Prepared for:

Prepared by:

Robin Weingast
President
Robin S. Weingast Associates, Inc.
100 Quentin Roosevelt Blvd, Suite 507
Garden City, NY 11530

Phone: 516.794.8146
Fax: 516.794.8146
Email: rsw@rswtpa.com
Website: www.rswtpa.com
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Fully-Insured Defined Benefit Plan

IRC Sec. 412(e)(3)[1]

Maximum Benefit

The maximum benefit under a defined benefit plan is measured in two ways:

- **Percentage:** The retirement benefit cannot exceed 100% of the average of the highest three consecutive years of compensation.[2] This is reduced by 10% for each year of service less than 10.
- **Dollar amount:** The maximum dollar benefit is indexed at $210,000 per year (2014) for retirement between the ages of 62 and 65.
  This amount is actuarially reduced for retirement prior to age 62. Retirement at age 55 would typically produce a maximum annual benefit of about $120,000, depending on the assumptions used, cost of living adjustments, and number of years of participation. The dollar amount will also be actuarially increased for retirement after age 65, subject to the percentage and dollar limitations. Lastly, if the individual has fewer than 10 years of participation at normal retirement age, the dollar amount is reduced proportionately.

First- and Subsequent-Year Contributions

The contribution will be the premium for the annuities or combination of annuities and life insurance policies necessary to fund the benefit. This will almost always be higher than in a traditional defined benefit plan when established and then may, or may not, decline as real earnings exceed policy guarantees. The initial contribution for the benefit and future benefit increases are based on the guaranteed rates in the policies. Future premiums will reflect actual investment experience of the policies.

Methods of Defining the Benefit

- **Level percentage plan:** Example - The benefit is equal to 50% of compensation,[2] reduced by 1/25 for each year of participation less than 25 years.
- **Step rate service weighted for prior service:** Example - The benefit is equal to 8% of compensation for the first ten years of service plus 5.2% of compensation for all other years, but not to exceed a total of 33 years.
- **Service plan:** Example - The benefit is 2.5% of compensation for each year of service. Younger participants may also be favored if the benefit formula is service related.
- **Participation plan:** Example - The benefit is 5% of compensation per year of participation with a maximum of 20 years.

[1] The Pension Protection Act of 2006 moved former IRC Section 412 (i) to a new code section, IRC Section 412(e)(3).
[2] For those self-employed, compensation is limited to net self-employment income, e.g., gross income less the contribution and the deduction allowed for one-half of the self-employment tax. In certain unusual circumstances, the required contribution may be more than the allowable deduction.

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Top-Heavy Plans

If the present value of the accrued benefits of key employees[1] is 60% or more of the total value of all accrued benefits, the plan is top-heavy. In that instance, the plan must provide for a minimum level of benefits for non-key participants.

Accrued Benefit

Each participant's accrued benefit is measured by the cash value of the policies purchased for each participant.

Special Requirements

For a plan to be considered as "fully insured" under IRC 412(e)(3), certain criteria must be met:

- The total benefits must be provided by one or more annuities or a combination of annuities and life insurance policies.
- The premium on the policies must be level from date of issue until scheduled retirement. Exception: "Dividends" or "excess earnings" may reduce such premium.
- Premiums must not be in default.
- There must be no outstanding policy loans.

Special Considerations

- If a plan qualifies, no actuarial certification is needed.
- If the plan is top-heavy, it may be necessary to fund top-heavy benefits with a separate "side fund." This would require an actuarial certification.
- To convert an existing plan to fully-insured status, several things must happen:
  - All existing assets must first be liquidated.
  - The net proceeds are then used to purchase single premium annuities for each participant based on their accrued benefits at time of conversion.
  - The difference between the projected retirement benefit and the benefit purchased by the single premium annuities is then funded.
  - It may prove difficult to convert from a fully-insured plan to a traditional defined benefit plan.
- In some cases, if care is not taken, the plan may become over funded.
- Because this is a specialized type of plan, someone with experience in this area is necessary to establish a fully-insured plan.

[1] A "key" employee is someone who, at any time during the plan year was: (1) an officer of the employer whose compensation from the employer exceeded $170,000; or (2) a more than 5% owner; or (3) a 1% owner whose compensation from the employer exceeded $150,000.

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- Converting to fully-insured status may help an "over-funded" defined benefit plan.
- The fully-insured plan is not a universal panacea but may be a useful tool in the right situation.
- In 2004, the IRS issued guidance designed to prohibit certain arrangements that it considers abusive. This guidance prohibits the plan from purchasing life insurance for a participant in excess of the death benefit provided by the plan, requires any policies distributed or purchased from the plan to be done so at full fair market value (not cash surrender value), and requires these plans to provide similar policies in a non-discriminatory manner to all plan participants.[1]

Advantages to Employer

A. Contributions are tax deductible.
B. It can reward long-term employees with a substantial retirement benefit even though they are close to retirement age.
C. Larger contributions for older employees may reduce corporate tax problem, e.g., excess accumulated earnings, high tax bracket current earnings, etc.
D. Forfeitures of terminating employees will reduce future costs.
E. It can provide employees with permanent life insurance benefits that need not expire or require costly conversion at retirement age.
F. A higher initial contribution will be produced than with a traditional DB plan.
G. If former participants do not provide the plan with distribution instructions, the plan may automatically distribute accounts less than $5,000. In the case of a plan that provides for such mandatory distributions, the plan must automatically roll an eligible distribution amount that exceeds $1,000 to a Rollover IRA in the former participant's name. A plan may allow direct rollovers of less than $1,000.

Advantages to Employees

A. Annual employer contributions are not taxed to the participant.
B. Earnings are not currently taxed.
C. Participants may also have a traditional, deductible IRA (subject to certain income limitations based on filing status), a traditional, nondeductible IRA, or a Roth IRA.
D. Distributions may be eligible for 10-year income averaging,[2] or, at retirement from the current employer, rolled over to a traditional or a Roth IRA or to another employer plan if that plan will accept such a rollover. Federal law allows retirement distributions to employees who are at least age 62 even if they have not separated from employment at the time distributions begin.
E. If the plan allows, there is the ability to purchase significant permanent life insurance under the plan. Purchase of life insurance will generate taxable income to the employee.
F. Employee is guaranteed a known retirement benefit.
G. ERISA and federal bankruptcy law provide significant protection from creditors to participant accounts or accrued benefits in tax-exempt retirement plans.

[1] See IRS press release IR-2004-21, February 13, 2004.
[2] Those born before 1936 may be able to elect 10-year averaging or capital gain treatment; these strategies are not available to those born after 1935.

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Disadvantages to Employer

A. In low profit or cash flow years, the employer is still obligated to make contributions, which may be substantial.
B. There is far less flexibility with the level of contribution even if profits are low, than with some other types of plans.
C. Even though an actuarial certification is not required, other administrative costs arise. The administrative costs will be similar to those in a traditional defined benefit plan.
D. Employer contributions may drop dramatically in future years.
E. The employer has no control over the investments.
F. Participants often do not understand the defined benefit plan as easily as they do other types of plans.

Disadvantages to Employees

A. Younger employees may not receive as great a benefit as they would under other plans.
B. The plan concept and details are more difficult to understand.

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