GRECO
PLANNING GROUP

# 412(i) aka: 412(e)(3) Plans/Turbo – Charge your Pension Plan

There has been a great deal of buzz in the financial planning industry regarding 412(i) aka: 412(e)(3) pension plans mainly because of the massive tax deductions these plans offer the small business owner. These deductions can be as high as $450,000 for a sole proprietor! Yet most professionals do not understand the mechanics of the plan, or worse, understand only half of the story.

Financial planners often confuse 412(i) aka: 412(e)(3) with section 419A(f)(6) plans, an aggressive welfare benefit plan that has recently come under fire from the IRS. 412(i) aka: 412(e)(3) plans, however, are actually quite conservative. This plan is simply a type of defined benefit pension plan that invests only in guaranteed investments. Although part of the I.R.S. Code since 1954, 412(i) aka: 412(e)(3) plans have only recently regained their popularity with the small business owner in part due to several factors, of which include:

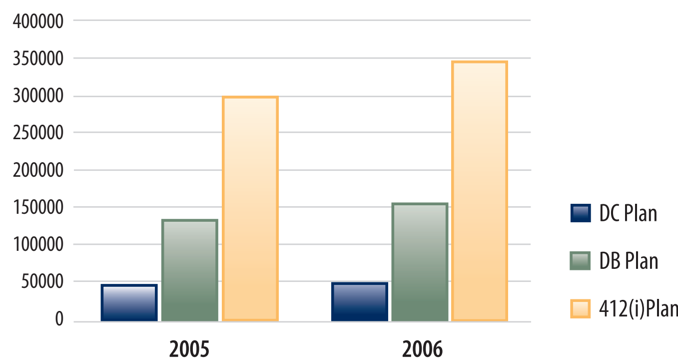
> Recent tax legislation
> The Aging of the "Baby Boomers"
> The Stock Market Debacle

## Recent Legislation

Over the past several years we have seen a great deal of positive legislation enacted in the area of qualified pension plans. The goal is to provide incentives for companies and business owners to sponsor plans for themselves and their employees. The incentives include greater tax deductions, more flexibility, and less cost & administration.

One of the major reasons defined benefit plans are making a strong comeback is due to the repeal of section 415(e). Section 415(e) put a combined limitation on one's defined contribution plan and defined benefit plan. Contributions to one plan offset future contributions to the other and vice a versa. Defined contribution plans include 401(k) plans, profit-sharing plans, money purchase plans, and SEP plans amongst others. Since its repeal, business owners are once again able to take advantage of the large tax deductions afforded by defined benefit plans without regard to their accumulated account balance in their defined contribution plan.

The Economic Growth Tax Reconciliation and Relief Act (EGTRRA) was the most sweeping reform in the pension field that we had seen since 1974. EGTRRA accomplished a number of things for the business owner: First, it increased the amount of income that we may recognize. Second, it increased the amount of benefit we can fund for a defined benefit plan. Lastly, it lowered the age that one can begin collecting this benefit to age 62. What this adds up to is tax-deductible contributions that are 30% to 40% higher than the previous year. Consider the following example for a 55-year-old earning $210,000+ in income and retiring at age 65.




## "The Baby Boomers"

Many small-business owners and professionals have put off saving for retirement for a variety of valid reasons which include investing money in their business or practice, paying for their children's education, or even to just enjoy some reward during their working years. Now with a stable and growing income, they are looking for a means to catch up in a fairly short period of time. Since defined contribution plans are

limited to contributions of $42,000 in 2005 and $44,000.00 in 2006 per person, per year, the plan will not provide sufficient contributions to fund their retirement goals. Defined benefit plans are not subject to this limitation; defined benefit plans allow contributions to create a future stream of income that affords one a comfortable retirement mainly because these contributions are often in excess of $150,000.

## The Stock Market

The past several years have shown us that we cannot simply rely on investment return to carry us into retirement. The latest bear market will not soon be forgotten. Investors are rediscovering asset allocation and are looking at conservative investments more seriously.

## The 412(i) aka: 412(e)(3) Advantage

What is unique about 412(i) plans is that they must be invested only in investments that pay a guaranteed rate. More specifically, they may only be invested in fixed annuities and whole life insurance. When I first heard that, I thought to myself "That is the dumbest thing I have ever heard. Who in their right mind is going to invest their retirement plan in fixed annuities and life insurance?" But, consider this: When we fund a traditional defined benefit plan, we are using investment growth assumptions of 5.25 % to 8 %, which is within the IRS guidelines. When we fund a 412(i) aka: 412(e)(3) Plan, we are allowed to use the guaranteed minimum interest rate of the insurance products for our investment assumptions. This is usually from 1.5 % to 3 %. Since we are assuming a lower rate of return on our money, now and in the future, it requires a larger tax-deductible contribution to fund the same benefit at retirement. In other words, there is an inverse relationship between investment return and required contributions. Because of this, the 412(i) aka: 412(e)(3) Plan can create tax deductions that are double or even triple that of a traditional defined benefit plan and seven to eight times greater than a defined contribution plan. One of the options with a 412(i) aka: 412(e)(3) is to eventually terminate it. The plan is to front-load the contract with as many tax-deductible dollars as possible, maintain the plan until it is fully funded and then terminate it. At that point, the assets can be rolled over to a profit sharing plan or IRA and reinvested with tax-deferred growth in any allowable investment. This includes stocks, bonds, mutual funds and real estate.

## Additional Benefits of a 412(i) aka: 412(e)(3)

**Low Cost** - Since the plan is guaranteed by the insurance company, an actuary is not needed. It also eliminates much of the costs associated with the Pension Benefit Guarantee Corp. insurance (PBGC). With the recent bankruptcies filed, the PBGC will be increasing its cost to remain solvent. 412(i) aka: 412(e)(3) plans, however, will not be affected.

**Easy to Understand** – The business owner and the employees know exactly how much will be in their account at the end of year 1, year 2, year 3, etc. . .

**No Investment Risk** – Everything is guaranteed. The plan is never over funded or under funded. The employer is not liable for choosing investments.

**Creditor Proof** – Many professionals, especially doctors, accountants, engineers and architects look for ways to shelter money from creditors and potential lawsuits. Pension Plans are completely creditor proof and the 412(i) aka: 412(e)(3) Plan shelters more money than any other type of pension plan.

Keep in mind that because of the large contributions for 412(i) aka: 412(e)(3) plans, they are not for everyone. They work best for small closely held companies (10 employees or less) where there is disparity in age and/or income between the owner and the employees. Groups up to thirty employees can work, but require additional planning. All types of companies qualify for adopting a plan including C-corps, S-corps, PCs, and LLCs.

This is truly one of the most exciting developments in the qualified plan arena in decades. The 412(i) aka: 412(e)(3) aka: 412(e)(3) plan addresses several of the most common needs of our wealthier clientele. It creates large income tax deductions today and a large tax-advantage flow of income at retirement. It may be designed with estate planning in mind or business planning with a buy-sell agreement. Lastly and most importantly, it is one of the safest investments available.