Funding Life Insurance with Pre-Tax Dollars: 401a, 412i, 419e Plans Explained

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By way of introduction, our firm, The Heritage Group LLC, is a full-service, third-party administration and employee benefit firm. We specialize in the world of qualified and non-qualified plans, including 412(i), 419(e) and estate planning with an emphasis on pre tax use of life insurance. Today's program will cover the benefits of using life insurance within a qualified plan and while there are many different formats that we can choose, I am going to cover The World of 4's: Included in this presentation will be the 412(i), 419(e) and 401(a) plans.

Most people do not know the rules as they apply to life insurance and qualified plans. There are many aspects of the tax code which can incorporate life insurance and where we might take advantage of that which the tax code allows. Your clients, once they understand and accept these concepts, will want to buy life insurance. The analogy would be like going to a wholesale store versus a store that sells at retail – wouldn't you want to buy an item on sale versus full fare? It is the same as buying life insurance within a qualified plan – it costs the client less money in real dollars!

Some of the recent changes in law, as well as the economic climate, have given a real boost to the 412(i) world. Specifically, EGTRRA 2001 which affected compensation and contribution limits as well as plan and family aggregation. The new funding limits, uncertain market conditions and demographic changes have had a huge impact on the use of 412(i) programs. There is also the influence of a technique we refer to as "Pension Rescue" which again utilizes life insurance.

We will also cover the world of 419(e). While we will not go into its validity be aware that there exists a plan known as 419A(f)(6) which has become a tax shelter and listed transaction. We will cover what happened in July of '03 as to why the 419(e) plan works and why they can work very well for your clients.

I have spent almost my entire career in the qualified plan and life insurance world which is over 23 years. I am going to try to bring you some of those experiences, some of the situations that I/we have dealt with and how

Funding Life Insurance with Pre-Tax Dollars: 401a, 412i, 419e Plans Explained *(continued)*

you can leave here today feeling good about going to see your clients with new ideas. There are two other things that are going to happen today. You are going to increase your comfort level in working with clients and you are also going to learn techniques which will increase your confidence. The other important point is that you should build relationships with professionals such as us, people in our business and other third-party administrators. These professionals can work hand in hand with you to navigate through the road map of qualified plans and life insurance. Keep that in mind as we go forward.

Let us start with 401(a) plans. The 401(a) profit sharing plan has been in existence for many years. We used to have money purchase plans but now we simply have profit sharing 401(k) plans. As long as the documents are properly structured, within a 401(k) profit sharing plan, you can purchase life insurance. Most people do not use the technique because they simply are not familiar with it. All of our clients are given the opportunity to buy life insurance within the qualified plan because of the advantages it affords. Basically it gives you the opportunity of buying life insurance at a discount. You are paying for the insurance with pretax dollars. As you pay with pretax dollars you also have to pay the "economic benefit" in order to keep that death benefit from being taxable. Further, you have to pay the economic benefit every year. The "economic benefit" is the table 2001 numbers or the applicable term rates that an insurance company may have. You have to claim the "economic benefit" as income in order to keep that death benefit tax-free to your family.

Remember, you may use assets within a qualified plan/profit sharing plan, up to certain levels, to purchase insurance. If you buy insurance with a single pay, using aged money, in other words money that is over two years old within a qualified plan itself, you may use potentially all of those funds for the insurance.

A typical scenario involves something called "pension rescue". "Pension rescue" has had some ups and downs, over the last year, based on proposed regulations concerning the valuation of insurance. This is not new. It is something that has been going on for quite a while and essentially it is detailed in the following example: We have a balance of $2 million in an IRA or qualified plan and we move that $2 million to a profit sharing plan where we then buy a life insurance policy (in the profit sharing plan). The money transferred would buy us a death benefit from $40 to $50 million depending on the age and health of the client. Two to five years down the road we value the contract and get it out of the retirement plan. While it is in the retirement plan, the insurance is still in your estate. We need to get it out of the retirement plan and into a life insurance trust. Once in the trust it is out of the estate and Department of Labor Prohibited Transaction Exemption, DOL 92-6 allows us to transfer the life insurance directly to the irrevocable trust and get it out of the estate day one. That is very, very important for you, as insurance producers, to know.

The big question is, when the transfer occurs, what is the value of the policy? In other words, how do we currently value a life insurance contract? Because of some abuses that existed in the industry, and interestingly the abuses started in the world of 412(i), agents were rolling out these contracts out at ridiculously low values. What is a low value? Normally we would have a value at the end of three to five years of somewhere between 40 to 60 percent of the original deposit within the life insurance contract. What started happening was that the other contracts, contracts in the market which were abusive, were coming in between 10 and 20 percent of premium, so that the arbitrage was tremendous. The IRS said "it is too advantageous" and, as a consequence, they were going to set up a new valuation process. The eventual outcome might be accumulated value or deposits made. Another possibility is the fair market value of the policy. At this point in time we do not know what the valuation of the policy will be. Currently we can still work off of IRS notice 8925 rules until such time as somebody comes out and says exactly how the regulations are going to read. The conservative approach would be to work off the accumulated value at the time of distribution. If the rulings are more favorable, that would be terrific, but at the same time, for now, we will use a very conservative approach. It

Funding Life Insurance with Pre-Tax Dollars: 401a, 412i, 419e Plans Explained *(continued)*

still works because you are buying life insurance within the qualified plan. If the joint estate is over $3 million or in '05 over $3.5 million, the asset could be taxed as high as 80 percent. Therefore, a $2 million estate is going to translate to $400,000 passing to your heirs. If you have $400,000 passing to your heirs, what does that really mean? It means that you're going to pay $1.6 million in income tax and estate tax. If you do not need those assets, why pay tax on them? Why not turn them into a multiple much greater than 20 percent? Why not use insurance and allow the inheritance to multiply 6 or 10 times.

Once we get the multiple in place we present it to the client, even though they're going to have to pay tax on it or buy it out of the profit sharing plan, it still works. If the client does not have a need for retirement dollars, wants to leave a greater estate for their family and does not want the family to pay estate taxes, this is the way to really solve that problem using pretax dollars.

You can see the evolution of the qualified plan world and the "pension rescue" technique with profit sharing plans, so now let us move to the world of 412(i). The 412(i) incorporates life insurance and fixed annuities as a funding vehicle and has been an enormous boon for our industry as a whole, as well as for our clients. Why did 412(i) become so popular? The stock market decided to go south over the last number of years and it is still spotty and as a consequence people have lost a tremendous amount of value within their retirement plans. You have seen $2 million balances go to $700,000. You've seen people that were planning on retiring at 55 now having to work until 60 or 65 because they do not have the accumulations that they need. Over the early years of the '90s, if you went to somebody with a two or three or four percent return they would laugh at you. We sold some 412(i)s over the 90's but it was a lot more difficult to deal with when you had a market that was doing 30, 40, 50, 60 percent a year (now it is easy to sell a 412(i) because people are happy with a guaranteed return.)

The 412(i) has been in the code since 1954 and it really has not changed. It's been around for 50 years. 412(i) has not changed all that much with the exception of people putting different twists onto it. The problem with the different twists was that there were abusive practices taking place, similar to what I said earlier. You have to look at it, first and foremost, as a defined benefit plan. It is a defined benefit plan that must be funded with life insurance and annuities, or annuity only, within parameters that essentially say "I can take care of my insurance needs and I can take care of my retirement plan needs in this one program". There are guidelines and as long as they are followed, the plan will work well. We know that a qualified plan gives you the ability to put away dollars on a pretax basis. The 412(i) cannot discriminate, but we can do a carve-out. Carve-outs are very important and I will cover them later in the presentation.

If we look at the Defined Contribution Plan limitations in '05, they are going to be $42,000 in total. We will now cover the new limits for Defined Benefit Plans (DB) which are going from $165,000 to $170,000. We can fund to the limits as far as benefits go and we are also going to take a look at traditional DB's versus 412(i) and review why the contributions are so different. If we take a 55 year old, earning $165,000 a year, or in this year $170,000 a year, they can contribute to a traditional DB $110,000 and $120,000. In a 412(i) plan, the contribution may be somewhere north of $300,000, and it is primarily because of the interest rate assumptions which are used. The interest rate assumptions that we work with, within the 412(i) world, are between one and a half and three percent. In the world of traditional defined benefits plans, we use anywhere between six and a half and seven and a half percent, depending on where the actuary has a comfort level. When comparing defined benefit plans and defined contributions plans, you need to look at both the upside potential and the down side risk. The big thing about a defined benefit plan, which you cannot ignore, is that the contribution has to be fixed and has to be set up so that permanence is involved within the plan. What does that mean? You must be prepared to make the contribution for a number of years and you may not reduce it during the ongoing

Funding Life Insurance with Pre-Tax Dollars: 401a, 412i, 419e Plans Explained *(continued)*

years. Is there flexibility within these programs? A little bit, but there is not a lot of wiggle room which you would find within a traditional defined contribution plan.

We want to be able to fund these programs, at a specified contribution, for a minimum period of five to ten years. We don't want to be making adjustments to the plan, especially if we have employees. If we have a single-life scenario, we have an opportunity to be a little bit more flexible. Contributions are going to be based on the present value of the future benefits. The price of life insurance is going to be determined by actuarial calculations which I will cover. We will look at this program as a retirement plan that is going to accomplish other things for us.

It is a way for us to buy our life insurance on a pretax basis for family protection. It is a way for us to potentially start to do some estate planning. It is a way for us possibly to use the insurance within a buy/sell scenario. We can use the contributions going into a family partnership to purchase buy out funding. Therefore, we have to look at this as not just a 412(i) defined benefit plan, but rather as a concept which has the ability to solve a lot of different needs. When we look at defined benefit plans versus 412(i) plans, the biggest differences are these:

We never have to worry about over-funding or under-funding the contract.

We never have to worry about what the interest rate assumptions are.

Essentially what will happen is that you will fund the program with annuities and life insurance. You may do 100 percent annuity, but you may not do 100 percent life insurance.

There are two ways to illustrate the 412(i). It can be done with an annuity-only contribution or have insurance and annuity in conjunction with one another. With the combination the insurance portion may follow the hundred times rule, which is one hundred times the monthly benefit. So if you had a $10,000 a month benefit, you can have a million dollars of insurance. Whatever it costs to fund that million dollars of death benefit that is the amount of contribution you would put into the plan itself combined with the annuity or we can run 74-307 (another computation to calculate insurance).

In some cases, and we work with a lot of different carriers, the carriers limit you to 50 percent of contribution going towards insurance and we abide by that. Also, what is unique and interesting in the low interest rate environment is that you will see the insurance (whole life insurance policy), periodically outperform the annuity contract because of the interest rates and guarantees that are being used within the annuity contracts. Some carriers are guaranteeing one and a half percent; others are guaranteeing two or three percent. In a low-interest rate environment the life insurance really works well for the client.

What really should jump out at you is how the traditional DB plan differs from the 412(i): Contributions are much larger. You can put so much more into one of these programs versus any other type of typical plan. You are going to fund the 412(i) in a very short period of time because your earnings are going to be in excess of what your actual guarantees are. Higher earnings will fund in a shorter period of time. What does this mean? It means that the 412(i) will be at maximum funding and the lump sum single amount you may withdraw is going to be somewhere between $1.8 and $2.6 million.

When you reach the point of full funding, no more contributions may be made into the plan and it is at this point that decisions must be made. Traditionally, what I like to do and what I think every 412(i) plan should do, is that when you set up a 412(i) you should also set up with a profit sharing 401(k) plan. It gives you the ability to fund your 412(i) to the maximum and you'll also have the 401(k) plan. With the 401(k) plan you can still make employee contributions so salary reduction contributions still go into the plan. At the point of full funding in the 412(i) we terminate the plan and roll all of the assets and the insurance into the 401(k) profit sharing plan. The 401(k) profit sharing plan does not have any limitations as to how much money may be

Funding Life Insurance with Pre-Tax Dollars: 401a, 412i, 419e Plans Explained *(continued)*

in it. Once the money/insurance is in the profit sharing plan, decisions must be made:

Do I want to keep the single life insurance?
Do I want to have life insurance at all?
Do I have any need for insurance?
Do I want to cash in the insurance?
Do I want to invest the funds in equities?
Do I want to buy real estate with the funds?
Do I want to buy survivorship life?

The bottom line is that whatever was in the 412(i) itself, I can take advantage of in the profit sharing plan. I can also go to the "pension rescue" scenario we described earlier and talk about second to die insurance within the qualified plan. So based upon all of the above and all of the different opportunities, I am really setting the stage for the next step – Estate Planning. That is the primary focus of what we do in the world of 412(i).

There are a fair amount of people that are going to use the funds from the 412(i) for retirement plan purposes and for them it is a tremendous asset. As you know, programs vary with carriers so you must know what assumptions were used. Assumptions change, so today's assumptions will not be tomorrows. Therefore let us always look at the lump sum benefit not the monthly.

I mentioned EGTRRA previously. Let me now cover the benefit limits which just increased. This year we are going to $210,000. As I mentioned previously, as far as compensation, we take into consideration $170,000 in maximum benefit which we can receive on an annual basis from a defined benefit plan. What does this mean for us? It means revisiting accounts and if they are maxing out there is an opportunity to put more dollars into the program on an annual basis. We may have to sit down and do some new underwriting on some of these clients because we have to buy them more insurance in order to facilitate the need by raising the contributions. It is a good way for us also to keep our annual earnings going because there are going to be continued increases within the code itself and as that happens we have to make adjustments for our clients which is always a good reason to speak with them. We review the client's scenarios and see what has changed and also bring them up to date on the new rules and regulations within the world of qualified plans.

Most important – and I can't say this enough - life insurance in this market is tremendous because it minimizes the risk for the client; it really does. The client's risk, in the 412(i) world, has just been reduced because you are dealing with guarantees. When I sit down in front of a client, I tell every one of them (and we have been involved with hundreds of clients), this is not a great investment today, but down the road you are going to be absolutely astonished at what this is going to do for you and how the insurance is going to work for you.

Let us take a look at a few examples of how to market some of the programs and who we should be talking to. I prefer not to look at companies that have over 30 employees for the world of 412(i) and some may say that 30 is too high. At the same time, there is something called a carve-out, which is allowable, and it is implemented based on two different coverage tests. One test the 410b involves Highly Compensated to Non Highly Compensated Employees and the second test 401A26 is a minimum percentage test. We also want to look at who are the ideal prospective clients for 412(i). The obvious are the professionals: doctors, lawyers, CPAs and small business owners. But don't forget some of the more traditional players. I always use the line "does anybody know a poor electrician or poor plumber"? Always look at the trades from that perspective, because they have a lot of union people. When they have a lot of union people you are able to exclude an entire class of employees. We have done a fair amount along those lines. You also want to look at it from a marketing perspective: who else should we really be talking to? I'm of the opinion that if we can have single employers, which is terrific, or we can have companies with five or less employees, maybe ten, it turns out to be a real good number for us to be going after independent of the type of business as long as it has a very consistent level of cash flow. The key is that the company has to contribute consistently, without an issue,

Funding Life Insurance with Pre-Tax Dollars: 401a, 412i, 419e Plans Explained *(continued)*

over a five- to ten-year period of time and that is where the permanence comes into play.

Let us cover a few different examples. There was a firm where we did a carve-out. Essentially there were ten employees: two partners, four other highly-compensated employees and four other individuals who were not highly compensated. They had a 401(k) profit sharing plan in place. They were able to max out contributions. It really wasn't giving key employees the amount of contributions they wanted. I presented a 412(i) in its traditional format covering everybody and I presented the carve-out. Throughout this process we worked with a law firm. In every situation, no matter who, what, where and why, you want the CPA, attorney, or other financial advisors involved in the sale. If you get them involved in the sale at the beginning it will make your life a lot easier going forward. Try to get the professional advisors in there day one. What I was able to accomplish based upon the coverage test, was to cover the two principals and two of the other non-highly compensated individuals. I was able to eliminate four highly compensated individuals which let my ratios drop so I could discriminate against the non-highly compensated and now cover the two owners at $500,000 (aggregate) with $17,000 going to the two non-highly compensated individuals. What a terrific case we were able to put together only because we followed the rules. As long as you follow the rules with the carve-outs it works like a charm. That is why you should never discount larger employers because they might fit within the world of 412(i).

Another example, which we worked on, was a single physician with an assistant. Essentially what we can do here is have the assistant and the doctor put the plan together. How does it work? The concern is getting the doctor more contributions? How do we put more money in on an annual pre tax basis? Here you take one assistant earning $40,000 a year and have a profit sharing plan putting $60,000 a year into it for both; $20,000 for the assistant, $40,000 for the doctor. It's okay for him, but he wants to do a lot more. The plan I was able to put together accomplished the following: I put $30,000 in for the assistant, which is ten thousand more than was going in before, but the doctor has $287,000 going into the pot and he's thrilled to do it because he doesn't need the income. Do not assume that the employer's will not make contributions to the employees, because they will. They most definitely will.

But as good as 412(i) is and all the marketing opportunities that exist there, we have all those coverage tests. We have to cover all the other employees unless we have the perfect scenario, what I refer to as "where the stars and moon line up the right way". The 412(i) is not the cure-all for everybody's needs. So we do have to have other alternatives which allow us to use life insurance in a pre-tax scenario.

One of the alternative scenarios is the 419(e) Single Employer Welfare Benefit Plan and Trust. After the new regulations came out pertaining to the world of 419, a year ago, we decided that we could live with the new regulations. We were very uncomfortable about A(f)(6) because of the intricacies and abuses we felt were taking place. We liked the idea of 419(e) program. We decided to develop our own trust. We have the rules that we were going to live by, and 419 is a great alternative for clients as far as that need to buy life insurance. The reasons are as follows:

The single employer plans, based upon the July 16, 2003 rulings, are not affected in a negative way. We are using the (e) program, which is a non-controversial plan and all contributions are tax deductible.

The plan allows for deferred growth and is a death-benefit-only plan. Contributions are not taxed to the employee with the exception of the imputed income numbers, which was covered previously, namely the PS58 cost - table 2001 or alternative term rates of the insurance company.

The single employer plans are subject to IRS rules but are single-employer plans subject to IRS rules of qualified plans? The answer is no, they are not a qualified plan. There are no penalties for early withdrawal, and no complicated compensation issues to be dealt with. The plan is subject to ERISA and you still have to make sure

Funding Life Insurance with Pre-Tax Dollars: 401a, 412i, 419e Plans Explained *(continued)*

that we do things the "right way". Here again, we have to have an Adoption Agreement and a Summary Plan Description. We also have to do a 5500 and the trustee is subject to all the fiduciary liabilities and disclosure reporting required for ERISA but it is not an ERISA plan. The question is what is the benefit that the 419(e) plan provides? The answer is <u>Life insurance</u>. The 419(e) provides a death benefit and most importantly, all the dollars going into the 419(e) are on a pretax basis. How do you calculate the death benefit? The basic rule that you work with is that the death benefit cannot be more than 20 times the annual earnings of the participant. If you have a client making $100,000 a year the maximum death benefit is $2 million. If you have a client making $1 million a year, it is $20 million in death benefit. The cost to fund that death benefit is the necessary cost of maintaining the policy to retirement. Essentially the qualified direct cost is the levelized premium for the working life of the employee. Therefore, the death benefit itself goes through the employee's working life. That is how the death-benefit-only programs work. The asset is protected from creditors and could also be out of the estate.

There is no employee vesting. Keep that in mind. When you terminate one person you are terminating the entire trust. Can you use multiple trusts? Maybe! Can you get this asset out of your estate? The answer is yes, you can. It is a great estate-planning tool. How do you get it out? If you want to remove the death benefit out of your estate day one, an irrevocable beneficiary must be named. If you name an irrevocable beneficiary such as an ILIT and make that decision day one then the proceeds are out of the estate. That is why the 419(e) makes a very good estate planning tool.

Once the program is established what are the exit strategies or how do you move from A to B? Within the program itself there are two ways out - death or cash out. There is no rollover. There is no buyout. There is nothing fancy as far as how are we going to get the assets. If you die, that is it. If not, you take the cash and transfer it.

Remember, we pay income tax on any of the distributions. 419(e) is not a retirement plan. We cannot make it look like a retirement plan. Is there a cash value affiliated with it? Absolutely! Can the client take that cash value? Yes! It is not subject to a penalty prior to 59 ½, which is even better.

Now I have the ability to purchase all of my insurance for business purposes, family purposes, and estate tax purposes using pretax dollars. Who should consider this type of benefit? Any type of business, including an S Corp., C Corp., LLC, etc. Especially companies with funded retirement plans where we are not able to get the majority of the contribution going into the plan on behalf of the owners. What is nice is that the plans allow for a certain amount of discrimination because we now have certain ratios that we want to maintain, i.e. for every three highly compensated individuals that we have, we want to maintain one non-highly compensated employee. If any one of those employees were to leave, prior to the plan terminating, all these benefits stay within the firm itself and are distributed among the remaining participants based on the percentage share.

Every year we are going to make contributions and those contributions may vary. As in a 412(i) plan where we have to maintain a pretty stringent rule, it has to be actuarially sound but by the same token, we can make adjustments in contributions. Again, we have no obligation to make fixed payments. The employer maintains the right to make changes. What I do suggest, though, to keep it even more an arm's length transaction, is that we use an outside trustee such as a bank. The bank is the actual owner and trustee of the contract. I like to name another person who has the right to make a change within the plan. Preferably an individual that does not have direct control over the checkbook, i.e. accountant. It is one step removed as far as having the plan be more legitimate in the world of 419(e) because the owner of the firm isn't the only one who can make a decision within the plan itself.
Now, in making the contributions to these programs you have to make your contribution by the end of the fiscal year. Employers reporting on an accrual basis have until 75 days after the fiscal year ends. At that point, it is not like a qualified plan where you have to contribute the

Funding Life Insurance with Pre-Tax Dollars: 401a, 412i, 419e Plans Explained

dollars up to tax filing deadlines and extensions. These funds have to actually be deposited by the end of the year. Even though the program is not in place, and possibly all the insurance is not in place, as long as the contribution is taken care of prior to the end of the year we are in good shape. What type of insurance can be used; all types. We can use UL, variable, whole life or second to die (the spouse should be an employee of the firm, but we can use second to die).

When we take a look at 419(e), 412(i) and 401(a) plans as a whole, all we are really doing is showing our clients better ways to buy after-tax benefits with pretax dollars. That is what it really rounds itself down to.

Today I have touched on a number of topics. There happens to be a lot more detail that we can go into on each one of these topics. We can probably write 50 pages and still not be done. At the same time we can sit up in front of you and talk for hours on any one of these topics. But essentially what I wanted you to get out of this presentation was to be able to say this may make sense for some of my clients. It is an opportunity I should take a look at discussing with my clients or maybe even marketing to people with whom I have had success in the past.. We have done that on a national basis with our business. We have gone out of our comfort zone. I am getting attendees at meetings to think about it all the time. When I present at a seminar, attendees walk out saying, "I have somebody for this." or "this makes sense", whether it is a CPA, an attorney or a financial advisor.

In conclusion, remember to get your CPAs in the game early. You need to have them along with a good quality third-party administrator and know your material cold and you will be very successful in your marketing efforts within these programs.