Price & Farrington's Estate and Tax Planning *Fast*Faxts

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Estate, Tax and Wealth Planning for Advisors and Clients

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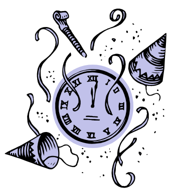
412(i): A Little-Known Retirement Plan Offers Big Tax Savings

This month's topic revisits a powerful planning strategy for the right client and a lucrative selling opportunity for the informed advisor. For more on 412(i) , see our November, 2001 Fast*faxts *and our article: "The 412(i) Defined Benefit Pension Plan". Both are available on our website, www.pricefarrington.com.



Happy New Year!

Current tax law permits many business owners, professionals, and self-employed individuals to benefit from a $41,000 annual contribution to a tax-deferred retirement plan. Often, that's sufficient. Some people, though, may want to make, and deduct, larger contributions. That's especially true if you need to build a large retirement account in a relatively short time.

Defined-benefit (DB) pension plans allow you to crack the $41,000 contribution ceiling. Among DB plans, 412(i) plans—so called after a section of the tax code—may permit the largest initial deductible contributions.

Funded by guaranteed life insurance products (life insurance and annuities), 412 (i) plans provide the chance to safely make contributions that may run well over $100,000 per year.

Retirement arrangements such as 401(k) and profit-sharing plans are *defined-contribution* (DC) plans, which allow you to contribute a certain amount each year, depending on the Tax Code limits. Your ultimate benefit depends on how well those contributions are invested. DB plans, by comparison, are traditional pension plans. They are meant to deliver a certain amount of retirement income. Actuaries determine the required contribution.

Example: Your retirement benefit goal is $165,000 per year (which is now the maximum allowable amount). The lump-sum equivalent of that annual benefit is approximately $2.2 million. The less time you have until retirement, the more money you must contribute each year to accumulate that desired $2.2 million. What's more, the lower the projected yield on your investments, the more you can contribute.

Example: Sam Jones is 52 and plans to retire at age 62. He earns more than $200,000 per year, so he qualifies for the maximum defined benefit. In order for Sam to reach his goal, his company must make a contribution of about $163,000 per year to its DB plan, assuming an investment return of 6.5%.

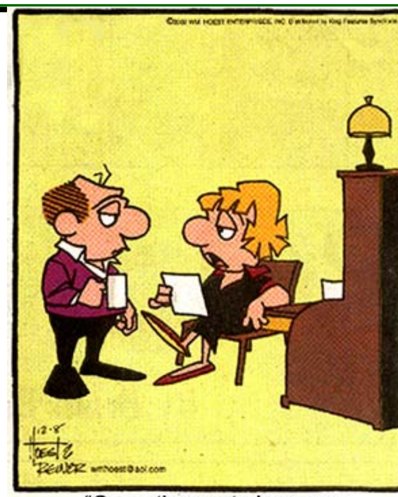
SURE THINGS

The only difference between a 412 (i) plan and the DB plan mentioned above is that a 412(i) plan must be funded with guaranteed insurance products. Your 412(i) plan contributions will be used to purchase annuities and, frequently, to buy life insurance as well.

Bonus: This technique allows you to buy life insurance with *pretax*, rather than after-tax dollars.

With life insurance in the plan, it is "self-completing", meaning that your heirs will receive a pension in case of your premature death.

Method: With a 412(i) plan, you are allowed to use the insurance company's guaranteed rates as the projected investment return. Such guarantees probably will be low, perhaps 3% per year. The upside is that the lower the projected investment result, the greater the required contribution needed to fund the future pension.



"Our retirement plans now depend on finding a magic lamp."

Example: With a 412(i) plan, 52-year old Sam Jones might be able to make an annual tax-deductible contribution of $191,000 to a guaranteed annuity at 3%, rather than about $163,000.

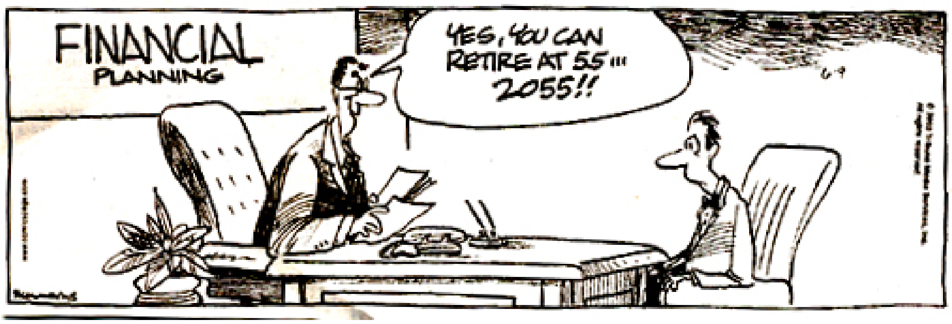
What happens if the plan uses a 3% projected return but the actual returns turn out to be higher? The interest earned in excess of the guaranteed rates will reduce next year's contribution.

Result: A 412(i) plan typically front-loads deductions. This may be a desirable outcome if it permits you to make larger contributions during peak earning years and then taper off as you near retirement.

For greater deductions in later years, the 412(i) plan can be converted to a "regular" DB plan by investing in assets other than insurance company products. You may prefer to stay with a 412(i) plan, though. Since it is backed by insurance products, your retirement income is secured. You won't have to rely on future

The 412(i) Advantage:

- **You receive *immediate tax deductions.***
- **Your plan assets grow *income tax-deferred.***
- **You can make *large plan contributions.***
- **Your plan assets are *creditor-protected.***
- **Your plan benefits are *fully guaranteed.***
- **Your *FLP or LLC can adopt the plan.***



results in the financial markets.

Important: Look for a 412(i) plan administered by a financially strong insurer that will be able to deliver on long-term promises. Moreover, a DB plan such as a 412(i) rewards long-tenured, higher-income employees—the ones that you want to motivate to help your business grow.

In addition, having a 412(i) plan in place means that you'll be able to rely on a sizeable income stream in retirement. Your other investment assets can be aggressively invested in stocks, which are riskier but which might deliver outstanding long-term returns.

THE AGE FACTOR

Defined-benefit plans, including 412(i) plans, are not for everyone. 412(i) plans work best if you are in your late 40s or older. The closer you are to retirement, the more that can be contributed on your behalf. These plans generally gain appeal if you have relatively few employees, and those employees tend to be much younger than you are. In such situations, your company will only have to make modest contributions for employees other than yourself. If a business has two or more principals, each of whom is middle-aged, all of these owners can benefit from a 412(i) plan.

DRAWBACKS

Disadvantages of 412(i) plans include:

Costs. As is the case with all DB plans, 412(i) plans can be expensive to create and maintain. Ongoing actuarial services also will be needed. *Cost:* About $1,000 to 3,000. In addition, the annuities and other life insurance products you buy for the plan come with their own costs. You should work with reputable professionals to get a plan that delivers good value for the money you'll spend. On balance, your overall expenses to set up and administer a 412(i) plan could be well worth it.

Staff Contributions. If you have employees who are eligible, the contributions you are required to make on their behalf can be substantial. For that reason, you should work with a firm than is familiar with "carve-out" designs - more sophisticated plans that will allocate more of the annual contribution towards the owners of the business. While many 412(i) plans use insurance company "prototype" plans, a more sophisticated approach—a "custom" plan— is needed when there are five or more employees.

Commitment. Your business must make substantial contributions year after year. It's possible to cut back in a bad year, but such a reversal could involve some hassle and expense. 412(i) plans are best suited for small companies that consistently enjoy plentiful cash flow.

Declining tax shelter. As mentioned, deductions are often front-loaded in a 412 (i) plan. If that's not attractive to you, a traditional DB plan may be a better choice.

TOO GOOD TO BE TRUE?

In recent years, the federal government has repealed various rules that reduced the allure of DB plans. The upper limits for DB funding have been increased. Make sure you are familiar with all the rules of 412(i) plans and not just the financial products.

Caution: As DB plans have regained appeal, some promoters have stretched the design and funding limits to create plan designs that the IRS considers abusive, such as unrealistic interest rate assumption. Be wary of 412(i) plans that are funded 100% by life insurance. Also, be skeptical of plans that require you to "exchange your policy" for a better one in the future. IRS guidance is expected before the end of the year. ■

If you think that you or a client of yours are appropriate candidates for a 412(i) defined benefit pension plan, contact us to learn how to take the next step.

G.D.P.

Why Asset Protection Is Important: The "Stella Awards"

We recently received an e-mail listing for the annual Stella Awards. The "Stellas" are named after 81-year old Stella Liebeck, who spilled coffee on herself and successfully sued McDonald's. That case inspired the Stella Awards for the most frivolous successful lawsuits in the United States. Sharing them with clients may be the straw that's needed to break their resistance to moving ahead with all-important asset protection planning:

3rd Place—A Philadelphia restaurant was ordered to pay Amber Carlson of Lancaster, Pennsylvania $113,500 after she slipped on a soft drink and broke her coccyx (tailbone). The beverage was on the floor because Ms. Carlson had thrown it at her boyfriend 30 seconds earlier during an argument.

2nd Place—Kara Walton of Claymont, Delaware sued the owner of a nightclub in a neighboring city when she fell from the bathroom window to the floor and knocked out two of her front teeth. This occurred while Ms. Walton was trying to sneak out the window in the ladies' room to avoid paying the $3.50 cover charge. She was awarded $12,000 and dental expenses.

1st Place—This year's runaway winner was Mr. Merv Grazinski of Oklahoma City, Oklahoma. Mr. Grazinski purchased a brand new Winnebago motor home. On his trip home from a football game, having driven on to the freeway, he set the cruise control at 70 mph and calmly left the driver's seat to go into the back and make himself a cup of coffee. Not surprisingly, the RV left the freeway, crashed and overturned. Mr. Grazinski sued Winnebago for not advising him in the owner's manual that he could not actually do this. The jury awarded him $1,750,000 and a new Winnebago. The company actually changed their manuals on the basis of this suit.