Are Defined Benefit Plans or 412(e)(3) Plans Good for Successful Small Businesses or Professionals?

A major part of the 2001 Economic Growth and Tax Relief Reconciliation Act (EGTRRA) was to encourage the establishment of small-business retirement plans. Since, as an incentive to small-business owners, the tax-deductible dollar limit and the allowable compensation percentage for such plans has increased. In 2008, the maximum contribution limit for defined-contribution plans under IRC Sec. 415(c) (I) (A) is $46,000. Participants at age 50 or more are allowed an additional catch-up limit of $5,000. The next problem for the successful business owner or professional is that even with the maximum contribution to a Profit Sharing plan and the maximum deferral in a 401(k) plan (Defined Contribution plans or DC plans) from age 50 to age 65 there is still not enough to retire on. There is more…

While Sec. 401(k) plans are common, they limit the professional or business owner’s tax-deductible contributions. One other seldom discussed issue with the 401(k) plan is that it is the most tax, inefficient retirement plan. Why? Because elective deferrals are still subject to a Social Security and Medicare tax of 15.3%. Another seldom discussed fact is that they discriminate against the success full professional or business owner. Because of recent tax-law changes (provided by EGTRRA and the Pension Protection Act of 2006), which amend the Employee Retirement Income Security Act by establishing new minimum pension funding standards, many of these successful professionals or owners of companies are eligible for a 401(k) plan, as well as defined-benefit and profit-sharing plans. These provisions were permanently installed in the code with WRERA 2008. An advisor’s awareness of these changes will enable him/her to provide new options to clients.

What is a Defined Benefit Plan?

A defined-benefit plan is a qualified plan where a pre-determined formula sets the amount of retirement income received by a participant. With a traditional defined-benefit plan, the size of the tax-deductible contribution made to fund retirement income benefits under the plan is calculated annually.

The actual deductible contributions are determined by a complex set of mathematical calculations and regulatory requirements, which must be performed by qualified actuaries (preferably enrolled actuaries). Depending on the age of the participants and benefit levels provided, a defined-benefit plan can achieve tax-deductible contributions well in excess of Sec. 415 limits.

The ability of these types of plans that allow significant contributions also adds to the complexity and reporting requirements. Annual contributions and deductions must be calculated each year and are affected by actual earnings or losses from investment of the trust assets, actuarial assumptions and limitations imposed by the minimum funding standards and full funding limitations of IRC Sec. 412. As a result, administration costs tend to be higher for these plans than for defined contribution plans.

The alternative to these higher cost plans is to use a Sec. 412(e)(3) plan—referred to in the IRS regulations as an "insurance contract plan"—that is exempt from the funding requirements of IRC Sec. 412.

The Fully Insured Defined Benefit Plan Solution

Sec. 412(e)(3) plans are exempt from the section's funding rules described above because the burden of providing the benefit is shifted from the *employer* to an *insurance* company and provides many guarantees not provided under the other plan choices. Prior to the Pension Protection Act of 2006, these plans were known as 412(i) plans. They are referred to as a "fully insured defined benefit plans" because the benefits are guaranteed by an insurance company (subject to the insurance companies claims paying capacity).

Fully insured, defined-benefit plans are unique in the retirement planning arena because they have a higher tax-deduction limit than most plans. Moreover, plan contributions may be greater than those made to traditional defined-benefit plans. They are funded using fixed-annuity products and some guaranteed whole-life insurance contracts may also be included.

The interest-rate assumptions are much more conservative in these types of contracts than in traditional defined-benefit plans. The irony is that in the last decade these contracts would have outperformed the S&P 500 without the inherent risk of the stock market. This not only eliminates the investment risk it allows for a greater deduction. While contributions (which are based on guaranteed interest and mortality assumptions) to a fully insured plan generally remain high, they can decrease over time if the assets contributed toward the plan earn dividends or interest over and above the guaranteed levels. In this situation, these "extra" earnings must be used to offset contributions.

The accrued benefit for a participant at retirement is a stated monthly pension, or simply the guaranteed cash values of the underlying policies. Business owners and professionals who would appreciate the ability to set aside large amounts of money each year for their retirement, while taking large tax deductions for doing so—as well as the *fully guaranteed* retirement benefits the plans provide. When combined with a profit sharing plan and 401(k) in what is sometimes called a "custom carve out plan" the professional or business owner can maximize the contributions for themselves and have the best of both a DB plan and a DC plan. Contributions under this "three Pod " strategy can be as high as $300,000 in the DB/412 (e)(3) plan and $49,000 in the profit sharing plan and $16,500 in the 401(k) plan. This strategy can optimize the tax deductions available.

The retirement payout is subject to the same IRS limits as all other defined-benefit retirement plans. For 2009, the maximum annual amount that can be received by each participant is generally the lesser of $195,000 or 100 percent of the participant's average up to $245,000 of annual compensation for the highest three years of work <u>with the same the same company</u>. Just like a traditional defined-benefit plan, you have an alternative to taking periodic distributions from the fully insured plan; a participant may take a lump sum and roll the assets into an IRA.

Who Qualifies for a 412(e)(3) Plan?

By and large, 412(e)(3) plans are ideal for business owners with relatively few employees that can commit to making large, regular contributions. The concept works best for businesses that are well-established, highly profitable and the owners are within 10 to 15 years of retirement.

The plan is equally suited to successful, self-employed professionals or individuals, who may have been unable to set money aside for retirement in their early years, due to education, family or other obligations and now need to put away large amounts of money in a short amount of time to in essence “catch up”. Individuals starting a second career are also good candidates for these plans, as are those who want to provide for family members and heirs should they die unexpectedly? These plans may also be used as part of a business succession strategy. Note that any life-insurance contract transferred from a plan to the individual plan participant must be taxed at its fair-market value, and an employer may not buy excessive life insurance under a plan.

Also, Sec. 401(a) 4 discrimination testing could allow business owners to receive a substantial portion of the plan’s benefit for themselves especially if a “custom carve out design is used. A first step in determining if a defined benefit plan is appropriate is a feasibility study. This should be performed by a qualified pension consultant to determine the right type of plan and its costs and benefits.

Easier to Use

Employers may find a standalone 412(e) (3) plan attractive because they avoid the complications commonly associated with traditional defined-benefit plans. For example, no enrolled actuary’s certification is needed; there are no required quarterly contributions; there is no full funding limitation applied that might limit contributions; and administrative costs are generally lower. The risk of penalties for over funding the plan or underfunding the plan as in traditional defined benefit plans are tremendously reduced. Another popular feature includes protection of plan assets from lawsuits and creditors.

A third-party administrator (TPA) will establish the plan, which includes providing the plan and trust documents and providing the plan trustee with all documents and administrative forms that may be needed in the future. The administrator also provides annual processing of all IRS and Department of Labor forms, plan valuation and 5500 forms.

What are the next Steps?

Many Professionals and small-business owners with successful and mature businesses have higher incomes and assets than traditional wage earners. The problem is that this doesn’t always translate into higher retirement savings. Many times they have spent years sacrificing to build a successful business or acquiring the education needed for success in their profession and because of this have not built a retirement plan for themselves. According to a 2004 study by The Public Policy Institute of the AARP, only 12 percent of self-employed individuals over age 50 have a pension or retirement plan. Worse still, based on several recent studies the average retirement plan account balance is just $70,000 to $90,000. Professionals such as doctors, architects, lawyers, CPA's and individuals with second incomes may benefit from a fully insured defined-benefit plan or the flexibility of a custom carve-out strategy.

We believe these tax law changes create opportunities for an advisor to help clients increase tax deductions through retirement plans, increase baby boomer retirement income and enhance the advisor's relationship with their clients. For a calendar tax year business, the new plan must be adopted by Dec. 31 and funded by the tax due date *(including extensions).*

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