Caution Flags

The 412(i) plan is getting heavy promotion as a valuable tool for older business-owner clients. But does it live up to its advance billing?

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First it was charitable split dollar, then IRC Section 419A(f)6 welfare benefit plans. Soon it could be the 412(i) defined benefit plan. These are hot-button planning issues that are under scrutiny from the IRS for abusive practices. Because 412(i) plans are being aggressively marketed to agents and brokers, and in turn their clients, advisers should be careful. They need to be aware of the proper use of a 412(i) plan and what to watch out for when being pitched by their promoters.

A 412(i) plan is a special type of defined benefit pension plan that is funded entirely through annuity or life insurance contracts. It must follow the same qualification rules as traditional pension plans, including the limits on retirement and death benefits.

But unlike a traditional defined benefit plan, which may be based on 5% to 6% annual investment returns, the 412(i) plan buys annuities from insurance companies that offer guarantees of 2% or 3%. With a 2% or 3% return floor, the 4l2(i) plan allows employers to make significantly higher annual tax-deductible contributions for employees. For example, a company can contribute $100,000 or more to a 412(i) plan for a 50-year-old employee making more than $170,000 a year.

Who are good candidates to use 412(i) plans? Most often, professionals or business owners who want their companies to make large tax-deductible contributions (more than the current $40,000 limit for 401(k) or profit-sharing plans). The businesses get a tax deduction, and the business owners reduce their salary and taxable income to pay for the deduction. A 412(i) can be especially attractive to clients older than 50 who have saved little or no money in a qualified plan or IRA. Often, these clients are divorced and have big large chunks of earlier retirement plans to former spouses. Or they have taken most of their income home every year instead of funding their pension plans. The 412(i) also appeals to clients who are interested in big deductions with guaranteed investment products like annuities or life insurance.

There are several problems that can crop up with traditional 412(i) plans, however. They include the following:

Smaller is better. The more employees that an employer has, the less financially viable the plan becomes, particularly if the employees are older or highly compensated. Because 412(i) plans are governed by ERISA, employers are not allowed to discriminate in funding them. For example, a 50-year-old owner-employee could have the company contribute $100,000 a year on her behalf to a 412(i) plan, but then the company would also have to fund 40% more ($40,000) to the plan on behalf of its employees.

Looking for more. Clients want more than skimpy rates of return for their retirement savings. Deferral just for the sake of deferral means little if the deferred asset grows at a pathetic 2% or 3%. Clients would rather pay income taxes on their money and then invest it in the market or alternatives, where the average return will net out much higher than tax-deferred money that grows at a minimal rate.

Regulatory scrutiny. The regulators are getting skeptical. Specifically, the IRS is starting to look at the use of insurance in 412(i) plans in cases when the client buys the policy from the plan after five years or so at a huge discount to its cash account value.

With these headaches, why are so many advisers promoting 412(i) plans? Simply put, ease and greed, the twin pitfalls of the insurance and financial planning community. Ease, because the plan is easy to sell from a technical standpoint. The consultant can point to the tax code, and a client's CPA or attorney can read the code and approve the plan. Greed, because the agent can counsel a client to put hundreds of thousands of dollars into the plan and earn sizable commissions.

Just because a plan is easy to sell does not mean that an adviser or client should use it for long-term planning. Most agents are getting wind of 412(i) plans from large and eager insurance companies, so even those who don't do much advanced tax research are on the receiving end of these pitches.

In addition, the outsized funding of some of these plans via annuities is attracting advisers who typically would ignore them, since they don't make big commissions from annuities. Today, some companies are allowing clients to put 100% of their 412(i) contributions into a particular type of life insurance policy. Conservative consultants dealing with 412(i) will only allow 49% of the contributions to a plan to be used for the purchase of life insurance.

Promoters are counseling clients to put significant amounts of money into a "sponge" or five-pay life insurance policy. The sponge policy is ordinarily recommended to clients to help avoid the double taxation of money in a traditional qualified plan (typically a client who has $500,000 or more in a qualified plan or IRA who also has an estate greater than $3 million).

The insurance policy, which sucks up the money in a qualified plan like a sponge absorbs water, is specifically designed to have a low cash surrender value (CSV) at the end of the fifth year. So at the end of the fifth year of the 412(i) plan, the client buys the policy from the plan for the low cash surrender value and then waits at least five years before accessing tax-free loans from that life policy.

Why is this good in theory? Follow the numbers for a hypothetical client:

If the client put $250,000 into a 412(i) plan each year for five years as a tax-deductible expense, he would have funded $1.25 million over that period. At the end of the fifth year, the policy's CSV is approximately $250,000. The client then buys the life policy from the 412(i) plan for that $250,000 CSV. The client feels he got a great deal because the cash account value (CAV) of the policy is actually around $1.1 million. (Another $400,000 or more gets eaten up by commissions and policy design.) The client then waits for the surrender charges in the life policy to evaporate and takes tax-free loans from the policy.

Buying an insurance policy with a low CSV but a high CAV seems like a steal because the client only paid 20% of the value of the asset when buying it out of the 412(i) plan. In addition, this strategy is supposed to save the client 80% of the tax on that money, since the client avoids future tax on the bulk of the money that funded the 412(i) plan.

Sounds too good to be true, right? First, advisers should be aware of a potential nasty twist to the 412(i) plan. Some of the five-pay life insurance policies (sponge policies) used in 412(i) plans have almost no flexibility in payment. That means that if a client cannot or does not want to make a premium payment to the life policy, there is no way to lower the internal life insurance costs of the policy without losing substantial cash account value or having the policy become a modified endowment contract.

For example, let's assume the cost of insurance in a five-pay policy is $60,000 a year. In year three, the client cannot pay the premium for some reason. The result will be a huge hit to the policy's account value, since the premium will be paid internally from the cash account value of the policy. This internal payment will drain the cash value, and eventually the policy will surrender itself, unless the client pays more premium. Most clients who get into a 412(i) have no idea how inflexible the plan can be in this area.

Second--and potentially more devastating--the IRS is stepping up its scrutiny of 412(i) plans that are aggressively funded by "sponging" money out of the plans with the five-pay policies. Any time a national marketing campaign is launched with a complicated tax strategy, the IRS tends to sit up and take notice.

The IRS has issued only vague notices on 412(i) plans so far, but that could change. Given its increased focus on executive compensation and abusive tax schemes, chances are good the IRS will target the 412(i) plan and kill it. Aggressive split-dollar and 419A(f)6 plans met a similar fate earlier at the hands of Uncle Sam.

While a properly structured and funded 412(i) plan can be a nice option for the right client, for most clients under the age of 60 it should not be the plan of choice. Do your homework.

Side note:

Real example – Assumption: Client age 50 with no employees who deducts $250,000 a year for five years into a 412(i) plan and corresponding money into the ExTRA Plan, the A/R Factoring Plan, and the Equity Disability Trust. Assume the benefit taken from each plan is from age 60-85.

Outcome:

412(i) Plan – Client could get an income tax free benefit of **$116,552** for 25 years starting at age 60.

Equity Disability Trust (EDT) - Client could get an income tax free benefit of **$143,000** for 25 years starting at age 60. *See the December, 2002 issue of FPM to read about an EDT.*

A/R Factoring - Client could get an income tax free benefit of **$170,673** for 25 years starting at age 60. *See November, 2003 article in FPM on the A/R factoring plan.*

ExTRA Plan - Client could get an income tax free benefit of **$178,036** for 25 years starting at age 60.

This example completely ignores the fact that most clients will have employees where the employer, in order to implement a 412(i) plan, will have to fund sometimes ten's of thousands of dollars into the plan to allow the key owner to contribute.

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