Fully Insured Plans: A Viable Retirement Solution, Part 2

By Richard M. Perlin

This article continues where last issue's article left off, discussing some of the more practical issues, such as decertification of fully insured plans, conversions to fully insured plans, the funding and insurance concerns, and cash balance plans.

Decertification

This is a term used informally to describe a former 412(e)(3) plan that, either through intent or error, no longer has 412(e)(3) status. Such a plan reverts to being subject to the normal funding rules under Internal Revenue Code (Code) Sections 412 and 430. A plan sponsor may intend to revoke 412(e)(3) status in various circumstances, such as:

1. *The cost to fund a particular benefit with insurance annuity contracts is significantly higher than the minimum cost calculated according to the Section 430(h) funding segment rates.* This is largely due to the insurance company's more conservative annuity purchase rate tables relative to the factors used under Code Section 430. In addition, the costs of issuing the annuity contract contribute to the relatively higher rate. In some cases, a sponsor may wish to reduce the cost of funding future benefits, without freezing future accruals. Decertifying an insured plan to an actuarially funded plan may accomplish this.
2. *The required funding for a 412(e)(3) plan is a fixed dollar amount in a given year.* There is no range of permissible funding. By switching to an actuarially funded plan, the sponsor can selectively adjust funding within the permissible range to better match its year-to-year profits.
3. *A participant who continues in employment past normal retirement age must generally receive the greater of the actuarial equivalent benefit at normal retirement age, or the accrued benefit at the current age.* In some cases, insurance companies do not state an equivalent benefit once normal retirement age is attained, so these must be calculated. In one participant, owner-only plans, it may be easier to treat the plan as actuarially valued after normal retirement age.
4. *The plan sponsor wants to diversify the pension plan investments.*
5. *The plan sponsor wants to change the benefit formula to one that requires general testing under Treasury Regulation Section 1.401(a)(4)-3(c).* In order to apply the general nondiscrimination test using the annual method, it is necessary to define the amount of benefit accrued over a particular period, such as a plan year. The regulations offer no specific guidance on the meaning of an annual accrual in a 412(e)(3) plan. In a 412(e)(3) plan, benefits are accrued over the participant's period of participation to normal retirement date. But the benefits are not accrued in a linear manner, as in the case of fractional accrual. Non-linear accrual may be due to such considerations as loads and variations in credited interest over time. To avoid walking over uncharted territory in defining the annual rate of accrual, a plan sponsor may choose to decertify.

The decertification can occur unintentionally due to a failure to meet a requirement under Code Section 412(e)(3). For example, the trustee of the plan can place all the existing annuity contracts on a "paid up" status (before the participant's retirement age under the plan). Alternatively, the trustee could fail to purchase additional annuity contracts when a participant's benefit increases, or fail to make a required premium payment. It should make no difference that the failure is inadvertent or intentional, because

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412(e)(3) treatment is not mandated to maintain plan qualification. The Code provides a list of requirements that must be met to be exempt from funding requirements and to receive special accrued benefit treatment. Even if a plan sponsor meets all the requirements to maintain 412(e)(3) status, it is possible to simply not elect 412(e)(3) treatment.

What are the consequences of a decertified 412(e)(3) plan? How are future benefit accruals calculated? What benefits are protected under Code Section 411(d)(6)? A plan that does not meet the requirements of Section 412(e)(3) throughout the entire plan year probably may not be treated as a 412(e)(3) plan for deduction and funding purposes for that plan year. The employer would always seem to have the option to prospectively adopt actuarial funding in any plan year.

If a plan is no longer treated as a 412(e)(3) plan, then the accrued benefit would no longer equal the cash value of a participant's contracts. However, prior to decertification, the cash value represented the value of a participant's accrued benefit, so that benefit (along with future growth) must be protected after the date of decertification. For this purpose, it would seem to be a safe course to protect the cash values/accrued benefits as of the last day of a plan year, because that would provide participants with the greatest protection. In the case of a 412(e)(3) plan that terminates its fully insured status, it likely is necessary (or, at least, recommended) for the sponsor to adopt a plan amendment, specifying the protected benefit. Such an amendment could add new accruals to the protected benefit, or leave the protected benefit frozen until the new formula exceeds it (*i.e.*, a "wear-away" structure).

Even a plan that is inadvertently decertified must be amended to specify how future accruals will be measured. A plan could contain a fail-safe provision, specifying how benefits are accrued in the event of a decertification. This would be useful if the decertifying event is not discovered until a later plan year.

Revenue Ruling 2004-20 deals with two general situations associated with Section 412(e)(3) plans. The first of these situations has relevance for the decertified 412(e)(3) plan.

The plan discussed in the ruling purchases life and annuity contracts for a participant that will provide benefits in excess of those derived under the plan formula. If the plan has not yet paid a benefit in excess of Section 415 limits, this Code Section is not violated. However, the company has taken a deduction for funding benefits in excess of those provided under the plan formula. This is properly viewed as a violation of the level funding rules under Code Section 412(e)(3). Thus, the plan is treated as violating those provisions and is, therefore, "decertified" and becomes subject to the actuarial funding rules.

This conclusion would seem to be mandated, even in the absence of Revenue Ruling 2004-20. The ruling further goes on to state that the exception to the normal accrual rules for fully insured plans under Code Section 411(b)(1)(F) no longer applies. Nevertheless, the anti-cutback rule under Code Section 411(d)(6) would appear to preserve the value at the time the plan was decertified, and all future growth associated with that value.

The best practice would be to place all annuity and insurance contracts on a paid up basis as of the last day of the plan year in which it met the 412(e)(3) requirements. As previously mentioned, Code Section 411(d)(6), the anti-cut back provision, prevents a plan from reducing benefits already accrued. At the time of decertification, a participant will be entitled to the value of the contracts. At any point in the future, the participant would be entitled to any increase in value on those contracts, much like the present value of a fixed accrued benefit that increases with the passage of time. If the contract is placed on a paid-up status, then the current value of the contract is the grandfathered value.

With participating contracts that pay annual dividends above a guaranteed rate, the protected value would not include the accumulated dividends, because these are considered excess earnings. Under Treasury Regulation Section 1.412(i)-1(b)(2)(ii), dividends may be used to reduce premiums and do not need to be added to contract values. However, there appears to be no prohibition against allowing dividends to accumulate within each participant's paid up-contracts. In this circumstance, it may be necessary to demonstrate that the accumulations are nondiscriminatory.

Termination of a Decertified 412(e)(3) Plan

All benefits accrued after the decertification date would be based on the plan formula and actuarial factors such as those contained in Code Section 417(e). If a terminating plan intends to allocate assets in excess of actuarial liabilities to participants, there must be a method for such allocation. If the assets include accumulated dividends paid with respect to the paid-up contracts, then it would be reasonable to use the value of each participant's paid-up contracts as the date of decertification, plus the present value of benefits accrued after decertification (this would apply to a

plan that used an approach without wear-away), as the base for allocating actuarial excess.

In some circumstances, a plan may have continued to pay premiums on existing contracts after decertification, or even purchased additional contracts. In these cases, it would be reasonable to provide participants (at least those that are not highly compensated) with an allocation of excess assets equal to the greater of the allocation they would have received had the contracts been placed on paid-up status with no ongoing premiums, or the actual value of their contracts. If there are similarly-situated highly compensated employees, *i.e.*, their contracts had premiums paid beyond the date of decertification, then it must be demonstrated that the method used for allocating actuarial excess is nondiscriminatory.

The following language is an example for a former 412(e)(3) plan that continued to purchase paid-up annuity contracts for participants after the decertification. The plan sponsor wants participants to retain all contract values, including those purchased after decertification. The plan will require that participants receive the greater of: (1) the current value of paid-up contracts, plus the lump sum present value of accruals post-decertification, plus (2) the lump-sum value of the accrued benefit under the fractional rule, assuming the plan was never a 412(e)(3) plan (fresh start with extended wear away). Because there are highly compensated employees, the allocation must also be tested for discrimination.

If the values of the paid-up contracts purchased post-decertification exceed the actuarial present value of benefits accrued post-decertification (which is likely), then some of those contracts represent excess assets. The employer may want these assets to be retained by each participant so that each participant is entitled to the contracts held on his or her behalf.

The employer must therefore demonstrate that this allocation of actuarial excess is nondiscriminatory. This might be done by performing a hypothetical allocation of actuarial excess based on the present values of accrued benefit (*i.e.*, lump-sum equivalencies) described above and then showing that nonhighly compensated employees receive a greater share of excess assets by allowing them to keep all contracts rather than receiving the hypothetical allocation of actuarial excess.

Conversion to 412(e)(3) Pension

A plan is able to convert from a traditional actuarially-funded pension plan to one that meets the requirements under Code Section 412(e)(3). Revenue Ruling 94-75 offers a road map to performing this conversion. It states five basic requirements:

1. The plan otherwise satisfies the requirements of Code Sections 412(i), 403(a), and 404(a)(2) for the plan year containing the conversion date.
2. All benefits accruing for each participant on and after the conversion date are funded by level annual premium contracts that satisfy the requirements of Code Section 412(i)(2).
3. All benefits accrued for each participant before the conversion date are guaranteed through insurance or annuity contracts, the purchase price of which equals the minimum amount required by the life insurance company for a contract that guarantees, on and after the conversion date, to provide the participant's accrued benefits, including any optional forms of payment at each retirement age available under the plan.
4. There are meaningful continuing benefit accruals under the plan after the conversion date. A plan is considered to satisfy this requirement if there are meaningful benefit accruals under the plan for at least three plan years ending after the conversion date.
5. The following actions are taken on or before the conversion date: (a) contracts are purchased guaranteeing the benefits accrued before the conversion date; (b) any remaining plan assets are applied to the payment or prepayment of premiums for level annual premium contracts described in (2) above; and (c) any plan amendments necessary to satisfy these requirements for conversion and the requirements of Code Sections 412(i), 403(a), and 404(a)(2) are adopted and made effective. Contracts purchased within one month after the first day of a plan year are deemed to be purchased on the first day of the plan year for purposes of this requirement.

Revenue Ruling 94-75 deals with the basic 412(e)(3) requirement that benefits under the contracts must be funded on a level basis from the start of participation to retirement. A plan that started life using actuarial funding, by definition cannot meet this requirement. The ruling gives an exemption from this requirement to a plan that funds the contracts on a level basis from the date of conversion to normal retirement date. The date of conversion is the first day of a plan year in which contracts have been purchased for all

accrued benefits as of that date. The ruling gives a reprieve to one month after the first day of the plan year for the plan to complete the process. The ruling also requires continuing accruals over at least three years to avoid plans using a conversion as a means to change the method of calculating benefits prior to termination.

Considerations and Issues in Conversion

1. Conversion to 412(e)(3) is more than just a change in the funding vehicle for the pension. It affects both funding costs for the plan sponsor and benefit accruals for participants. Therefore, this decision must be made by the plan sponsor and not by the actuary or the plan trustees.
2. The annuity purchase rates under a typical insurer's tables are much greater than those factors used for determining plan liabilities under an actuarially-funded plan. It is very likely that the plan assets are less than what is needed to purchase paid-up benefits with annuity contracts. The challenge is to make a large enough contribution so that assets are sufficient to cover accrued benefits, while staying within maximum deduction limits. The funding cushion amount under Code Section 404(o) is very helpful in meeting this goal. However, it is quite possible that the maximum deductible amount is not sufficient to fund the value of all benefits in a single year. In this case, the paid-up benefits can be purchased over more than one plan year, taking advantage of the Section 404(o) maximum each year. Revenue Ruling 94-75 contains no restriction on using a multiple year process. The plan must continue to use the actuarial funding rules until it is ready to convert to 412(e)(3) status.

Example:

An actuarial funded plan with one participant and $1 million of assets as of 12/31/2011 needs $1.5 million to convert to a 412(e)(3) plan as of such date. The maximum deductible contribution for 2011 is $250,000. The plan makes the maximum deductible contribution for 2011 in February 2012 and, on 12/31/2012, has $1.3 million of assets.

The amount needed to convert as of 12/31/2012 has increased to $1.6 million. The maximum deductible contribution is again $250,000 for 2012 and the company again makes the maximum contribution in February 2013. Assets as of 12/31/2013 are now $1.6 million.

The amount needed as of 12/31/13 to convert through the purchase of paid-up contracts has increased to $1.7 million. The annual premium for the benefit that equals the difference between the accrued paid-up benefit as of December 31, 2013, and the normal retirement benefit is $100,000. The maximum deductible contribution for 2013 is again $250,000. Prior to January 31, 2014, the company contributes $100,000, which along with the other plan assets, is used to purchase a paid-up benefit equal the accrued benefit as of 12/31/2013. The company also contributes another $100,000, which is the initial annual premium on the annuity contract for the 2014 plan year. The company deducts $200,000 for 2013. The company will pay another annual premium in 2015 on the annuity contract used to fund the remaining benefits. This amount will be deductible in 2014 under the Section 412(e)(3) rules. The conversion date is January 1, 2014.

3. The accrued benefits and projected benefits that need to be purchased and method for this purchase can be illustrated by the following example:

Tracy became a participant on 1/1/2003. Her compensation has remained at a level $80,000 per year for all years. The benefit formula provides for an accrual of 2 percent of average compensation for all years of participation up to 30. Her normal retirement date is 1/1/2040. She will have a normal retirement benefit of $48,000 per year (2% x $80,000 x 30). As of 12/31/2012, she will have an accrued benefit of $16,000 (2% x $80,000 x 10) per year. To convert to a 412(e)(3) plan effective for the 2013 year, the plan must purchase on her behalf a paid-up annuity contract that provides a benefit at normal retirement age of $16,000 per year. (As discussed in the prior section, if the plan does not have sufficient assets for this purchase and if the difference between what is present and what is needed exceeds the deductible amount, the difference may need to be accumulated over several years.) The plan must also buy for her a contract with level annual premiums for the future accruals that will take place from the period 1/1/2013 through 1/1/2039. This contract must have a maturity benefit of $32,000 per year (the total normal retirement benefit of $48,000 less the amount accrued as of the date of conversion that is being provided by the paid-up policies, $16,000).

Some actuaries have expressed a view that the plan is required to purchase only paid-up benefits having a value equal to the greater of the PVAB using plan assumptions or Code Section 417(e) assumptions. This author feels that this is a less plausible interpretation

of Revenue Ruling 94-75 than buying the paid-up accrued benefits as a periodic benefit. This alternative interpretation will almost always lower the threshold of assets needed to convert.

What Is a Year?

A regular pension plan can have a plan year, compensation year, and fiscal year for deductions that are different from each other. With 412(e)(3) plans, in addition, there can be a separate contract year. Ordinarily, the trustees would select a contract year that coincides with the plan year. However, it is not necessary to follow this convention. As long as the benefits are funded on a level basis from the date of participation to normal retirement date no issues should arise as a result of having a contract year that is not the same as the plan year. Examples of permissible contract years include:

1. The plan has a calendar plan year and two entry dates: January 1 and July 1. The plan uses the entry dates as contract dates. The funding continues, on an annual basis, until the contract date immediately preceding the participant's normal retirement age. This meets the literal requirements of Code Section 412(e)(3).
2. The plan has a calendar plan year and two entry dates: January 1 and July 1. The contract date is the plan year end of December 31. The first contract purchased for any participant who enters the plan on January 1 or July 1 is the following December 31. This method is supported by Treasury Regulation Section 1.412(i)-1(b)(2)(ii), which allows the use of the first contract purchase date after the participant's entry date (or date of benefit decrease).
3. The plan has a calendar year and entry dates on January 1 and July 1. The plan is in process of converting to a 412(e)(3) plan. In 2010 and 2011, when the plan remains subject to an actuarial valuation, paid-up contracts are purchased with a December 31 contract date, providing benefits that are paid up on the December 31 immediately preceding the participant's normal retirement date. As of December 31, 2011, the plan has purchased contracts that cover each participant's accrued benefit on that date. Before January 31, 2012, the plan purchases Section 412(e)(3) annual premium contracts with a January 1 contract date for all participants eligible on January 1, 2012. The benefits are fully paid as of the January 1 immediately preceding the participant's normal retirement date. Future participants will have their initial benefits purchased as of their actual entry date.

Life Insurance

As with all qualified plans, insured death benefits in fully insured plans must be incidental to the primary purpose of providing retirement benefits. [Treas. Reg. § 1.401-9(b)(1)(i); Rev. Rul. 74-307] Pursuant to Revenue Ruling 74-307:

> Accordingly, death benefits under a pension plan of any type will be considered incidental within the meaning of section 1.401-1(b)(1)(i) of the regulations if either (1) less than 50 percent of the employer contribution credited to each participant's account is used to purchase ordinary life insurance policies on the participant's life, even if the total death benefit consists of both the face amount of the policies and the amount credited to the participant's account at the time of death, or (2) such death benefits would be considered incidental under Rev. Rul. 68-453 and the total death benefit before normal retirement date is equal to the greater of (a) the proceeds of ordinary life insurance policies providing a death benefit of 100 times the anticipated monthly normal retirement benefit or (b) the sum of (i) the reserve under the ordinary life insurance policies plus (ii) the participant's account in the auxiliary fund.

On its face, the ruling applies to "pension plans of any type," which would include defined benefit plans as well as money purchase plans. Nevertheless, there is language referring to a participant's "account" that suggests this applies only to defined contribution plans. It is a fairly common practice, however, to limit the premium for whole life insurance in 412(e)(3) plans to the same amount as the annuity premium in order to comply with the 50 percent rule under Revenue Ruling 74-307. In the context of a 412(e)(3) plan, the 50 percent rule has clarity that is absent in an actuarially-funded plan.

An IRS Field Service Bulletin from 1992 recognizes this contradiction:

> The 25-percent general test and the 50-percent test were designed for application to defined contribution plans. Nonetheless, *Rev. Rul. 74-307* indicates that both percentage limitation tests are applicable to defined benefit pension plans as well. *Rev. Rul. 74-307, 1974-2 C.B. 126*, states in part: [A]ccordingly, death benefits under a pension plan of any type will be considered incidental

> within the meaning of section 1.401-1(b)(1)(i) of the regulations if either (1) less than 50 percent of the employer contribution credited to each participant's account is used to purchase ordinary life insurance.... (emphasis added).

The IRS has, with informal pronouncements, promulgated a 66-2/3 percent rule starting in the 1970s. However, instructions to Form 5626 concerning submissions of plans under Cycle A on or before January 31, 2012, provide more information. The 66-2/3 percent rule provides that the premium applied to life insurance contracts for a participant cannot exceed two-thirds of the theoretical normal cost based on the participant's period of participation from the date of entry to normal retirement date, the actuarial assumptions stated in the plan, and the participant's normal retirement benefit. This represents the IRS's adaptation of the 50 percent rule to defined benefit plans. The Form 5626 instructions take the position that the 50 percent rule, as stated in Revenue Ruling 74-307, cannot be unambiguously applied to a defined benefit plan. This would not be the case with a Section 412(e)(3) plan. The Form 5626 instructions further take the position that the 66-2/3 percent rule is the exclusive "premium-based" test for defined benefit plans.

The Form 5626 instructions also state that the death benefit would equal the insurance policy death benefit, minus the cash value, plus the theoretical reserve. The theoretical reserve is the annual theoretical normal costs accumulated at interest, to the date of death. However, many 412(e)(3) plans are written to pay the entire death benefits, both insured and annuity, to the participant's beneficiary. This informal IRS position disregards the use of the words, "pension plans of any type" in Revenue Ruling 74-307.

As a practical matter, this will only become an issue where the application of the 50 percent rule results in a greater premium than is permitted under the 66-2/3 percent rule. The relevant language in the instructions to Form 5626 are stated below:

> Line f. Under Rev. Rul. 74-307, preretirement death benefits under a pension plan of any type will be considered incidental if either (1) less than 50 percent of the employer contribution credited to each participant's account is used to purchase ordinary life insurance policies on the participant's life even if the total death benefit consists of both the face amount of the policies and the amount credited to the participant's account at the time of death, or (2) the total death benefit before normal retirement date does not exceed the greater of (a) the proceeds of ordinary life insurance policies providing a death benefit of 100 times the anticipated monthly normal retirement benefit, or (b) the sum of (i) the reserve under the ordinary life insurance policies plus (ii) the participant's account in the auxiliary fund. Rev. Rul. 74-307 is directly applicable to defined contribution pension plans (i.e., money purchase pension plans), but cannot be directly applied to defined benefit plans. The reason for this is that there are no participants' accounts in a defined benefit plan. Also, employer contributions are not allocable to individual participants' accounts, but are made to fund the benefits of the plan as whole. However, the general principle of Rev. Rul. 74-307 that death benefits will be considered incidental if less than a stated percentage of employer contributions made on behalf of each participant are used to purchase life insurance, can apply to defined benefit plans. To apply the "50 percent" rule of Rev. Rul. 74-307 to defined benefit plans, an amount representing the "employer contribution for a participant" must be computed. This amount is the "theoretical contribution," which is the contribution that would be made on behalf of the participant, using the individual level premium funding method from the age at which participation commenced to normal retirement age, to fund the participant's entire retirement benefit without regard to preretirement ancillary benefits. The theoretical contribution is computed based upon reasonable actuarial assumptions (i.e., interest rate, mortality) that must be stated in the plan. The "amount credited to the participant's account at the time of death" for this purpose is the theoretical individual level premium reserve that is computed using the theoretical contribution. The theoretical individual level premium reserve is the reserve that would be available at time of death if, for each year of plan participation, a contribution had been made on behalf of the participant in an amount equal to the theoretical contribution. In applying Rev. Rul. 74-307 to defined benefit plans, the maximum premiums for ordinary life insurance may be no more than 66 (33 if term and/or universal life insurance) percent of the theoretical contribution. The death benefit payable may not exceed the face amount of the insurance policies plus the theoretical individual level premium reserve less the cash value of the insurance policies. In addition to incidental death benefits under the above application of Rev. Rul. 74-307, preretirement death benefits under a defined benefit plan will also be considered incidental if: (1) the cost of the death benefit for any individual does not exceed 25 percent of the total cost of the individual's benefit, (2) the death benefit is not greater than 100 times a participant's anticipated monthly annuity, (3) the death

> benefit is equal to the present value of the participant's accrued benefit, or (4) a surviving spouse's annuity benefit is a stated percentage of the deceased participant's accrued benefit or a stated percentage of the anticipated normal retirement benefit where the stated percentage is within the guidelines set forth in Rev. Rul. 70-611, as modified by Rev. Rul. 85-15.

While it is typical to fund a 412(e)(3) plan with large whole life insurance policies, this is not the exclusive practice in the industry. At least one major insurer does not even offer a whole life component on its 412(e)(3) plan. There are serious risks to a plan that either has an insured death benefit that exceeds the amount permitted under the incidental death benefit rules, or exceeds the death benefit prescribed under the plan document. Revenue Ruling 2004-20 deals with two general situations associated with Section 412(e)(3) plans. The second situation deals with excess death benefits:

> The plan purchases life contracts for a participant with a death benefit greater than that provided in the plan. In the event of death, the excess death benefits are used to offset future premiums. A deduction is taken for the full amount of the premium. The policies also include a waiver of the premium if the participant becomes disabled.

In this situation, the annuity and insurance cash values fund the retirement benefit on a level basis. There are no violations of Code Section 412(e)(3). However, the company has taken a deduction for a death benefit that is not an incidental death benefit for a participant, but is essentially an advance payment on future premiums that are not yet deductible. Therefore, the deduction attributable to the excess death benefit is disallowed. The same applies to the waiver of premium. It is an advance payment on premiums that are not yet due. The ruling calculates the amount of premium attributable to the excess death benefit by multiplying the excess by the term factors contained in IRS Table 2001. None of the waiver of premium cost is deductible.

The big penalty, however, is contained in the last paragraph of the ruling. If the death benefit provided for a participant exceeds that determined under the plan by more than $100,000, then the program must be registered with the IRS as a listed transaction under Treasury Regulations Section 1.6011-4(b)(2). This penalty can potentially reach $200,000 for each year (since each year is a new violation).

In actual practice, it is not unusual for small amounts of excess death benefits to arise in a plan. This can occur, for example, when a participant's compensation decreases, and, therefore, the death benefit might decrease. (The plan might provide a death benefit equal to 100 times the monthly projected retirement benefit.) Some plans allow for a three-year period to adjust a death benefit, taking into account the time needed to adjust benefits and to disregard small fluctuations that can occur over time. If this language is present, would a death benefit not be characterized as an excess benefit if the excess amount was less than three years old? Could errors be corrected through self-correction under the IRS's Employee Plans Compliance Resolution System [Rev. Proc. 2013-12] and, therefore, not be characterized as an excess subject to the listed transaction rules? The uncertainty in the area in combination with the severe penalties might serve to discourage even legitimate uses of life insurance in these plans.

Erupting Valuations

Revenue Procedure 2004-16 adds guidance to prevent abusive situations that were prevalent at the time it was issued. IRS Notice 89-25, Q&A 10, sought to curb the abuse of springing cash values in the context of life policies distributed from qualified plans. Since that time, schemes (or scams) were created that seemed to work around the restrictions of Notice 89-25.

The following example illustrates the situation:

> Reed is promoting a new insurance contract that is part of a 412(e)(3) plan. The annual premium is $200,000. There is a surrender charge equal to 300 percent of the first year premium. The surrender charge stays level to year 4 and then decreases by 100 percent per year until it is zero in year 7. Reed tells his clients to fund the plan for 4 years, then distribute the policy from the plan (where ostensibly it will be taxed at its then surrender value, which is considerably less than the current cash value or the projected cash value after the seventh year) and continue to hold it as a personal policy.
>
> Here is how the guaranteed policy values play out over the first several years:
>
> Year 1:
> Premium: $200,000
> Cash Value: $100,000
> Surrender Charge: ($600,000)
> Surrender Value: $0

Year 2:
Premium: $200,000
Cash value: $275,000
Surrender Charge: ($600,000)
Surrender Value: $0

Year 3:
Premium: $200,000
Cash Value: $500,000
Surrender Charge: ($600,000)
Surrender Value: $0

Year 4:
Premium: $200,000
Cash Value: $700,000
Surrender Charge: ($600,000)
Surrender Value: $100,000

It is never expected or intended that the surrender charge will ever be assessed. The charge is there purely to reduce the taxable value of the policy when it is distributed in kind long before its maturity.

Revenue Procedure 2004-16 addresses the valuation of contracts and provides an algorithm for determining value. In general, legitimate contracts will meet these requirements. The ruling was very effective at suppressing these schemes relating to artificially reduced surrender values.

Cash Balance 412(e)(3)

The most recent final regulations on cash balance plans under Code Sections 411(a)(3) and 411(b)(5) issued October 19, 2010, offer some specific guidance on the crediting of interest on hypothetical accounts in cash balance plans. The main concern is that excessive interest credits will increase funding and deductions above reasonable levels. Another concern is that indexed interest credits preserve at least the participant's contributions over time. Some 412(e)(3) annuity contracts offer stable and excellent fixed income type returns over time, thereby lending themselves for use as a cash balance funding vehicle. Treasury Regulation Section 1.411(b)(5)-1(d)(5)(iii) states as follows:

> Furthermore, the regulations provide that the rate of return on the annuity contract for the employee issued by an insurance company licensed under the laws of a State is not in excess of a market rate of return, subject to an anti-abuse rule.

This suggests that the actual return on a 412(e)(3) annuity contract could be used as the interest credit for a cash balance plan. In this manner (assuming three-year cliff vesting), a participant's 412(e)(3) annuity contracts would equal the hypothetical account in the cash balance plan and also the value of the participant's accrued benefit, much like a traditional 412(e)(3) plan.

Because of sales loads or surrender charges, the cash value in the early years may fall under the amount of cumulative premiums. In this circumstance, the plan sponsor would have liability for the difference.

It is possible to conceive of this kind of arrangement meeting the requirements of Code Section 412(e)(3), but until there is formal validation of this concept, it would be advisable to perform an actuarial valuation to justify the amount of deductible premium payments.

Conclusion

In summary, 412(e)(3) plans offer a useful approach to funding a defined benefit pension plan in addition to normal, actuarially-funded programs. They contain guarantees and predictable returns, capturing the essence of a pension plan, and smoothing out contribution payments. They aid comprehension, since the participant's benefits are contained in the contracts held for their benefit. There are no Schedules SB and minimum funding requirements. In the past, 412(e)(3) plans offered larger initial deductions than trust-funded plans. However, with PPA and Code Section 404(o), this possible advantage has largely been neutralized.

However, there is a trade-off. Section 412(e)(3) plans have less flexibility than trust-funded pensions. They have to meet all requirements for qualified plans in general, and pensions in particular, except those relating to actuarial funding. In some cases, the application of these rules requires a careful interpretation of existing guidance, since these rules were generally conceived for trust-funded pensions. In addition to general guidance, there are complex rules specific to 412(e)(3) plans. Nevertheless, 412(e)(3) plans will continue to offer certain advantages over trust-funded pensions in appropriate cases. ■