund and administer fully insured plans. One reason is that usually standard products would not normally be allowed to fund a 412(i) plan. A new product would have to be designed, or existing products would need to be amended to comply with the specifics of the 412(i) funding. Additionally, not many insurance companies market and administer plans for the small business situation. Usually the funding options for a 412(i) plan would be to totally fund the plan with a fixed annuity, or to fund the plan with a combination of fixed annuity and whole life products. Variable annuity and universal life products generally do not have the necessary guarantees to accommodate the funding and benefit requirements of a fully insured plan.

Conclusion

To summarize, the future plans of choice for the small business may well be the new comparability profit sharing plan as the defined contribution option and the 412(i) fully insured plan as the defined benefit option. All small businesses and their advisors should be aware of both types of plans and the advantages of each.

See the following page illustrating maximum deductions available at selected ages for a 412(i) Defined Benefit Plan. Also included (as an additional bonus) is an illustration of the allocation possible within a New Comparability profit sharing plan favoring the owner of a small business.