

Fully Insured Plans: A Viable Retirement Plan Solution

BY RICHARD M. PERLIN

Slapping my knee with a loud guffaw, in a manner uncharacteristic for a serious pension professional such as myself, I read, for the first time, the part of the Pension Protection Act (PPA) where Code Section 412(i) had been redesignated as Section 412(e)(3). That will teach us creative pension people to name a type of plan after an Internal Revenue Code Section! This reshuffling was just what I needed to snap me out of the trance caused by reading the funding provisions of PPA for almost 10 minutes. Overwhelmed by this pure humor, I irresistibly tapped the shoulder of the man dozing next to me on the plane. I had to share this funny tidbit with the world.

Code Section 412(e)(3), in its original incarnation as Section 412(i), was added to the Internal Revenue Code as part of ERISA in 1974 to exempt certain fully

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insured plans from ERISA's new minimum funding standards. The concept of fully insured pension plans long predated the Code Section. Plans that meet the requirements of the Code, which are commonly called "412(e)(3) plans," have now replaced the earlier Code-inspired moniker of "412(i) plans."

Code Section 412(e)(3) and Treas. Reg. Section 1.412(i)-1 contain the basic rules. Various other related requirements are interspersed among other statutory and regulatory provisions. Under Section 412(e)(3), a plan qualifies as a fully insured plan if:

(A) The plan is funded exclusively by the purchase of individual insurance contracts,

(B) Such contracts provide for level annual premium payments to be paid extending not later than the retirement age for each individual participating in the plan, and commencing with the date the individual became a participant in the plan (or, in the case of an increase in benefits, commencing at the time such increase becomes effective),

(C) Benefits provided by the plan are equal to the benefits provided under each contract at normal retirement age under the plan and are guaranteed by an insurance carrier (licensed under the laws of a state to do business with the plan) to the extent premiums have been paid,

(D) Premiums payable for the plan year, and all prior plan years, under such contracts have been paid before lapse or there is reinstatement of the policy,

(E) No rights under such contracts have been subject to a security interest at any time during the plan year, and

(F) No policy loans are outstanding at any time during the plan year.

Section 412(e)(3) further provides that "a plan funded exclusively by the purchase of group insurance contracts which is determined under regulations prescribed by the Secretary to have the same characteristics" as those described above is to be treated as a fully insured plan.

Regulations elaborating on the basic statutory requirements are contained under the old Treasury Regulation Section 1.412(i)-1.

A 412(e)(3) plan captures the essence of a defined benefit pension plan with predictable contributions and a guarantee at retirement. The guarantee can be expressed as a lump sum or monthly benefit.

A 412(e)(3) plan avoids underfunding that can result from volatile returns of equity markets, as well as falling segment rates. These plans also eliminate the need to perform complex actuarial valuations and obtain actuarial certifications. All of the actuarial work is embedded in the annuity contracts and insurance policies. There is no AFTAP figure looming in the background that can disrupt the operation of the plan by restricting lump-sum payouts, requiring special notices, or even involuntarily freezing accruals. There are never any surprise shortfalls to amortize. But these simplicities come with a cost. In place of an actuary's certification, the plan must fund benefits in a somewhat inflexible manner. The 412(e)(3) plan buys simplicity with a reduction in flexibility relative to trust-funded plans, certified by an actuary.

Given the volatility in the stock market over the past 12 years, along with the break-even type of returns from the stock indexes, 412(e)(3) plans offer a simple and less worrisome means of funding a pension. Many contracts offer returns that are very competitive with investment-grade debt instruments of similar duration.

Cash balance plans have attracted recent attention because of PPA changes that make the hypothetical account look like a real account. Section 412(e)(3) plans have had this advantage for decades. Section 411(b)(1)(F) states:

411(b)(1)(F) CERTAIN INSURED DEFINED BENEFIT PLANS.—Notwithstanding subparagraphs (A), (B), and (C), a defined benefit plan satisfies the requirements of this paragraph if such plan—

- (i) is funded exclusively by the purchase of insurance contracts, and
- (ii) satisfies the requirements of subparagraphs (B) and (C) of section 412(e)(3) (relating to certain insurance contract plans),

but only if an employee's accrued benefit as of any applicable date is not less than the cash surrender value his insurance contracts would have on such applicable date if the requirements of subparagraphs (D), (E), and (F) of section 412(e)(3) were satisfied.

A participant in a 412(e)(3) plan has both a monthly benefit and a cash value. This is more tangible to a participant than a present value of an accrued benefit under a traditional defined benefit plan, or even the hypothetical account in a cash balance plan.

Besides simplicity and understandability, there are other practical implications of a fully insured plan. Because the policy's cash value always equals benefits, there can never be an unfunded benefit subject to the PBGC variable premium. This is particularly relevant in light of recently passed "MAP 21" legislation greatly increasing the PBGC variable premium rate.

Funding

The Code requires that benefits in a fully insured plan be funded on a level basis using the same series of contracts. Funding must be level over the period from the participant's initial date of participation to normal retirement date. [Treas. Reg. § 1.412(i)-1(b)(2)] An increase in normal retirement benefits caused by an increase in compensation or a plan amendment must be funded on a level basis from the valuation date on which the increase occurs to normal retirement date.

The requirement that all contracts must be in the same series is to avoid manipulation of deductions and value. [Treas. Reg. § 1.401(a)(4)-3(b)(5)(vii)] For example, the plan cannot buy a contract for the owner of the company with an age 65 annuity purchase rate (APR) of \$170 (for \$1 of monthly benefit) and for the other employees with an age 65 APR of \$150. This is because, at a given dollar level of benefit, the value to the owner would be greater than that to the other employees. Some practical deviations are permitted from a strict interpretation of the rules. For example, if an insurance company ceases to issue a certain type of contract, the plan may purchase the contract version that replaces it. If a plan decides to change insurers, the effect of the change must be examined to determine if it discriminates in favor of highly compensated employees.

There are two basic kinds of contracts that are used for 412(e)(3) plans: fixed premium contracts and flexible premium contracts. Fixed premium contracts purchase a specific benefit for a premium that the insurance company determines. For example, it costs \$190 of premium for each dollar of monthly benefit at age 65. The insurance company uses internal actuarial factors to determine the cost and funding of the benefit based on the participant's current age. This kind of contract is generally one dedicated specifically for use with Code Section 412(e)(3) plans.

Certain contracts may be "participating," meaning that the cash value yields dividends in excess of a guaranteed amount. The dividends are based on a non-guaranteed interest rate applied to the cash value each year. Dividends are then used to reduce the guaranteed premium that would otherwise be due. Thus, a pattern

of decreasing net premiums over time is created, because the dividend rises as the cash value rises, but the gross premium remains fixed. Treas. Reg. Section 1.412(i)-1(b)(2)(ii) specifically characterizes a decreasing stream of payments due to the increasing dividends as meeting the level funding requirements.

Flexible premium contracts are often adapted “off the shelf” for use with 412(e)(3) plans. The annuity contract will often provide a fixed rate of interest for a period of one or more years. After the guarantee period, the insurance company can declare a new rate, although there is usually a floor below which the interest rate cannot sink. The contract would also provide an APR for \$1 of monthly benefit at normal retirement age. The initial premium would be determined by calculating the level annual dollar premium that would accumulate the cash needed to fund the retirement benefit at the normal retirement date. In performing this calculation, assumptions must be made about the preretirement interest rate. It would probably be acceptable to use the guaranteed initial rate for the initial guarantee period, then the floor rate until normal retirement age. If, after the initial guarantee period, the rate declared by the insurance company exceeds the floor rate, then the funding amount would be recalculated using the known interest rate. A specialist who is able to do these calculations is needed to service this type of plan structure.

The funding amount under the flexible premium contract is determined for each individual, based on the terminal cash accumulation, some blended interest rate assumption (which would vary by individual based on the assumed series of interest rates) and a method of allocating assets (in this case, the participant’s contract values). We assume for this purpose that the expenses of the contract are inherent in the net interest rates. There may also be a surrender charge to amortize the cost of issuing the contract over a period of years. Generally, the values used in calculating funding costs do not reflect the surrender charge.

For example, let’s assume the initial rate for the first three years is 5 percent and the subsequent floor rate is 3 percent. Let’s also assume that in year 4, the declared rate is 4 percent. Finally, assume the participant is age 45 with a normal retirement age of 65. The first year calculation will have 5 percent for 3 years and 3 percent for 17 years for a blended rate of about 3.3 percent. The calculation in the 4th year would be based on 4 percent for 1 year and 3 percent for 16 years or a blended rate of approximately 3.06 percent.

Loans

A 412(e)(3) plan must prohibit loans. [Treas. Reg. § 1.412(i)-1(b)(2)(vii)] However, many annuity contracts create a policy loan automatically for unpaid premiums to prevent a contract discontinuance. Often, the window for paying premiums before a loan is created against the policy is short. Recognizing this, the regulations permit premium loans that are repaid within one year of the time the premium was otherwise due. Failure to repay the loan within this time period would revoke 412(e)(3) status and the plan must retain the services of an actuary to perform a funding valuation and file a schedule SB with the Form 5500. In practice, because the annuity purchase rates used by an insurer tend to be higher than those utilized by actuaries, it is likely that the minimum funding requirement generated by the actuary will be lower than that of the normal policy premium. The maximum deductible amount, however, will probably be similar. In addition, the failure to repay a policy loan within this time period often results in a failure of the participating contracts from mutual companies to receive a full dividend.

The Initial Benefit

The initial benefit is determined using the retirement benefit formula and the participant’s average compensation. For a plan in which funding is actuarially determined, current compensation is generally projected to normal retirement age, then the averaging conventions specified in the plan are applied. This same approach can be used in a 412(e)(3) plan. If a participant works through until normal retirement age, the final benefit will accurately reflect the participant’s accrued benefit at normal retirement age. However, if benefits are paid early due to termination of employment or termination of the plan, then the cash value of the policies could be based on an a projected, rather than historical, average compensation. Non-412(e)(3) plans would ordinarily use a historical average to determine accrued benefits at any point in time.

The projected compensation approach more closely follows the procedure used in pre-PPA terminal funding methods. Section 412(e)(3) plans, by their inherent nature, use a terminal funding approach. The accrual rule for 412(e)(3) plans under Code Section 411(b)(1)(F) equates the insurance cash value to the accrued benefit. There is no sound basis for reading into these rules a requirement that 412(e)(3) plans calculate preretirement accrued benefits under a fractional accrual rule with historical compensation.

The alternative to using projected compensation would be to use historical average compensation to determine normal retirement benefits. Using this approach could result in significant benefit increases for participants with pay increases close to retirement age. These benefit increases, in turn, can create large increases in funding due to the short period in which they would be funded. The resulting large increments in funding call into question whether this approach is funded on a level basis as required under the regulations.

Benefit Increases

A benefit can increase due to a change to the retirement benefit formula, but in most cases, the increase will be due to a change in compensation. The increase is calculated as the change in the normal retirement benefit. This is funded from the date of the increase to NRA and is considered funded on a level basis. The plan document may provide a threshold beneath which a benefit increase need not be funded. This provision can be useful in reducing the number of policies for a participant's benefit, especially where the policies have a fixed dollar policy fee.

Benefit Decreases

Benefit decreases also can be due to a change in benefit formula, but more often result because of a decrease in compensation. Fixed benefit contracts often have a mechanism to adjust benefits downwards. The specific rules for calculating the adjustment may be based on the insurance company's procedures rather than contractual. In the absence of an adjustment mechanism, an existing contract can be placed on a paid-up status, with a new contract purchased in an amount that, when added to the paid-up benefit, equals the newly reduced benefit. Because the cost of issuing a new contract may be significant, it may be prudent in situations in which benefits are expected to fluctuate up and down to issue more than one contract at the outset. Because first-year contract charges are often the largest, this method minimizes the costs associated with surrendering a contract when the benefit decreases and rebuying a new contract (at a higher premium) when the benefit increases once again.

Example. A new 412(e)(3) plan funds a benefit for Crystal using a single contract with a retirement benefit of \$3,000 per month. After two years, due to slow business, Crystal does not get a bonus and her compensation, as determined for her retirement

benefit, decreases. This results in a benefit decrease to \$2,500 per month. The cash value of her existing contract would buy an annuity of \$400 per month at retirement. That existing contract is placed on "paid-up" status. The plan purchases another contract for Crystal of \$2,100 (\$2,500 new benefit minus \$400 paid up benefit). The drawback is that the high first-year issuance cost is again incurred on the new \$2,100 benefit.

Instead of one contract at the outset, let's assume Crystal received four contracts, each with a projected benefit of \$750 per month. Now, when Crystal's compensation decreases, three of the four contracts can be left untouched. Those three contracts' benefits total \$2,250 per month which is less than the new benefit of \$2,500 per month. The last contract of \$750 is placed on a paid-up status. It will pay a monthly benefit at retirement of \$100 per month. Therefore, the total monthly retirement benefit will equal \$2,350 per month. This means a new contract of \$150 per month will need to be purchased to bring the total projected benefit up to the required \$2,500. This smaller contract will have much lower issuance costs than a new contract of \$2,100 per month, which occurred when Crystal received only one contract at the start.

With flexible premium contracts, the task is simpler. The current cash value, assumed interest rate, and retirement cash accumulation are known. The revised premium is calculated on this basis.

Postnormal Age Retirement Benefits

What happens when a participant continues to work past normal retirement age? If the participant has fully accrued the normal retirement benefit because he or she has earned sufficient years of service to receive the maximum benefit under the plan formula, then the participant receives only an actuarial increase after normal retirement. This actuarial increase should equal the benefit provided by the current cash value of the contracts, which continue to receive interest credits over time. Most preapproved plan documents offer a choice for postnormal retirement age adjustments. The selection under the plan should be consistent with this process.

If the participant can earn additional benefits by receiving credit for additional years of service, then the plan should provide the greater of: (i) the current cash value of the contracts, postnormal retirement age, or (ii) the benefit under the plan's formula, postnormal retirement age. This often must be manually

calculated using the insurance company's APR at each age, and determining whether the current benefit under (ii) above would require additional annuity contract values.

The plan language should reflect that the postnormal retirement age benefit should be the greater of the actuarial equivalent of the previous year's benefit (i.e., the increase in the policy cash value), or the benefit determined under the formula.

For participants who have passed normal retirement age, the late retirement age should be set to the following valuation date to enable any new benefits to be funded. Otherwise, a participant who can earn additional benefits from more years of service would have a funding gap at normal retirement age, i.e., there could be no new benefits until the following year. This is analogous to the same situation under the pre-PPA individual aggregate funding method. If a participant had hit normal retirement age, the allocated assets were set to equal the retirement funding goal, resulting in a normal cost of zero. So it was common to treat these participants as having a late retirement age one year later to force a normal cost. This is a more reasonable approach and also consistent with the goal of level funding.

Benefit Formulas

If only highly compensated employees participate in the plan, then the plan automatically passes nondiscrimination requirements. There even could be separate benefit formulas for each highly compensated participant. The benefit formula still must meet the requirements of Section 416 (top heavy), Section 401(a)(26) (minimum participation), Section 415 (maximum benefits), and Section 411(b)(1) (benefit accrual).

If the plan has any nonhighly compensated employees, then any of the safe harbor benefit accrual formulas allowed for defined benefit plans under Treas. Reg. Section 1.401(a)(4)-3(b)(4) would be acceptable. Treas. Reg. Section 1.401(a)(4)-3(b)(5) imposes some additional requirements for safe harbor fully insured plans:

1. The plan must provide that the accrued benefit equals the policy's cash value.
2. The plan must be an insurance contract plan within the meaning of Section 412(e)(3).
3. The benefit formula may not recognize years of service before the employee commenced participation in the plan.

4. The scheduled premium payments under an individual or group insurance contract used to fund an employee's normal retirement benefit must be level annual payments to normal retirement age. Thus, payments may not be scheduled to cease before normal retirement age.
5. The premium payments for an employee who continues benefiting after normal retirement age must be equal to the amount necessary to fund additional benefits that accrue under the plan's benefit formula for the plan year.
6. Experience gains, dividends, forfeitures, and similar items must be used solely to reduce future premiums.
7. All benefits must be funded through contracts of the same series.
8. If permitted disparity is taken into account, the 0.75-percent factor in the maximum excess or offset allowance [must be] adjusted by multiplying the factor by 0.80. (This is apparently a rough adjustment that takes into account the lower internal interest rates used in 412(e)(3) contracts relative to the rates that apply to the maximum permitted disparity under Section 401(l).)

Basically, the rules require that benefit accruals meet one of the fractional accrual safe harbors. This is logical, since the cash values accumulate over a period starting with the participant's entry into the plan and ending with normal retirement age. This is why the regulations prohibit use of a safe harbor formula that counts service before participation in the plan, as that would require a significant first-year accrual that is disproportionate to the accruals for later years. It is noted that the increase in paid-up benefits purchased by cash values would not likely be linear, as would be the case with a fractionally accrued benefit.

In theory, a 412(e)(3) plan can be subjected to a general nondiscrimination test, rather than rely on a safe harbor. However, at the core of any such test is the meaning of the term, "accrued benefit." For 412(e)(3) plans, there are at least several possibilities for the meaning of accrued benefit:

- The equivalent benefit purchased by the cash value, using the testing actuarial assumptions;
- The incremental increase in the paid-up monthly benefit payable at normal retirement age; or
- The benefit determined under the fractional accrual rule.

This uncertainty frequently will deter practitioners from engaging in the kind of creative planning that often occurs with trust-funded defined benefit plans in closely held companies. Nevertheless, it is interesting to note that the safe harbor under Treas. Reg. Section 1.401(a)(4)-3(b)(4)(C)(3), which requires defining a normal accrual rate, seems to remain available as a quasi-design-based safe harbor formula.

There are also other benefit formula restrictions. For example, it would be acceptable under a safe harbor formula to have a retirement benefit formula of 125 percent of average compensation, reduced for participation of fewer than 25 years. This kind of formula is useful where the principal has a relatively short service period to normal retirement age. For younger participants who will achieve more than 25 years of service at normal retirement age, the plan can fund for a benefit of not more than 100 percent of compensation, but the accruals would be accelerated based on the higher percentage stated in the benefit formula.

This kind of formula becomes unworkable in the context of a 412(e)(3) plan. Since the plan cannot buy contracts providing for a benefit greater than 100 percent of compensation, and since the growth of the cash value represents the participant's accrual, the benefit in excess of 100 percent of compensation becomes meaningless for employees with at least 25 years of service to retirement.

Section 415 Issues

Treas. Reg. Section 1.415(b)-1(c)(3)(i) generally limits the value of a lump sum to the present value determined using a 5.5 percent interest rate and the IRS standard mortality tables. Typically insurers use interest rates that are much lower than 5.5 percent and mortality tables that show people living longer than the IRS tables. The net effect is that the annuity purchase rates for the annuity contracts are significantly higher than those used to determine the maximum lump sum permitted under Code Section 415 (i.e., the "415 maximum").

If a plan funds a 415 maximum benefit (as opposed to the lump sum) for a participant, it is likely that the participant's contracts will accrue values well in excess of the 415 maximum lump sum. In that circumstance, the participant will be faced with either an unwanted annuity payout, or the plan will be subjected to a set of confiscatory income and reversion excise taxes on the amount in excess of the 415 maximum.

One technique to avoid this problem is to determine the benefit that will provide the maximum lump

sum at the participant's retirement age under Section 415 and fund for this benefit. However, this method can "leave money on the table," because it disregards cost-of-living adjustments to the 415 maximum. This assumption is probably prudent in the current political climate. In a less sensitive environment, the plan could project a modest COLA for Section 415 and determine a benefit formula that would result in a lump sum at retirement that is less than the projected 415 maximum. In any case, the benefit cannot exceed the applicable adjusted 415 monthly benefit.

If a plan brushes against the 415 maximum lump sum, there may be relief. If the affected participant has less than 10 years of participation, then continuing the plan to take advantage of another year of participation will increase the 415 maximum. The plan sponsor may wish to decertify the 412(e)(3) election at that point in order to cease funding while the benefits catch up to the assets. In extreme cases, the trustee may wish to liquidate annuity contracts and let the funds reside in a no interest option, such as a money market. A similar strategy could apply if the normal retirement age is less than 62. The actuarial increases in the maximum lump sum may start to eat away at the excess assets.

It may be possible to transfer assets in excess of the 415 maximum that is payable to the participant to a defined contribution qualified replacement plan to avoid any excise taxes.

If a participant falls in the nether region between ages 62 and 65, the Section 415 issue should be reviewed and any necessary action should be taken, to ensure that any problem is not permitted to compound. Between the ages of 62 and 65, a participant with at least 10 years of participation will see his or her maximum lump sum benefit values erode since the maximum dollar benefit remains static, but the value of that benefit decreases due to a shorter life expectancy.

Setting a normal retirement age of 55 at the outset of the plan commonly produces greater funding. However, Section 401(a)(36) and Revenue Notice 2007-8 make some pre-age 62 normal retirement dates suspect. Using age 62 or later eliminates this potential scrutiny.

Example. Jon has compensation of \$200,000 per year. The plan provides for a benefit at retirement age 65 equal to 100 percent of average compensation. Jon will have 10 years of participation at normal retirement age.

- Jon's benefit at NRA 65 = \$200,000/year or \$16,666/month

- APR @ 65 based on 5.5% interest and IRS Mortality Table: \$138.95/\$1 monthly benefit
- Maximum Cash @ age 65: \$138.95 x \$16,666 = \$2,315,740
- Insurance Company APR @ 65: \$189.75
- Cash value of contract with retirement benefit of \$16,666 @ 65: \$3,162,373
- Undistributable projected excess assets: \$846,633

Now assume an increment of the 415 maximum by 2 percent per year (suspect in current political climate).

- Section 415 maximum cash value at 65: \$2,315,740 x 1.02¹⁰ = \$2,822,874
- Revised projected 415 excess: \$399,499
- Revised maximum benefit: (\$2,822,874/\$3,162,373) x \$16,666 = \$14,876
- Revised maximum benefit formula: (\$14,876/\$16,666) x 100% = 89.26%

Using this method, the plan could fund the projected benefit of 89.26 percent of compensation, payable at age 65 for Jon. Assuming that the cost-of-living increase in the Section 415 maximum is at least 2 percent per year during Jon's participation, the amount payable from the policy at that time will equal the maximum amount permitted by law.

Top Heavy Minimum Benefits

A top heavy defined benefit plan must provide a top heavy minimum accrual to all nonkey employees. In determining the top heavy ratio of a Section 412(e)(3) plan, the most logical approach is to use the cash value of the contracts as the value of benefits. The top heavy minimum accrual can be determined by looking at the incremental paid-up benefit over the plan year. While it is less accurate, it is possible to look at the incremental benefit using fractional accrual over participation.

Example. Danny has a contract with a value of \$25,000. The contract has a guaranteed interest credit of 4 percent per year. Danny is age 45 and retirement age is 65. The APR in the insurance company tables at 65 is \$185 per \$1 of monthly benefit.

The projected cash value of the contract at age 65 = \$25,000 x 1.04⁽⁶⁵⁻⁴⁵⁾ = \$54,778.

The projected paid up benefit at retirement age is \$54,778/\$185 = \$296/month.

Danny's cash value next year at age 46, including the premium attributable to the plan year, equals \$30,000.

The value of the paid-up benefit at age 65 = \$30,000 x 1.04⁽⁶⁵⁻⁴⁶⁾ = \$63,205.

The projected paid-up benefit at retirement age 65 is \$63,205/\$185 = \$342/month.

The benefit accrued between ages 45 and 46 equals \$342-\$296 = \$46/month.

Assuming Danny has an average monthly salary (over five years) of \$4,000, the benefit of \$46/month accrued over the year represents an accrual of 1.15 percent. If the plan is top heavy and Danny is a non-key employee, then he must be provided with some additional benefit in order to meet the top heavy minimum. One approach might be to purchase an additional single premium paid-up annuity benefit which provides an accrual of 0.85 percent of average monthly compensation at retirement (i.e., the difference between the required 2 percent and the provided 1.15 percent of compensation). If the situation is likely to repeat itself, then the plan might purchase an additional annual premium contract designed to provide the necessary additional accruals each year. This should not be an issue except in the very unusual circumstance where the nonkey employee is highly compensated (because of the additional benefits provided). If the sponsor maintains, and the participant also participates in, a defined contribution plan, then the top heavy minimum may be provided in that plan, avoiding the need to adjust the benefit in the defined benefit plan. This can be done by providing a contribution equal to 5 percent of compensation for the nonkey employees, or by using a "floor offset" approach, whereby the profit sharing contribution provides the differential between the defined benefit accrual and the requisite 2 percent.

The top heavy regulations permit a top heavy 412(e)(3) plan to provide a supplemental benefit either through an auxiliary fund, or deferred annuity contracts. [Treas. Reg. § 1.416-1 Q&A M-17] However, if a 412(e)(3) pension uses an auxiliary fund to meet top heavy minimums, actuarial certification is required for the auxiliary fund, which appears to add unnecessary complexity. This requirement does not apply to the supplemental deferred annuity. This regulation also appears to validate the use of the incremental paid-up benefit as a measurement of benefit accrual.

Section 417(e)(3) Minimum Lump Sum

Section 412(e)(3) plans remain subject to the minimum lump-sum calculation under Code Section 417(e)(3). However, there are no special rules for

determining the accrued benefit for which the Section 417(e)(3) rates must be used. In the early years of a contract, in particular for younger participants, the fractional rule accrued benefit under the plan benefit formula will often exceed the paid-up benefit under the annuity because of the costs of issuing annuity contracts. Based on the paid-up benefit according to the insurance company tables, the cash value would very likely always exceed Section 417(e)(3) minimums because of the low interest rates on which the contract guarantees are based. Because the paid-up benefit under the contract is a reasonable definition to use, it will be very unlikely that the cash value would be less than the value based on Section 417(e)(3) rates.

Conclusion

Section 412(e)(3) plans can be attractive because of the predictability of the annual funding requirements, predictability of investment returns, avoidance of actuarial funding rules, and overall simplicity as it relates to defining a participant's benefits. However, issues can arise with 412(e)(3) plans that are unique to these kind of pension plans. In some cases, the type of specific guidance that often exists for actuarially-funded pensions is lacking in the 412(e)(3) arena and a reasonable and careful interpretation of existing guidance is essential.

In the next installment, issues relating to 412(e)(3) conversions and deconversions, termination of 412(e)(3) plans, life insurance contracts, and recognizing abusive tactics will be explored. ■