412(e)(3)

Fully Insured Defined Benefit Plans

Life's Goals

You've been successful in business

Now you want to extend that success to your personal life

You've worked hard over the years to build a successful business. You've put in long hours, re-invested a substantial portion of your profits back into the business, and you're pleased with the success you've been able to attain.

But while your business and current lifestyle may finally be on solid ground, your future financial security – in particular your retirement savings – may not be. As many self-employed and small business owners eventually come to discover, building a successful business doesn't always leave a lot of time for personal planning. Still, you know there are important financial concerns you need to address.

- First, because most of your profits have been re-invested in your business, your retirement accounts may be seriously under funded.
- Second, even though you may now be in a position to set aside extra money for retirement, federal tax law limits the contributions you can make to your 401(k) or other retirement plans. Plus, under most such plans, the "lion's share" of any plan contributions may be allocated to your employees.
- Third, even if you could pull money out of your business, the income taxes on such a transaction would be prohibitive.
- Fourth, because you're now so much closer to retirement age than when you first started the business, you may be hesitant to risk your savings in investments that could be adversely affected by market volatility.

So what can you do to address these concerns? The solution may be a Fully Insured Defined Benefit Pension Plan, also known as a 412(e)(3) plan.

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What is a 412(e)(3) plan?

A 412(e)(3) plan is a defined benefit pension plan funded with annuity and life insurance contracts or a combination of both. Because plan benefits are based on guarantees built into the contracts which fund them, 412(e)(3) plans allow for substantially larger tax-deductible contributions in the early years of the plan than are allowed under 401(k) and other Defined Contribution plans, including age-weighted plans.

In 2011 for example, tax-deductible employee contributions to a 401(k) plan are limited to $16,500. Contributions to an age-weighted plan – even with the majority of contributions shifted to older employees – are capped at $49,000 per participant (or 100% of pay, whichever is less). 412(e)(3) plans, however, have no such limitations, and early contributions often can be more than $100,000, if desired.

412(e)(3) plans typically have four features:

- They are funded solely with individual life insurance and/or annuity contracts that are part of the same series and use the same mortality tables and rate assumptions for all participants.
- The insurance/annuity contracts funding the plan have level premiums for all benefits. Payments (contributions) begin when a participant enters the plan and may extend no later than the retirement date stated in the plan.
- All plan benefits must be provided by the insurance/annuity contracts, and an insurance company must guarantee the contracts, thus making the plan "fully insured." (Note: All guarantees are based on the claims-paying ability of the issuer.)
- Plan participants may not take loans from the plan.

Who can benefit most from a 412(e)(3) plan?

412(e)(3) plans work best for business owners with highly profitable small businesses or professional practices that have relatively few employees. Ideal candidates for 412(e)(3) are business owners who are age 45 or older, or who are within 10 to 15 years of retirement, who are able to commit to regular plan contributions over several years, and who are older than the firm's other employees.

Because life insurance can be included in a 412(e)(3) plan, individuals and business owners with dependants, or those who need life insurance protection, are also good candidates. What's more, this life insurance protection can be purchased on a tax-deductible basis.

How does a 412(e)(3) plan work?

One of the more attractive features of 412(e)(3) plans is their simplicity: they provide a pre-determined benefit at retirement that is fully guaranteed through the purchase of life insurance and/or annuity contracts. Each year, only the amount of money needed to fund the guaranteed benefits can be paid into the plan. Thus, unlike traditional defined benefit plans, no actuarial certification is needed, and the plan cannot be over or under funded due to investment results, market volatility, or other external forces. In a 412(e)(3) plan, if dividends are paid on the underlying contracts, or if the interest earned in the underlying contracts exceeds the contract guarantees, these extra earnings are used to reduce plan contributions in the following year.

Establishing a 412(e)(3) plan is also simple. Initial tax-deductible contributions are determined based on your age (and, if applicable, the ages of your employees), the number of years to your normal retirement age, the amount of benefit you select, and the guaranteed purchase rates of the underlying life or annuity contracts which are being used to fund the plan. Because these are all known factors, investment risk is minimized. From that point on, annual tax-deductible contributions are determined each year for you and your participating employees. And because life insurance and annuity contract guarantees are considerably lower than the interest rates used to calculate funding for traditional defined benefit plans, your early contributions and tax deductions will be higher in a 412(e)(3) plan.

At retirement, you can choose to receive benefits in a number of ways. The maximum benefit is 100% of your highest consecutive three years of average compensation, up to $195,000* per year (2011), or you can roll all or a portion of your retirement benefit into an IRA, allowing you to continue enjoying ongoing growth and tax-deferral. (When you reach age 70 1/2, however, you generally must begin taking required minimum distributions.) If you choose this second option, the amount being rolled out must comply with certain limits imposed by Internal Revenue Code Section 415. Your Penn Mutual representative can explain these limits to you in greater detail.

*This amount is reduced if benefits are taken prior to age 62.

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Addressing business concerns

412(e)(3) plans can be a solution for the problems facing successful business owners and self-employed individuals. To illustrate the power and flexibility of 412(e)(3), let's go back and revisit the four major concerns we identified earlier, and see how a 412(e)(3) plan could help.

Concern number one: Because most of your profits have been re-invested back into your business, your retirement savings may be seriously underfunded.

> It's no secret that many self-employed business owners spend years re-investing their profits back into their businesses. If you've adopted such a strategy – either by choice or necessity – you may now be faced with a serious cash shortage at retirement. Traditional retirement savings plans such as a Simplified Employee Pension (SEP) or 401(k) might help, but these types of plans limit both the amount of money you can set aside and the tax deduction you can take for doing so. Let's face it – if you've got just 10 to 15 years (or less) to play "catch up" with your retirement savings, the traditional methods aren't going to cut it. You need to make substantial contributions and you need to take equally substantial tax deductions. With a 412(e)(3) plan, you can do both. A 412(e)(3) plan will allow you to set aside upwards of $100,000 or more each year, and every dollar you contribute will be completely tax-deductible. What's more, your earnings will accumulate on a tax-deferred basis, and your benefits will be guaranteed.

Concern number two: Even though you may now be in a position to set aside considerable sums for retirement, federal tax law limits the contribution you can make to traditional defined benefit or defined contribution plans. Plus, under such plans the "lion's share" of contributions may be allocated to your employees.

> We've answered the first part of this question already – you can set aside substantially more money into a 412(e)(3) plan than you can into any other type of defined benefit or defined contribution plan. But what about having to allocate the lion's share of contributions to employees? Under a 412(e)(3) plan, there is no such requirement. Higher contributions can be allocated to owners and key employees, especially if they are older than the other employees.

Concern number three: Even if you could pull money out of your business, the income taxes on such a transaction would be prohibitive.

Among the many attractive features of 412(e)(3) plans is the ability to transfer assets out of a business and into a personally-owned life insurance policy while minimizing income taxes. Initially, the pension plan purchases the insurance or annuity contracts funding the plan – resulting in an annual tax deduction. At a specified point in time, the life insurance policy can be transferred to you – either you can purchase the policy for an amount equal to its cash value, or it can be distributed to you and you will be taxed on its current value. Depending upon the type of policy purchased, cash values could still be fairly low, resulting in minimal tax consequences. After the policy's cash values have grown – in most cases, substantially – during the later years, you could access those values to supplement any other retirement income you may have.

Concern number four: Because you're now so much closer to retirement age than when you first started your business, you may be hesitant to risk your savings in investments that could be adversely affected by market volatility.

Again, because 412(e)(3) benefits are guaranteed by the life and annuity contracts through which they are funded, they aren't subject to investment fluctuation or market volatility. You can choose the amount of retirement income you want and have the peace of mind that comes with knowing your benefits will be there when you're ready to retire.

412(e)(3) plans can provide guaranteed retirement benefits.

What are the advantages of a 412(e)(3) plan?

412(e)(3) plans have a number of advantages, chief among them their simplicity and guarantees. The accrued benefit at retirement for all participants is simply the cash value of the underlying life insurance and annuity contracts – an amount that is known in advance and guaranteed. This feature alone makes it easy for participants to plan for retirement. Other advantages include:

- Contributions are income-tax-deductible
- High early contributions and tax deductions
- No full-funding limitations or current liability test to limit contributions
- No possibility of over- or under-funding the plan
- The availability of life insurance
- No required actuarial certification
- Low administration costs
- Protection from creditors
- No quarterly contributions are required
- The ability to favor older participants.

Potential disadvantages include:

- Because contributions are fixed and must be made each year, only well–established, highly profitable businesses should consider a 412(e)(3) plan.
- No policy loans can be outstanding at year-end.
- There is no investment flexibility – the plan must be funded entirely with insurance and annuity contracts.
- There may be limitations on the deductions or the amount of life insurance that is purchased.

Commonly asked questions

Q: Who may participate in a 412(e)(3) plan?

A: Sole Proprietors, Partnerships, Corporations, and just about any business entity may benefit from a 412(e)(3) plan. 412(e)(3) plans are most advantageous, however, for self-employed individuals and owners of small, well-established, and highly profitable businesses who need to play "catch up" with their retirement savings; who are looking to maximize tax deductions; and who want to provide substantial retirement benefits to themselves and key employees.

Q: What are the tax ramifications of 412(e)(3) plans?

A: Contributions to a 412(e)(3) plan are income-tax-deductible and plan accumulations grow income tax-deferred. Benefits are taxable as ordinary income, and benefits received prior to age 59½ may be subject to an additional 10% penalty tax.

Q: Is there a cost to employees?

A: It depends upon the design of the plan. If life insurance is included in the plan, participants will owe a small amount of income taxes on the "current economic benefit" provided by the plan.

Q: What is the maximum amount of money that can be set aside?

A: While there is no established limit to the amount that can be contributed, the contribution will vary depending upon the age of the participant and the amount of retirement benefit he or she chooses. But because they are based on conservative life insurance and annuity guarantees, contributions could be as much as three, four, or five times more than those generally allowed under traditional defined benefit or defined contribution plans.

Q: Can an employer skip a year of funding?

A: No. 412(e)(3) plans must be funded each year in order to retain their status.

Q: Who must be included in the plan?

A: All full-time (more than 1,000 hours annually), non-union employees who have completed one year of service and are age 21 or older generally must be covered under the plan, which is one of the reasons 412(e)(3) plans are best suited for companies with only a few employees.

Q: If insurance is included in the plan, what happens to the policy at retirement?

A: At retirement, the policy can be transferred to the participant, who can elect to continue the policy, or the policy can be surrendered for its cash value. If the participant elects to keep the life insurance, he or she will own the contract individually. With proper planning, the proceeds may be sheltered from estate taxes.

Q: Can a 412(e)(3) plan be adopted in conjunction with another retirement plan?

A: Yes. However, how this is accomplished will depend on what the other retirement plan is. Your Penn Mutual representative can advise you further in this regard.

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Could a 412(e)(3) plan could be right for you?

For all of these reasons, 412[e][3] plans are becoming the solution of choice for individuals seeking a secure financial future. Working together, we can tailor a plan to meet your particular situation. But don't delay. The longer you wait, the less you'll have when you need it.

A secure financial future doesn't happen by accident.

It requires:

- Examining your current circumstances
- Identifying your goals and objectives
- Developing a plan to achieve those goals and objectives
- Taking action to implement your plan
- Periodically reviewing your plan.

The tool that helps us gather the appropriate information to begin this planning process is referred to as a fact-finder – a series of questions specific to your unique situation. You can rest assured that all the information that you provide will remain strictly confidential.

Once we have a good understanding of your current situation we will be better prepared to serve your needs, both now and in the future.

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