

412(i) Defined Benefit Plans

Fall 2003

THE CONTENTS OF THIS PRESENTATION ARE NOT TO BE CONSIDERED OR CONSTRUED LEGAL OR TAX ADVICE. CLIENTS SHOULD CONSULT WITH THEIR OWN COUNSEL AND ADVISORS AS TO ALL LEGAL AND TAX MATTERS CONCERNING THEIR QUALIFIED PLAN.

What is a 412(i) Plan?

- **A Qualified Retirement Plan**
 - **Current tax deduction for all contributions**
- **Referred to in the IRS regulations as an “insurance contract plan”**
- **Special type of Defined Benefit Plan**

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Types of Qualified Plans

- **Defined Contribution**
 - 401(k) is an example
 - **Contribution defined** by compensation
 - Example - Contribution equal to 10% of pay
 - Retirement income or “pot” not defined, depends on investment returns along the way
- **Defined Benefit**
 - 412(i) is an example
 - Retirement benefit or income based on compensation
 - Example - Benefit equal to 100% of average monthly compensation
 - **Retirement income or “pot” defined**

Defined Benefit Plans

- **Funding for a “pot” at retirement age**
 - **Greater the “pot” and/or less the time to fund, the greater the contribution needs to be**
- **Defined benefit plans can be the best way to provide for a large tax deduction for a retirement plan**
 - **Especially for those who are older**
 - **Catch-up funding**

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If Goal Is Max Deduction

Defined Benefit Plan Makes Sense



Owner age 52, Salary \$160,000

Limits:

- **Defined Contribution** **\$40,000**
- **Traditional Defined Benefit** **\$79,085**

“Traditional” Defined Benefit Plans

Funding “Problem”

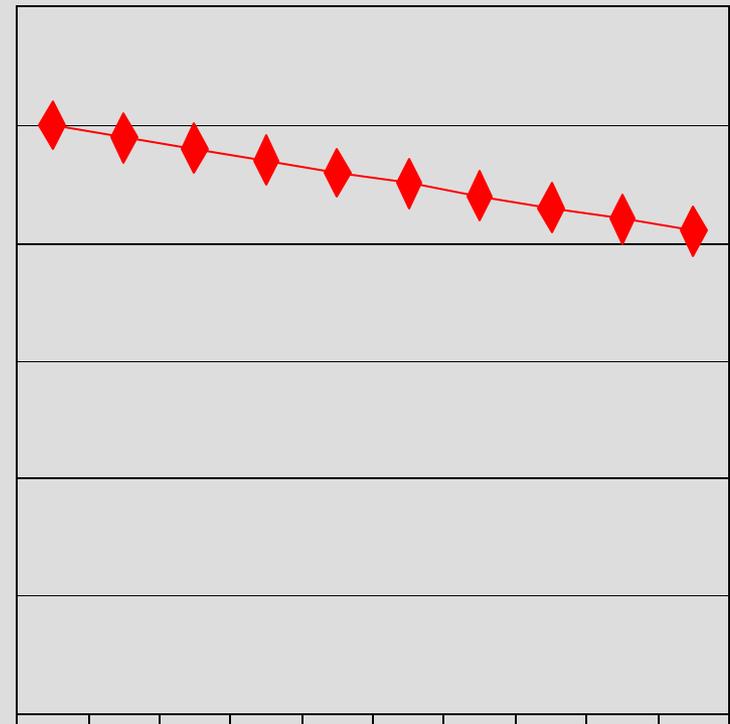
- Once pot is defined then each year there is an actuarial calculation made to make sure that the pot is reached
- Calculation based on interest rate assumption that changes every year
- So calculation could increase or decrease contribution, depending on the actual interest rate



Defined Benefit Plans

The 412(i) Plan Difference

- Initial contribution based on guaranteed interest rates in life insurance products – fixed annuities, life insurance
- The next years' contribution is offset (lowered) by the difference between the guaranteed and current rates
- Each year the contribution goes down
- Maximum contribution is in early years – “front end loading”



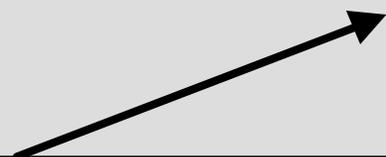
If Goal Is Max Deduction



Owner age 52, Salary \$160,000

Limits:

- Defined Contribution \$40,000
- Traditional Defined Benefit \$79,085
- **412(i) Plan \$210,000**



This number is the initial tax deductible contribution. It is much larger than a Traditional DB Plan because it is based on the guaranteed rates in the products providing the investment in the 412(i) Plan.

412(i) Plan

- **Retirement benefit based on guarantees inherent in specific insurance company products**
 - Annuities, life insurance
 - Contributions based on the guaranteed interest rates of the products
- **No actuarial computations**
- **Largest initial tax deductible contribution possible in any Qualified Retirement Plan**

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412(i) Plan

Ideal Client

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- **Small business owner**
- **Usually age 45 or older**
- **Profitable company --- Steady income stream**
- **Wants large tax deduction now**
- **Maximum number of employees is usually 4-7**
 - **Or family business**
 - **Or with high turnover**

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Who Participates

- **Cannot discriminate, but can leave out**
 - **those who are 21 or younger**
 - **working 1,000 or less hours**
 - **those benefiting from certain union plans**

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How it Works - Funding

- Usually 100% fixed annuity or split funded with fixed annuity and life insurance, Whole Life
- As per Code Section 412(i)
 - “funded exclusively by the purchase of life insurance contracts”with “level annual premium payment”
 - “benefits...guaranteed by an insurance carrier..to the extent premiums have been paid”

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How it Works – Accrued Benefit

- **The accrued benefit is simply the cash value of the insurance and annuity contracts issued to each participant**
- **All participants subject to the vesting schedules of qualified retirement plans**
- **Forfeitures reduce subsequent contributions**

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Why Buy Life Insurance in a 412(i) Plan?

- **Ability to “guarantee” a retirement income for loved ones**
- **Lower net cost since purchased with pre-tax dollars**
- **Does not lower benefit provided, it increases the contribution made, maximizes tax-deduction**
- **Subject to “incidental insurance” rules of Treasury Reg. Section 1.401 (b)(1)(i)**

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Life Insurance Incidental Benefit Rules

- **100 TIMES RULE**
 - Life insurance limited to no more than 100 times the expected retirement benefit
 - Most common method
- **74-307 RULE**
 - Life insurance is limited to 66 2/3% of the “theoretical level premium” of a non-insured plan

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Life Insurance

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- **Economic benefit cost to employee**
 - Table 2001 rates
 - ART
- **Flexibility of product may be an issue unless you fund for a long time**
- **Policy can be distributed based on Interpolated Terminal Reserve in policy**

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How it Works

EMPLOYER ADOPTS PLAN

PLAN FUNDED W/ FIXED ANNUITIES & LIFE INSURANCE

PLAN CHANGES ANNUALLY WITH CENSUS & W-2 CHANGES

PLAN DESIGN “FIXED,” THOUGH CHANGES CAN BE MADE

**WHEN PLAN TERMINATED OR EMPLOYEE LEAVES,
ASSETS GO WITH THEM
TYPICALLY TO SELF DIRECTED IRA**

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What Happens If?....Review

- **Employee leaves plan**
 - Plan benefit based on values in that employee's policies
- **Employer needs to lower funding**
 - Plan design can be altered - with valid reason
 - Plan can be shut down - with valid reason
 - Minimum funding period 5 years, should assume 10
- **Options after plan terminates or employee leaves**
 - Rollover IRA -- provides equity investment

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