

412(i) Defined Benefit Plans

Description of 412(i) Plan

A 412(i) plan is a type of retirement savings plan that was developed to provide retirement income with either an individual annuity contract or with annuity and life insurance contracts that fully guarantee the cash value *before* retirement and the benefits *after* retirement, in accordance with terms specified under Internal Revenue Code Section 412(i).

A 412(i) plan is a “defined benefit” as opposed to a “deferred compensation” plan. In a defined benefit plan, the amount of benefit to be *received from* the plan is defined at the inception of the plan, usually as a percentage of a participant’s compensation, and the contract and consequently the premium are designed to provide and guarantee that specific benefit amount. In a defined contribution plan, the contribution amount is determined, but the amount of benefit eventually available will depend upon the total contributions and earnings accumulated in the plan over time.

Advantages:

- Risk is eliminated because the 412(i) plan is funded with a fully guaranteed annuity contract or an annuity and life insurance product, rather than with an investment or securities-based product.
- Benefits accruing in the plan are always equal to the cash value of the underlying contract.
- Since a 412(i) is categorized as a type of “qualified” retirement plan, contributions to the plan are deductible as business expenses. Designed properly, deductible contributions may be significantly larger than what is allowable with other types of plans.
- The plan sponsor is not required to engage in an “enrolled” actuary or file Schedule B or Form 5500.

Description of Northwestern Mutual's RAI Product for Funding 412(i) Plans

Northwestern Mutual's Retirement Annuity with Insurance (RAI) product was specifically designed to fund retirement benefits under the requirements of IRC Section 412(i).

Features and benefits:

- Eliminates investment risk that a defined benefit plan sponsor typically assumes; guarantees cash values *before* retirement and payment of benefits *after* retirement.
- Accommodates lump sum contributions at issue so that assets from existing defined benefit pension plans can be converted to a 412(i) plan.
- Generates a guaranteed cash value at a rate of 4.5%, after expense loads.
- Guarantees benefits as projected, as long as premiums are paid until the maturity date (maximum maturity age is 70).
- Participates in the general account dividend rate, which adds to the yield.
- Based on level premium payments until the maturity date, reduced each year by dividends.
- Requires annual premium payments; grace period ends 31 days after the annual premium due date.
- Offers two optional benefits:*
 - Decreasing term life insurance (*benefit of 100 times the projected monthly income*).
 - Waiver of Premium benefit (*premiums are paid by Northwestern Mutual upon the disability of the annuitant*).
- Has no policy fees.
- Policy proceeds are available only with a full surrender or via election of a payment plan.

**The cost of insurance is considered a taxable economic benefit to employees and is measured by a federally determined rate called a PS-58 rate. Employers are not able to deduct the cost of providing the waiver of premium benefit. In the state of New York, the decreasing term life insurance benefit is required.*

Eleven Reasons Why 412(i) Plans Are Still Viable

These developments (other than Revenue Ruling 2004-21) are aimed at curtailing the use of certain arrangements that skew the benefits already afforded by Section 412(i) plans. They do not undermine the general utility and viability of code sanctioned legitimate Section 412(i) plans, which offer at least eleven important advantages over other retirement plans.

First, these plans provide a front-loaded contribution pattern that accelerates employer deductions and, thus, magnifies the economic advantages of tax deferral. The annual contributions to the usual trusted non-fully insured plan generally start at a relatively low level, and then increase, as the participant ages, receives higher compensation, and serves more years, and benefits continue to accrue. In a fully insured plan, however, the plan is required to use a level-funding approach, thereby maximizing the initial years' deductible (premium) contributions. Thus, there is a very significant time value of money advantage to a 412(i) plan.

Second, investment assumptions for fully insured funding vehicles are generally conservative, tending to increase the initial contributions. In later years, positive investment results or dividends from participating contracts can reduce the costs.

Third, these plans shift the risks from an employer to an insurer willing to provide guarantees and make conservative investments. All benefits are guaranteed by the third-party insurer, so the employer's investment risks are minimized, as long as the premiums are fully paid.

Fourth, these plans may be easier and less expensive to administer and to explain than many other retirement plans.

Fifth, participants entering these plans after a certain age (depending on the actuarial assumptions, but generally in their early 50s), can make a contribution significantly higher than \$41,000, the cap for contributions to defined benefit plans.

Sixth, these plans are exempt from the funding requirements of Section 412, including the minimum funding standard account, the full funding limit, quarterly contributions, and the Enrolled Actuary Requirement, and are deemed to meet the Code's benefit accrual rules. To some extent, this reduces the overall costs of 412(i) plans.

Seventh, these plans are eligible for the simplified Form 5500 Series ERISA reporting requirements. This tends to lower both the costs and record-keeping problems.

Eighth, these plans have no direct actuarial costs, minimizing the employer's administration expenses, though they are subject to the Pension Benefit Guaranty (PBGC) coverage and annual premium requirements.

Ninth, it is relatively easy to calculate and explain benefits under these plans.

Tenth, these plans avoid excise taxes and income taxes on reversion, because by design they can be neither over – nor underfunded.

Eleventh, balance sheet liabilities under Financial Accounting Standards Board Standard 87 should be eliminated with a Section 412(i) plan, due to the fully funded nature of the plan.

THE BOTTOM LINE:

The end result of the new guidance will be to curtail valuation gaming and discriminatory practices with respect to life insurance in qualified plans and in employer-employee transactions.

And it will clear the air with respect to what is – and what is not – a viable 412(i) plan.