

Introduction to Retirement and Tax Planning Using I.R.C. §412(i) Plans

The 412(i) Defined Benefit Pension Plan*

*A simplified defined benefit pension plan allowing for immediate tax deductions of \$70,000 - \$300,000 annually.



What is a little-known, underused technique to establish a pension plan that offers the following benefits?

- ☑ You receive immediate income tax deductions.
- ☑ Your plan assets grow income tax-deferred.
- ☑ Your plan assets are creditor-protected.
- ☑ Your plan benefits are fully guaranteed.
- ☑ Your plan contributions are not subject to the Alternative Minimum Tax (AMT).
- ☑ Your plan provides retirement, disability and income-replacement-on-death benefits.
- ☑ Your C or S Corp, FLP or LLC can adopt the plan.
- ☑ 90% of your plan contributions can benefit you as the employer.

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The 412(i) Defined Benefit Pension Plan

What is a 412(i) plan?

A 412(i) plan is a simplified, guaranteed defined benefit pension plan established under §412(i) of the Internal Revenue Code. It is a pension plan that is sponsored by major insurance carriers. The plan is governed by the Employee Retirement and Income Security Act of 1974 (“ERISA”), the federal act governing the funding, vesting, administration and termination of private pension plans. (29 U.S.C.A. §1001 et. seq.)

How do recent changes in 412(i) law benefit me?

Recent changes in the law have made the 412(i) plan more popular and more powerful as an estate, tax and retirement planning tool. Section 415(e) of the Internal Revenue Code, which limited the effectiveness of 412(i) plans, was repealed effective December 31, 1999. Section 415(e) required a complicated calculation which limited a participant’s ability to fund a 412(i) plan. With the repeal of §415(e), a 412 (i) plan may now be funded with sufficient assets to provide a retirement benefit of up to \$160,000 annually for the rest of your life. This makes it a far more powerful technique than IRAs, 401(k)s, or profit-sharing plans for a business owner to plan aggressively for retirement while enjoying large immediate income tax deductions.

Congress recently handed you another dramatic change in 412(i) planning opportunities in the Taxpayer Relief Act of 2001: Effective January 1, 2002, you can receive an income tax deduction of up to \$300,000 annually by funding your 412(i) plan. In order to receive this substantial income tax deduction you may be required to make small annual contributions on behalf of your non-highly compensated employees. The “new comparability” and “cross-tested” plans allow you as the employer to make disproportionately large contributions to your plan, while also contributing to your employees (see comparison chart on page 4).

What are the benefits of a 412(i) plan for me and my company?

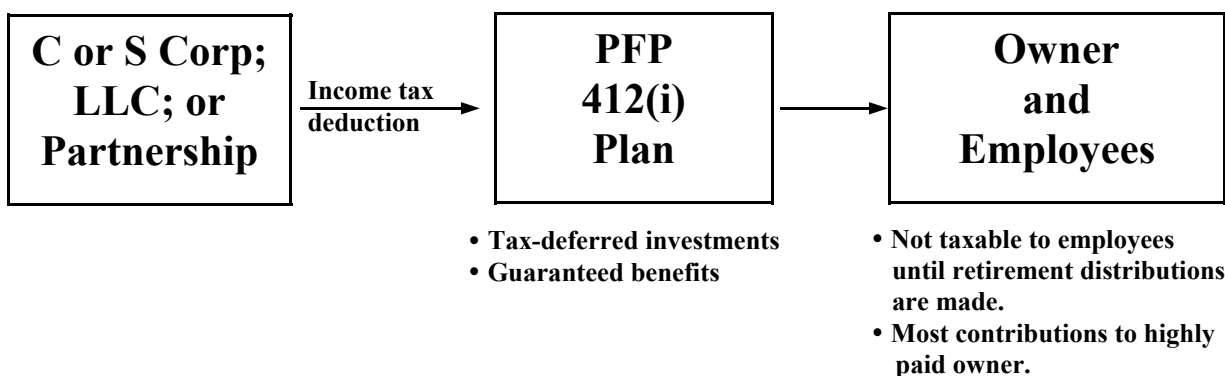
A 412(i) plan is appropriate for an owner of a small business or a larger company with a company-sponsored 401(k) who would like to take advantage of tax deductions granted to defined benefit pension plans. Costs to establish and maintain the

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plan are reasonable in light of the achievements obtained. Contributions to the plan are income tax-deductible to the company. The plan assets grow income tax-deferred and taxes are paid only when the benefits are distributed at retirement. Think of it this way: **for each dollar you contribute to a 412(i) plan, the government funds thirty to forty cents for your retirement through the available tax deduction.** While growing income-tax deferred, your plan assets are protected from the claims of your creditors. In addition, the government permits you to contribute substantially more money to your 412(i) plan than to an IRA, 401(k), or profit-sharing plan. Moreover, your plan benefits are fully guaranteed by the life insurance and annuity contract(s) owned by your plan.

In summary, the benefits of your 412(i) plan are:

- ✓ You receive immediate income tax deductions.
- ✓ Your plan assets grow income tax-deferred.
- ✓ You are permitted to make large plan contributions.
- ✓ Your plan assets are creditor-protected.
- ✓ Your plan benefits are fully guaranteed by a major insurance carrier.
- ✓ Your C or S Corp, FLP or LLC can adopt the plan.
- ✓ Your plan is governed by ERISA and registered with the I.R.S.



How is a 412(i) plan designed?

A 412(i) plan is designed by determining how much annual income you will need at retirement and calculating the annual contributions which will be required to reach that goal. The U.S. government allows you to plan for substantial annual retirement income of up to \$160,000 annually and permits a tax deduction for contributions which are made to the plan to meet this retirement goal.

**MAXIMUM FIRST YEAR DEDUCTIONS AVAILABLE AT
SELECTED AGES*:**

Age	Defined Benefit Plan	412(i) Plan
45	\$73,667	\$95,196
50	\$114,314	\$148,603
55	\$185,462	\$245,086
60	\$200,232	\$281,029

*The contributions above are based upon the guaranteed annuity purchase rates, the guaranteed insurance cash values, and the guaranteed annuity accumulation rate of a major insurance company's 412(i) qualified life and annuity products. The numbers also assume the business owner at the selected ages has earnings of at least \$160,000 and assumes a 2002 plan year.

How does a 412(i) plan affect my employees?

Since it is governed by ERISA, your 412(i) plan must allow employees to participate in the plan. Employee benefits are determined by a variety of factors. For example:

1. Employees must be over 21 to participate;
2. Employees must stay with the company for a period of 3 years or 6 years (depending upon the vesting schedule) to become 100% vested in their benefits;
3. Effective January 1, 2002, an employer's contribution of up to 7.5% of employees' pay may be necessary to pass the new "minimum gateway" rules;
4. Employees must work over 1000 hours each year; and
5. Employees must not benefit from a union plan.

How do I fund my 412(i) plan?

Your 412(i) plan is typically funded with approximately 50% retirement annuities and 50% investment grade life insurance contracts. These investment assets make security and simplicity the hallmarks of the 412(i) plan. As an example, investing

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in an indexed annuity allows you to receive a guaranteed 3% interest on your account (no loss) or an annual blended return of the Standard & Poor's 500, *whichever is greater*. This arrangement protects both your downside and your equity upside. The insurance contract guarantees a 3% interest rate or a current rate, generally 5.5%-7.5%, whichever is greater. The insurance contract also provides a death benefit that guarantees the surviving spouse an income for life. While your retirement benefits are calculated on the guaranteed part of the contract, the historic return on indexed annuities generally exceeds that guaranteed rate, so your returns could exceed the guarantee.

How does a 412(i) plan provide *retirement benefits*?

The cash surrender value of the insurance/annuity contracts can be converted into an income stream of up to \$160,000 per year for life for each participant.

How does a 412(i) plan provide *disability benefits*?

Following the onset of a disability the cash value of the insurance and annuity contracts can provide disability income. Fully-funded, the disability income for each participant can be as high as \$13,333 per month until retirement benefits are triggered.

How does a 412(i) plan provide *income replacement upon a participant's death*?

A 412(i) plan, fully-funded, can provide your surviving spouse or children up to \$13,333 per month for the rest of their lives.

How may I take distributions from my 412(i) plan?

Before reaching age 59½, you may take penalty-free distributions as long as they are uniform, systematic distributions based upon your life expectancy. A pre-59½ lump sum distribution will trigger a penalty of 10% of the amount distributed (the I.R.C. §72(t) penalty), plus applicable income taxes. If you have reached age 70½ and you are retired you must take the required minimum distribution from your plan (the calculated annual planned benefit). If you have reached age 70½ and you are not retired you may defer distributions until your retirement.

If I am already retired, may I contribute to my 412(i) plan?

Yes, if you are already retired or are over age 70, you can contribute to your 412(i) plan for up to five years, under certain circumstances.

Are my 412(i) plan contributions subject to the Alternative Minimum Tax (AMT)?

No. Contributions to your 412(i) plan are not subject to AMT and could lower your overall exposure to AMT. This is a powerful tax-saving opportunity.

With a 412(i) plan can I receive an income tax deduction in excess of my salary?

Yes, you can receive an income tax deduction in excess of your salary. Generally, all types of compensation are used in calculating the formula for determining benefits in a 412(i) plan. This includes: base salary; bonuses; vacation pay; over-time; and any other compensation that meets your definition as the employer.

Are the assets in my 412(i) plan protected from lawsuits and creditors?

Yes, your plan is creditor-protected. A properly drafted 412(i) plan is an ERISA defined benefit pension plan. As such, its assets are fully immune from the claims of creditors. The most notorious, widely publicized example is the O.J. Simpson case. O.J. Simpson enjoys his daily round of golf in Florida and his \$25,000 monthly NFL pension benefit, even in the face of an outstanding \$30 million civil judgment returned against him in California for the deaths of Nicole Brown Simpson and Ronald Goldman.

Can I amend my 412(i) plan?

Yes, your plan may be amended. If a plan amendment will result in a significant reduction in the rate of future benefit accruals, the plan administrator must notify all participants, certain beneficiaries, and any union representing plan participants. The required written notice is often referred to as the 204(h) notice. For example, if your plan changes the definition of compensation in a way that would lower benefits, a 204(h) notice is required.

Can I terminate my 412(i) plan?

Yes. As plan sponsor, you may terminate your 412(i) plan as long as the plan document provides for termination. In general, a plan must be fully funded and there must be a bona fide business reason for the plan termination, including: a change of ownership of the business by merger; the liquidation or dissolution of the employer; a change in ownership through sale or transfer; the existence of adverse business conditions; and the adoption of a new plan. Upon termination, plan proceeds may be rolled over into an IRA, tax-free.

What documents must be prepared to establish a 412(i) plan?

The documents required to prepare your 412(i) plan are:

- Plan Census
- Adoption Agreement
- Summary Plan Description (for employees)
- Plan Trust Instrument

Fair Warning to Advisors, Clients and Prospective Clients:

A 412(i) plan is a legal pension trust instrument that must comply with the Internal Revenue Code as well as with all ERISA and Department of Labor regulations governing these plans. The plan document itself as well as the implementation and administration of the plan must be in strict compliance with these rules. Even where a valid plan document and an I.R.S. tax determination letter are in place, lack of proper legal implementation may result in the disallowance of the deduction and invalidate the plan. In establishing your 412(i) plan it is important that you consult with a competent tax attorney who is experienced in this area.

How do I Get Started?

To get started designing a 412(i) plan which is appropriate for your circumstances and goals, please contact Price & Farrington, PLLC at 425.451.3583. We will be happy to help you determine what a 412(i) plan can accomplish for you.

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