COMPLIANCE

IRC 412(i) ABUSES: WAS THE IRS INITIATIVE OVERKILL?

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An IRC §412(i) plan is a defined benefit plan that's funded entirely by life insurance policies and/or annuity contracts. Recently IRC §412(i) has become §412(e)(3) but it will be referred to herein as §412(i). The employer pays the premiums on the insurance contracts. The participating employees receive an annuity at normal retirement age and may also have a death benefit paid by life insurance owned by the plan. The advantage for the employer is that, unlike defined benefit plans funded under IRC §412, they don't bear the risk of the investments underperforming expectations, which would result in the employer needing to contribute more to fund the promised benefits. Offsetting this benefit to the employer is the fact that the guaranteed rate of return on the insurance policies and annuity contracts are traditionally very low, usually no more than 3 percent per year.

However, in the post 2008 economic world, the conservative alternative to the traditional defined benefit plan offered by a 412(i) plan could have had an important place. At a time when a 3 percent guaranteed return and a lifetime annuity is very appealing to many employers and employees alike, the 412(i) plan has effectively been eliminated by the attacks of the IRS.

BACKGROUND

In the late 1990s and early 2000s, insurance companies developed life policies specifically

designed for use in 412(i) plans. These policies had high loads, high mortality charges, and high initial surrender charges. Consequently, the policies had low initial cash values, high premium costs relative to their cash surrender value, and high death benefits. In general, the 412(i) plans using these products were designed to create larger contributions for about the first five years. Thereafter, the policies could have been sold to the participant at their cash surrender value, and some policies had special provisions allowing for later conversion to another type of policy. In short, these types of 412(i) plans achieved the ultimate goal of all taxpayers—they provided for larger contributions and deductions with no comparable tax cost at a later date, and without an adverse economic impact.

Unfortunately, many pension representatives designing 412(i) plans at the time didn't follow the requirements of 412(i), or even the general coverage and participation requirements for qualified plans, so there was a perception by the IRS that all 412(i) plans were either "abusive" or merely non-compliant. Many plans did fail to satisfy the requirements of 412(i) and didn't determine the appropriate contributions required subsequent to the first plan year. However, there were 412(i) plans that did follow all the existing guidance for qualified plans, including the requirements of IRC §412(i).

2004 – THE IRS 412(i) INITIATIVE

On February 13, 2004, the IRS issued several items of new guidance aimed at curtailing what they believed to be abusive practices. In a nutshell, the IRS guidance attacked these arrangements by:

1. eliminating the current deduction for the premium attributable to insurance in excess of the participant's death benefit under the plan (Rev. Rul. 2004-20);
2. requiring that the true fair market value of the policy be included in income at the time the policy was sold or distributed to the participant [Reg. 402(a) and Rev. Proc. 2004-16];
3. requiring that all participants in the plan have identical types of insurance policies (Rev. Rul. 2004-21).

ITEM #1

In order to understand Rev. Rul. 2004-20, it's first necessary to know what constitutes the "incidental benefit rule" for defined benefit plans. Rev. Rul. 74-307 states, in part, that pre-retirement death benefits under a qualified plan are considered incidental if they don't exceed 100 times the anticipated monthly normal retirement benefit.

Alternatively, if the maximum amount of premium used to purchase life insurance is no more than two-thirds of the theoretical individual level premium cost of the normal retirement benefit for whole life policies, one-third for universal or term policies, then the pre-retirement death benefit may equal the face amount of the life insurance policies, plus the theoretical individual level premium reserve, minus the cash value of the life insurance policies, and still be considered incidental. This is the "reserve" method of Rev. Rul. 74-307.

Rev. Rul. 2004-20 stated that if a 412(i) plan was funded with both annuity contracts and life insurance policies owned by the plan, and the plan was the beneficiary of the life policies, then it was permissible under IRC §401(a) for a 412(i) plan to own a life policy with a face amount in excess of the participant's death benefit payable under the plan.

The IRS further ruled that the death benefit provided under the terms of the plan and payable to the beneficiaries of the insured participant must not be greater than the amount permitted under the incidental benefit rule. Any amount of premium paid above the amount needed to purchase the death benefit payable under the plan was deemed an investment of the plan. The excess portion of the life insurance after the insured's death would be used to fund benefits for other participants.

As a result of this bifurcation of the life insurance premium, only the portion of the premium needed to pay for the death benefit payable under the plan is permitted to be deducted in the year paid. The remainder must be amortized over future years.

Prior to this ruling plan sponsors took a current deduction for the entire premium. Under the new rule, because the excess portion of the premium was required to be amortized and deducted in future years, the excess portion of the contribution was subject to an excise tax under IRC §4972 of 10 percent, pyramided each year until the excess was fully eliminated. The IRS identified the situation of a plan with a life insurance policy providing for a death benefit larger than was allowed under the incidental limits as "Situation 2."

ITEM #2

Originally, cash surrender value rather than fair market value was used for valuing life insurance policies sold to participants from qualified plans because a prohibited transaction was avoided under class exemption Prohibited Transaction Exemption (PTE) 92-6 if the sale was for the policy's cash surrender value. However, under Rev. Proc. 2004-16, the IRS made it clear that for income tax purposes the policy received by the participant would be valued at fair market value, not its nominal cash surrender value. The IRS has provided further guidance in Rev. Proc. 2005-25 as to how such fair market value is to be calculated. These rulings were issued to ensure polices could not be distributed with a low cash value to the participant

(with minimal tax consequences) and then have the value suddenly rise to a significantly higher value shortly after the distribution.

ITEM #3

In Rev. Rul. 2004-21, the IRS made it clear that in order for a plan to comply with the rule that all participants receive comparable rights, benefits, and features, the life insurance policies offered to all participants must be comparable. This wasn't a new rule but simply a clarification of existing law.

These three items of guidance were more than adequate to curtail the promotion of abusive 412(i) plans using only life insurance policies for funding, or using insurance products for the owners of the sponsoring business that were different from those used for the other participants. The guidance eliminated the larger deductions resulting from life insurance policies outside the incidental death benefit limits, and imposed an excise tax on excess contributions that could not be deducted. They eliminated the incentive to have a low cash surrender value by requiring tax be paid on the fair market value of any life policies distributed to participants, and requiring fair market value to be paid to purchase a life policy. They also directed that any 412(i) plan provide equal types of benefits for all participants.

Why was any additional action needed by the IRS?

CODE SECTION 6707A – THE SLEDGE HAMMER

Having eliminated all possible abuses of 412(i) plans using life policies with suppressed cash value features, and funding with only life insurance policies, one might well say to the IRS, "well done!" But the IRS was far from finished in its attack on 412(i) plans. The IRS persuaded Congress to adopt the IRC §6707A penalty. Then the IRS added 412(i) plans with excess life insurance as a listed transaction under §6707A. Under this rule, if a plan sponsor failed to report that it had a "listed transaction" as part of its income tax return for any year, the penalty was $100,000 if the tax payer was not a corporation and $200,000 for corporate taxpayers. Moreover, if the corporation was a Sub S corporation, the penalty was $300,000 per year as both penalties were applied.

Not only was this penalty not needed to stop the abuses, but more important, it was a trap for the unwary. First, most taxpayers weren't even aware that the transaction was a listed transaction. An ordinary business person had no way to ascertain whether his 412(i) plan contained a listed transaction element. In fact, because of the vague and ambiguous language of the IRS guidance imposing listed transaction status, even pension experts were unsure of its meaning.

Second, even if the taxpayer somehow determined that he had a listed transaction and filed the appropriate Form 8886 with his tax return, he may well have failed to separately mail an initial disclosure to the Office of Tax Shelter Analysis.

The 6707A penalty doesn't permit a reasonable-cause defense. Once the penalty is imposed, the taxpayer has limited rights. He may take the case to the IRS appeals office but he may not go to the tax court. His only recourse is to pay the assessment of the penalty and apply for a refund with the U.S. District Court. As a practical matter, this means the IRS determination of the appropriateness of the 6707A penalty is final.

The 6707A penalty was imposed on 412(i) plans as part of Rev. Rul. 2004-20. The language of the guidance states that transactions that are the same as or substantially similar to the transaction described in Situation # 2 of Rev. Rul. 2004-20 are listed transactions if the employer has deducted amounts used to pay premiums on a life insurance policy with a death benefit that exceeds the participant's death benefit under the plan by more than $100,000.

The IRS has interpreted the listed transaction paragraph of Rev. Rul. 2004-20 to mean that if any amount of the premium is deducted on a life policy whose face amount is greater than the participant's death benefit under the plan by more than $100,000, then it constitutes a listed transaction regardless of whether any portion of the excess was improperly taken as a current deduction.

Because Rev. Proc. 2004-20 specifically permits a 412(i) plan to be a qualified plan and yet own a life policy whose face amount is greater than the permitted death benefit as long as the premiums paid for the excess portion are not currently deducted, it would not be logical to say that such a plan is deemed a listed transaction if it contains a life policy with an excess face amount of more than $100,000 without regard to whether any portion of the excess was deducted. Yet because of the procedural limitations contained in IRC §6707A, there is no practical way to challenge the IRS interpretation.

In 2010, after a loud public outcry about the unfairness of the size of the 6707A penalties being imposed on small businesses, Congress acted to reduce the amount of the penalty. Under the modified 6707A penalty, the amount of the penalty was reduced to 75 percent of the decrease in income tax shown on the return as a result of the listed transaction. Once again, it was left to the IRS to be the sole arbiter of the penalty, and there was still no reasonable-cause exception or ability to go to tax court.

The first thing the IRS did was interpret the language of the new rule to mean that the amount of the tax deduction taken on account of the entire contribution to the 412(i) was treated as the amount used to decrease the tax shown on the return. This was done despite the fact that every 412(i) plan is also a

defined benefit plan that's entitled to a deduction under IRC section 404, based on normal Section 412 funding. So, for example, if only $100,000 of the amount of the $200,000 pension plan deduction for the 412(i) plan was the premium for a life policy that was deemed to be a listed transaction, the IRS nevertheless used the entire $200,000 to determine the decrease in the tax shown on the return.

In another unilateral IRS interpretation of the revised 6707A penalty applying to a Sub S corporation, in addition to the 6707A penalty imposed on the individual owners of the Sub S, the corporation is also fined a minimum of $10,000, even though it's a pass-through entity with no taxable income.

CONSEQUENCES OF OVERKILL

The full burden of 6707A fell exclusively on small businesses that sponsored 412(i) plans with life insurance policies exceeding the death benefits payable under their plans.

One might hope that as a result of the IRS audit initiative targeting abusive 412(i) plans, the IRS would have addressed the authors of the depressed cash value life insurance policies. However, the IRS only addressed the individual plans subjecting the small-plan sponsors to defend themselves without the benefit of the large insurance companies' support. Many of the rules the IRS held the plan sponsors subject to weren't clear when the plans were set up. Unfortunately, plan sponsors whose plans were compliant were held subject to IRS interpretations on funding issues that had no historical or legislative precedent, and were left without adequate resources to fight the IRS on a united front.

In addition to these unfair results, a more long lasting effect of the IRS initiative was to eliminate the 412(i) plan for the future. It would be a bold advisor and/or plan sponsor who would dare to use a plan that could, at the whim of the IRS, be subject to 6707A penalties.

Perhaps the greatest irony was that many of these cases were being audited in 2008, when traditional defined benefit plans experienced substantial asset losses that left them sometimes grossly underfunded. The 412(i) plans with their guaranteed rates remained properly funded, and when set up to follow all of the qualified plan rules, achieved the goal of providing retirement benefits for plan participants without inflicting additional substantial funding requirements upon the plan sponsor who may have been experiencing severe financial setbacks. PC

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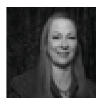
Holly L. Scott has specialized in all areas of qualified retirement plans her entire working career. Holly has worked with clients and advisors on 412(i) plans for the past decade, and represents clients before the IRS on audits of these and other plans. Holly is active on local and national committees for retirement planning education.

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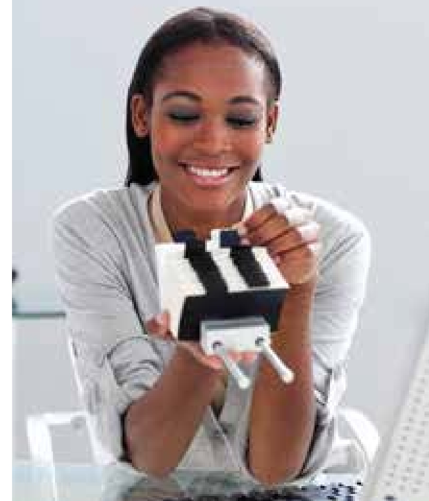

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