



## Agent Supplement

### 412(i) Defined Benefit Pension Plans (Form 1880)

#### Introduction

A 412(i) plan is a defined benefit plan. Defined benefit plans promise to pay a retirement benefit. The benefit is determined by the plan formula and each year the employer contributes a portion of the amount required to fund the benefit at retirement. It generally favors older, highly compensated employees. Investment gain or loss does not affect the benefit.

The 412(i) plan is a qualified retirement plan and must meet all requirements of IRS Code Section 401 regarding qualified plans such as eligibility, participation, coverage, vesting and distributions.

#### 412(i) Defined Benefit Plan Characteristics

The Internal Revenue Code section 412(i) describes the following characteristics:

1. The plan must be funded solely with individual insurance and annuity contracts;
2. The contracts must have level premiums from the issue date of the policy to a date not later than the individual's normal retirement;
3. The benefit under the plan must equal the guaranteed benefits under the policies (assuming all premiums are paid to normal retirement);
4. All premiums must be paid to avoid policy lapses;
5. No policy may be used as collateral to secure a loan;
6. No policy loans are allowed.

#### Target Market

Business owners who:

- Have five or fewer employees
- Are age 45 or older
- Have a consistent cash flow
- Desire a higher tax deduction
- Want an increased retirement benefit

#### Demographics

The demographics of the business are related to the funding cost for the plan. The age and compensation of the employees will affect the funding with mature employees increasing the cost.

#### Funding Comparison for a Traditional and a 412(i) Defined Benefit Plan

The funding assumptions are different between the two plan designs. The funding for a 412(i) plan requires the use of the guaranteed minimum interest rates of the insurance contract for the calculation. A traditional defined benefit plan funds based upon actuarial assumptions. The interest rates used for the actuarial assumptions generally are higher than the minimum guaranteed interest rates provided by the insurance contracts. A higher interest rate assumption generally decreases the contribution amount.

If a plan qualifies under 412(i), it is exempt from the normal funding requirements of Code Section 412. This includes exemptions from the minimum funding standard account, the full funding limitation, quarterly contributions, reasonable actuarial assumption interpretations and the Schedule B Actuarial certification.

#### Funding the 412(i) Plan

The plan is funded with life insurance and annuity, or annuity only. The funding is based upon the guaranteed interest rate. If the guaranteed minimum interest rate in the annuity is 3%, the plan pre-retirement interest rate assumption must be 3%.

If the annuity is paying interest in excess of 3%, does this mean the plan does not benefit from the excess interest being paid? The plan is credited with the full current rate of interest. For example, if the annuity contract guarantees 3%, any interest in excess of the 3% guarantee is considered excess interest and is used to reduce the next year's out-of-pocket plan contribution. Excess interest is not guaranteed.



Life insurance dividends, if any, must reduce the premium. Life insurance dividends are not guaranteed.

**Benefit Limit**

The retirement benefit is the earned benefit based upon years of participation, and plan formula.

The maximum benefit that can be accrued is a benefit equal to the **lesser** of 100% of the participant's highest 3-year average compensation or \$175,000. \* The 100% of average compensation limit is reduced for participants with less than 10 years of service at retirement. The \$175,000 limit is reduced for participants retiring before age 62 or with less than 10 years of participation.

\*\$175,000 benefit limit is subject to cost-of-living adjustments

**Life Insurance in a 412(i) Plan**

Life insurance in a plan provides important advantages for both the employer and participant. The premium payments are deductible for the employer and the participant has the protection provided by the death benefit. The life insurance premiums are paid by the employer and are a plan contribution. Using life insurance in a plan increases the maximum deductible contribution. The amount of life insurance in a plan is determined by the Incidental Benefit Rules.

**Incidental Benefit Rules**

The IRS incidental death benefit rules determine the amount of life insurance that is permitted in a plan. Exceeding the incidental death benefit limits is a disqualifying event. A 412(i) plan cannot be funded **solely** with life insurance. The purpose of a qualified retirement plan is to provide retirement benefits; the plan is permitted, however, to provide ancillary benefits such as a pre-retirement death benefit.

Generally, 412(i) plans meet the incidental benefit rule by using Revenue Ruling 74-307. This Rule allows 66 2/3 of the theoretical level-premium to be used for life insurance. The alternative rule states that life insurance is generally considered

incidental if the face amount of the insurance does not exceed 100 times the participant's projected monthly benefit.

**Life insurance and the Retirement Benefit**

In a 412(i) plan, the plan is funding for a specified retirement benefit. Providing a death benefit with life insurance does not affect the retirement benefit. In a 412(i) plan, the lump sum at retirement is the value of the annuity contract **plus** the cash value of the life insurance policy.

**PS 58 costs**

A plan purchases life insurance for the purpose of providing a death benefit. The participant is receiving a current benefit from the life insurance protection. The IRS taxes this current benefit. The PS 58 cost is determined by applying the one-year premium term rate at the insured's age to the difference between the face amount of the policy and the cash surrender value at the end of the year.

The PS 58 costs that have been taxed to the employee are a part of the employee's basis. This may be recovered from the benefits received under the policy.

The plan trustee will receive an annual report from Lafayette Life with the PS 58 costs, which are reported annually on Form 1099-R.

**Contribution levels – Maximum Retirement Benefit**

The chart provides an example of first year contributions with the maximum benefit and life insurance:

Age	Monthly Retirement Benefit Age 62	First Year Contribution*	Lump sum at retirement
45	\$14,583	\$137,709	\$2,331,020
50	\$14,583	\$214,469	\$2,331,020
55	\$10,208	\$285,046	\$1,631,714



### **Plan Assumptions for Contribution Chart:**

Plan effective date 1/1/06, business entity - corporation, annual compensation \$220,000, date of hire 1/1/96, 415 maximum monthly benefit is \$14,583.

Insurance company guaranteed annuity conversion rate, guaranteed cash values and annuity values under insurance company contracts, 3-year average salary, life insurance limits using Rev. Rule 74-307.

\*Contribution takes into account GATT limits

### **Conversion of an over-funded defined benefit plan to a 412(i) plan**

Some plans may be too over funded for a 412(i) plan conversion. Each situation is different. An analysis of the plan assets in relation to the accrued benefit will determine if a 412(i) plan is an appropriate option.

### **Pension Benefit Guaranty Corporation (PBGC)**

The Pension Benefit Guaranty Corporation is a government corporation that administers the termination rules and protects certain pension benefits covered under Title IV of ERISA.

A 412(i) plan is a defined benefit pension plan and is subject to the PBGC premiums. Only the fixed premium of \$19 per participant is due for 412(i) plans. However, some plans are exempt from coverage: plans solely covering owners and professional service corporations that do not have more than 25 participants.

### **Summary**

#### **Benefits of a Retirement Plan**

1. Employer contributions are deductible.
2. Life insurance protection with tax deferred premiums
3. Trust earnings are tax-deferred.
4. Attraction and retention of employees.

### **Plan Design Suitability**

Correlating the plan design to the employer's goals and objectives is one of the most critical aspects of a successful retirement plan. The plan needs to meet the employer's fiscal objectives.

### **Important Factors to review with the Client**

The *Proposal Request Form* (Form QM1736A) has a checklist of items to discuss with your client. Some of the important factors for the client to consider and disclose are:

- Ability to fund on an annual basis and the desired contribution amount
- Information on any existing or previous retirement plan
- Contributions made to a SEP, SIMPLE, or any other retirement plan for the current year
- Submission of census listing all employees and identification of ownership and family members
- Ownership interests in other businesses

Fax your completed proposal requests to your Pension Sales Consultant at Lafayette Life:

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