

IRS Section 412i

Defined Benefit Fully Insured Retirement Plan



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Preface

Private pensions serve as a key supplement to Social Security and can help workers receive adequate incomes in retirement. Employer-provided pensions are an important source of income for many retired persons. About thirty percent of all households aged 65 and older receive income from private pensions, and such income represents 9 percent of their total income. Over 50 million workers actively participate in over 730,000 private pensions, and such plans in 1998 represented over 4 trillion dollars in retirement savings. However, since the 1970's, only about half of all private sector workers aged 25 to 64 have participated in an employer-sponsored pension. The millions of workers who have no individual pension coverage are at particular risk for inadequate incomes during their retirement years.

To encourage employers to establish and maintain pension plans for their employees, the federal government provides preferential tax treatment under the Internal Revenue Code (IRC) for plans that meet certain requirements. The purpose of tax preferences for employer-sponsored pensions is to encourage savings for workers' retirement. Pension tax preferences are structured to strike a balance between providing incentives for employers to start and maintain voluntary, tax-qualified pension plans and ensuring participants receive an equitable share of the tax-favored benefits. In fiscal year 2002, these tax preferences for employer-sponsored pension plans are estimated at about \$88 billion and represent the largest federal "tax expenditure," exceeding those for home mortgages or health benefits.

In addition to certain requirements that private plans must meet to receive tax-favored treatment, federal law also stipulates certain obligations that plan sponsors must fulfill with respect to plan operation, funding and management. These obligations are designed to protect private plan participants and beneficiaries from mismanagement and misuse of assets and to ensure that they are entitled to benefits under their plans. The rights and obligations of plan sponsors and participants are spelled out in the Employee Retirement Security Act of 1974 (ERISA). For example, ERISA requires plan fiduciaries, or individuals who exercise discretionary control or authority over a plan's management or assets, to follow certain standards of conduct with respect to the administration of the plan. The primary responsibility of plan fiduciaries is to run the plan solely in the interest of participants and for the exclusive purpose of providing benefits.

The financial collapse of the Enron Corporation and other recent corporate failures, and their effects on the companies' workers and retirees, have prompted policymakers and the public to want to know more about private pensions and the benefits these plans provide. The private pension plan system is complex because employers offer a variety of plans to their employees, and sponsors must ensure that the design and operation of their plans satisfies a myriad of laws and regulations.

Introduction

Professionals and small business owners are looking for ways to reduce their tax burden and keep more of their hard earned profits for themselves. A qualified retirement plan is one of the best ways to not only accomplish this, but also **insure** that your clients' **Golden Years** will be just that.

Wouldn't you like to insulate your business from market downturns? Learn how to develop a market that is practically immune to economic cycles. We will show you how to reach successful business owners and professionals and tap into this lucrative market. Even at the bottom of a recession, money keeps pouring into your pocket.

There is no better time to be in the small plan marketplace. The tax reform act of 2001 created opportunities in the pension marketplace that have never existed before. Yet many small businesses aren't aware of the advantages of qualified plans and how they can be designed to favor owners. It is estimated that more than 80% of small businesses do not have a qualified plan.

How LifeBrokers and American National will help you succeed

In this program, you will learn how to take advantage of the opportunities in the small plan market. . Your time spent will enhance the client relationship.

Specifically, we'll show you:

- Why this market is a natural extension of your career.
- How to succeed in a time-efficient way.
- How to talk to professionals and business owners in powerful, yet simple terms with key questions that will get their interest..
- How to provide value-added service.
- Why this market will expand your success in other areas as well.
- How to utilize the LIFE BROKERS and American National Support Teams.

You're already an expert in communicating, simplifying, motivating and guiding the actions of your clients. Instead of making many prospecting calls to obtain one client, we will show you how to make one sale to obtain many potential clients. In each small plan sale, your first sale is to the company. When you are successful, these sales will open doors to:

- 1 several highly-paid corporate owners or professionals
- 2 many younger plan participants, some of whom are on the road to greater career success
- 3 other companies in the same industry
- 4 other advisors of the company like CPA's and attorneys.

How to Develop a New Profit Center

“You have more prospects than you know.”

The best place to start is with your existing clients and contacts by considering ideas such as these:

- Your self-employed clients are excellent candidates. Plus, they can be good sources of referrals. For example, many owners of garages, restaurants, and retail shops are self-employed and may hire only a few employees. They may have relationships and contacts with other businesses in the area, including suppliers.
- As you discuss estate planning and asset transfer strategies with your older clients, ask where their children work and whether or not these children participate in retirement plans. The ultimate goal of estate planning is to help heirs become more financially secure. Clients will appreciate your initiative in contacting companies that employ their children and advocating plan coverage for them.
- Let local businesses know that you can help them set up a retirement plan – especially businesses that you patronize personally such as your local hardware store, auto body shop or dry cleaner.
- Be aware of clients who are in a position to influence plan decisions at local companies. This includes owners and top managers of course but it can also include directors, key advisors to companies (such as CPAs and lawyers), and valuable or hard-to-replace employees.
- Focus on companies with ***growth and profit***. In the small plan market, a company with five employees can be more worthy of prospecting time than one with 50. The important factor is the company’s future ability to afford a plan.

Private Pensions and Public Policy

This section provides general information on the public policy framework for private pensions, including a broad discussion of standards that employers must meet to sponsor plans that qualify for preferential tax treatment.

Why do private employers offer pensions plans?

Private employers voluntarily offer pension plans to attract and retain workers and enable workers to take advantage of the tax preferences associated with pensions.

Private employers are not required to offer pension plans for their employees. The private pension plan system is voluntary; employers decide whether to establish a retirement plan and make decisions regarding the design, terms and features of the plan or plans they choose to sponsor. One of the fundamental determinations that private employers make if they decide to sponsor a plan relates to the level of benefits that the plan provides.

Although private employers are motivated to offer a pension plan for many reasons, the most important involve (1) the employer's need to attract and retain a workforce in a competitive labor market and (2) the tax advantages, or preferences, associated with pensions.

Employers typically want to attract workers, motivate them to perform efficiently in pursuit of the firm's goals, and retain them to reduce the costs associated with turnover. Pensions provide a tool for accomplishing these objectives. For example, pensions are a means of providing deferred compensation that may encourage workers to make long-term commitments to employers. At the same time, employers also want to manage the retirement of their workforce, and pensions are a means of offering incentives for workers to retire sooner or later than they would otherwise.

Employers also choose to sponsor pension plans because of the favorable federal tax treatment of contributions that employees make and the investment returns on these contributions. While workers' cash earnings are taxed immediately, pension plan participants typically do not include their employer's or their own contributions (and the investment earnings on these contributions) to a qualified plan in determining their tax liability until they receive benefits. The employer is also entitled to a current deduction (within certain limits) for contributions to a tax-qualified plan even though contributions are not currently included in an employee's income.

What types of pension plan arrangements can private employers sponsor for their employees?

Private employers can sponsor qualified plans and nonqualified deferred compensation plans or arrangements.

To encourage employers to establish and maintain pension plans for their employees, the federal government provides preferential tax treatment under the Internal Revenue Code for plans that meet applicable requirements. A **qualified pension plan** is a retirement plan that satisfies certain requirements set forth in the **Internal Revenue Code of 1986** (IRC or “Tax Code”). In order to be tax-qualified, private pension plans must satisfy a number of requirements, including minimum requirements on coverage and benefits. These minimum benefits and coverage requirements are intended to ensure that rank-and-file employees, not merely a top group of highly paid employees such as owners and executives, participate in and receive benefits from the plan. Plan sponsors must provide coverage and benefits in a manner that generally does not discriminate against workers who are not among an employer’s officers, executives, or highly compensated employees

Employers who sponsor tax-qualified plans are entitled to a current deduction (within certain limits) for the contributions they make to their plan. This means that an employer who sponsors a tax-qualified defined benefit plan is generally allowed to deduct contributions that it makes to the plan’s trust fund from its taxable income; an employer who sponsors a tax-qualified defined benefit plan is generally allowed to deduct contributions that it makes to participant’s accounts from its taxable income. In addition to favorable tax treatment for contributions, taxes on the investment earnings on employer and employee contributions to qualified plans are deferred until plan participants receive their benefits.

Employees do not include the benefits they accrue in qualified plans in their gross incomes until the benefits are distributed. Employer contributions and employee pretax contributions are not included in an employee’s income at the time the contributions are made. Thus, a tax deferral on contributions and earnings is provided from the time that contributions are made to the plan until the time that plan participants receive benefits.

A plan of deferred compensation that satisfies the applicable provisions of the Tax Code is termed a “qualified retirement plan.” The Tax Code classifies qualified pension plans as either **defined benefit** or **defined contribution** plans and includes separate requirements for each type of plan.

Private pension plans must also meet the requirements of the **Employee Retirement Income Security Act of 1974 (ERISA)**. Title I of ERISA, among other requirements regarding information that plan sponsors must provide to participants and defines the obligations of the individuals who administer the employer-sponsored plans. ERISA also sets standards concerning how long an

employee must work before becoming eligible to participate in a plan, how long a plan participant must wait until receiving a right to benefits that cannot be taken away (**vesting**), and minimum funding rules for defined benefit plans (and certain defined contribution plans) that require plan sponsors to provide funding for the benefits participants are entitled to receive. These standards are contained in title I of ERISA, and are also part of the Internal Revenue Code.

Nonqualified pension plans are plans that do not meet the applicable requirements for tax-qualification under the Tax Code. Sponsors of nonqualified plans typically do not have to satisfy laws and regulations requiring a minimum level of benefits or contributions to the plan. Additionally, they do not have to meet certain reporting, disclosure, bookkeeping, and core fiduciary requirements. Nonqualified plans are also typically designed for highly compensated employees or selected company executives, and are not meant to cover the broad spectrum of employees that a qualified plan covers. However, certain nonqualified plans may be subject to ERISA's title I provisions.

What are the tax advantages of sponsoring a qualified plan?

There are several tax advantages that employers and employees receive for making contributions to a tax-qualified plan.

The favorable tax treatment accorded to a qualified pension plan includes:

- The amount that the employer contributes to the plan is tax deductible (within certain limits) in the year contributions are made;
- The earnings on the investment of plan assets are tax-exempt;
- Participants do not have to pay income tax on the employer's contribution to the plan on their behalf or on the earnings to those contributions until benefits are received;
- Income taxes on certain distributions may be deferred by rolling over the distribution into an **Individual Retirement Account** or to another qualified plan; and
- Installment or annuity payments are taxed only when received.

What is the process by which plan sponsors obtain tax-qualified status?

Private plan sponsors may obtain tax-qualified status by applying to the Internal Revenue Service (IRS).

Typically, a plan sponsor might apply to the IRS seeking an advance determination as to the qualified status of its plan rather than waiting for the IRS to review its plan in connection with an audit.

All American National plans are filed and approved for use to eliminate the guesswork.

Qualified Retirement Plans

Qualified retirement plans are Congressionally approved retirement plans, which have several major tax benefits.

- The employer's contributions can be deducted for income tax purposes.
- The earnings on the plan's investments accumulate on a tax-deferred basis.
- When the funds are distributed at retirement age, they may be eligible for favorable tax treatment.
- Taxpayers may be in a lower income tax bracket after retirement.

Two Principal Types of Plans

Qualified retirement plans can be classified as either defined benefit or defined contribution plans.

Defined benefit plans define the benefit amount each participant will receive at retirement age and then estimate how much must be contributed each year to accumulate the necessary future fund. Interest rates, ages of participants, etc., will have an effect on the calculation. An actuary determines the amount of the contribution. The investment risk rests on the employer.

Defined contribution plans generally put a percentage of current salaries into the plan each year. The amount at retirement will depend on the investment return and number of years until a participant retires. The investment risk rests on the participant.

What is the Best Type of Plan?

There is no best type of plan. The choice of what type of plan to use is an individual one. The answer depends on factors such as employer goals and available cash flow.

Defined Benefit Plans

A defined benefit plan promises to provide a benefit that is generally based on an employee's salary and years of service.

The employer contributes an actuarially determined amount sufficient to pay each participant a fixed or defined benefit at his or her retirement. Methods of defining the benefit may be based on a flat percentage, which changes at certain compensation levels, etc.

This type of plan favors older employees, because more of the employer's contributions must go into his or her account to make certain that there will be enough to pay the promised (or defined) benefit at retirement age.

Defined benefit plans use a formula to determine the ultimate pension benefit that participants are entitled to receive. Typically, benefit formulas are either based on an employee's final average pay or career average pay in combination with the participant's years of service and a multiplier, or percentage factor that is part of the formula.

*Defined benefit plans usually express benefits as an **annuity**, or series of periodic payments over a specified period of time or for the life of the participant, beginning at a normal retirement age specified by the plan. Plans typically specify normal retirement age as 65. For example, a final average pay formula might determine monthly benefits payable at retirement on the basis of 1.25% multiplied by the participant's average salary over the last 5 years of service.*

Qualified defined benefit plan benefit formulas must provide benefits in a way that satisfies accrual methods specified in the Internal Revenue Code. These rules are intended to ensure that benefit accruals are not excessive for older participants or participants with many years of service in relation to younger participants or participants with fewer years of service.

Typically, annuity payments are received on a monthly basis by the retired participant and continue as long as the recipient lives. An annuity is the normal form of benefit payment that defined benefit plans provide to participants.

Example of defined benefit plan formula used to determine annual pension benefits:

1.25% (multiplier) X 25 (years of service) X \$65,000 (average of employee's final 5 years' annual salaries) = \$20,313 (annual pension benefit commencing at normal retirement age).

*Plan sponsors must offer married participants a **joint and survivor annuity** payment at retirement. Defined benefit plans may also offer those participants (who have a no forfeitable right to accrued benefits under the plan) the option of receiving their accrued benefits as a **lump sum distribution**, or a nominal cash amount, when they leave the plan sponsor before or at retirement. (Unlike traditional db plans, cash balance plans are a type of "hybrid" db plan that express accrued benefits as hypothetical account balances, and benefits accrue annually based on a set percentage of salary and interest earnings). Participants may elect to receive a lump sum amount only if the plan provides this benefit payment option and if spousal consent is obtained. If a participant receives a lump sum distribution, he or she may "**roll-over**" the amount directly to another qualified plan, such as an IRA or a defined contribution plan.*

*The employer is responsible for making contributions that are sufficient for funding the promised benefit, investing and managing the plan assets, and bearing the investment risk. Contributions are made to a pension trust fund that is invested on behalf of employees in the plan and must satisfy **minimum funding requirements** set forth in ERISA. The minimum funding standards, while technically complex, are designed to ensure that the value of benefits accumulated to date under the plan and the plan's assets bear a reasonable relationship to one another such that the plan can pay benefits due participants when they retire. The standards also provide flexibility to increase or decrease a plan's funding as necessary. Generally, if a db plan terminates with assets that are insufficient to pay the benefits accrued to date; the Pension Benefit Guarantee Corporation pays benefits promised by the plan up to levels specified by law.*

Defined Contribution Plans

Under a defined contribution plan, employees have individual accounts to which the employer, employees, or both make periodic contributions.

A Defined Contribution plan benefits are based on the contributions to and investment returns (gains and losses) on **individual accounts**. For each plan participant, the plan sponsor periodically contributes a specific dollar amount or percentage of pay into each account. Depending on the design of the plan, contributions may consist of pretax or after-tax employee contributions, employer matching contributions, and other employer contributions that may be made independent of any participant contributions. Defined contribution plans provide benefit portability because they typically pay benefits to participants by distributing their current account balances in full when they leave their employer to change jobs or retire. These lump sum distributions may be rolled-over into another qualified retirement plan, such as another defined contribution plan or IRA. **Unlike defined benefit plans, defined contribution plans are not required to provide an annuity option to participants.**

Example of annual increase in defined contribution plan account balance:

$\$20,000$ (beginning year account balance) + 6% of $\$50,000$ salary (employee contribution) + 3% of $\$50,000$ salary (employer contribution) + 6% investment return (earnings on beginning year balance) = $\$25,700$ end of year account balance.

[Note: This example is simplified. Contributions may be made to individual accounts during the course of the year; such contributions begin to earn interest immediately upon being deposited in participants' accounts.]

In a defined contribution plan, the employee bears the investment risk and often controls, at least in part, how his or her individual account assets are invested.

Defined Contribution plan participants realize any investment returns, or gains or losses on the investment of assets in their account balances. Defined contribution plans do not have insurance protection against the risk of losses they may incur.

In addition to lump sum distributions when an employee changes jobs, a dc plan may also allow pre-retirement access to account balances while they are working for the employer. For example a dc plan may allow loans on the portion of the account balance that is vested. A dc plan may also permit withdrawals under certain conditions, such as financial hardship or the purchase of a home.

Defined Contribution plans are classified into one of three main types: profit sharing, stock bonus, or money purchase plans.

A profit-sharing pension plan is a type of dc plan that provides for contributions to employees on the basis of employer profits. Profit-sharing plans were originally created as a means to enable employees to share in the profits of their employer's business. However, under current law, employers who sponsor these plans may make contributions regardless of whether they are profitable. Profit-sharing plans may provide for annual employer contributions based on profits from the previous year or may be made each year at the discretion of the employer. Profit-sharing contributions are not paid out currently but are deferred to individual accounts the employer has established for each employee.

Profit-sharing plans provide for employer contributions on the basis of a formula, which specifies how the contribution is determined. The formula is based on employee compensation but may be based on profits or employee contributions. For example, profit-sharing plans can specify that contributions to accounts are based on a flat percentage of pay or determined by calculating the proportion of each employee's compensation relative to the total compensation of all participants. Profit-sharing plans must also specify the events upon which distributions will be made to participants, such as separation from service or retirement. Profit-sharing plans may provide benefit payments while they are working.

A stock bonus plan is similar to a profit-sharing plan except that the plan benefits are payable in the form of stock. These plans may make benefit payments in cash amounts but must permit participants to receive their benefit payments in the form of stock. If the plan sponsor pays benefits with shares of company stock that are not readily tradable on an established financial market, the participant must be allowed to sell the shares back to the employer at a fair market price. This requirement ensures that benefits provided in the form of company stock have some financial value to the participants.

A money purchase plan is a defined contribution plan where the plan sponsor is required to make contributions. The required contribution is based on the plan's formula, which is specified in the plan's document. These contributions are determined as a specified percentage of salary. Retirement benefits are equal to the

amount in the participant's account at retirement. Similar to qualified db plans, the money purchase plans must satisfy minimum funding requirements because employer contributions are mandatory. A money purchase may not provide for benefit payments that may be made to participants while they are working for that employer except in the event of plan termination.

Within these types of defined contribution plans, plan sponsors may add special features, such as qualified cash-or-deferred-arrangement (**401(k) Plan**) or an **Employee Stock Ownership Plan (ESOP)** feature.

What types of contributions can be made to defined contribution plans?

Both plan sponsors and employees may make contributions.

There are several types of employer and employee contributions that may be made to tax-qualified defined contribution plans. Employers may make nonelective and/or matching contributions. Nonelective contributions are contributions that the plan sponsor makes regardless of whether the participant makes contributions. They are made independently of any employee contributions. Nonelective contributions maybe provided on a regular or discretionary basis according to the terms of the plan. Matching contributions are contributions that a plan sponsor makes only when participants make contributions. The level of matching varies among plans and can be made in shares of the employer's stock – without the option to direct the investment until certain conditions relating to age and/or service are met.

Employees, in accordance with plan provisions, may contribute on a pretax or after-tax basis. Pre-tax contributions are treated the same for income tax purposes as employer contributions. Unlike pre-tax, after tax contributions are included in the participant's taxable income. However, taxation of the investment income earned is deferred until it is received.

Common variations of defined contribution plans include:

- **Money purchase pension:** The employer contributes a specified percentage of the participating employee's salary each year. Whatever that fund grows to is what the retiring employee receives.
- **Target benefit pension plan:** The target benefit plan has elements of both the defined benefit and defined contribution plans. The benefits are determined as if the plan were a defined benefit plan, while the defined contribution plan annual contribution percentage and dollar amount limitations apply to the actual contributions.
- **Traditional profit sharing plan:** Similar to the money purchase pension, except that contributions do not need to be a specific percentage and they do not need to be made every year, as long as they are substantial and recurring.

- **Age-weighted money purchase and profit sharing plans:** Money purchase and profit sharing plans in which employer contributions are allocated to provide an assumed equivalent retirement benefit at normal retirement age.
- **Cross-tested or super-integrated money purchase and profit sharing plans:** These plans establish groups of participants to which are allocated specified allocation percentages. They must satisfy very complicated discriminatory requirements under Reg. 1.401(a)(4).
- **Stock bonus plan:** Similar to the traditional profit sharing plan. The plan may, but is not required to, invest primarily in the employer's stock.
- **ESOP – Employee stock ownership plan:** Like a stock bonus plan, to which the employer can contribute company stock instead of cash. The plan must be primarily invested in company stock.
- **IRC Sec.401(k) plan:** Also called a cash or deferred plan, this plan is any stock bonus plan or profit sharing plan which meets certain participation requirements of IRC Sec. 401(k). An employee can agree to a salary reduction or to defer a bonus which he or she has coming.
- **SIMPLE plans:** SIMPLE stands for savings incentive match plan for employees. SIMPLE plans can be in either an IRA format or a 401(k) format.
- **SEP:** This stands for simplified employee plan. A SEP is a group of individual IRAs established for employees to whom the employer and employees may contribute more than an individual employee could contribute to a traditional IRA or Roth IRA.

What is the accrued benefit provided by defined benefit and defined contribution plans?

For defined benefit plans, the *accrued benefit* is the amount that the plan participant would receive annually as a life annuity beginning at the plan's normal retirement age. A participant's accrued benefit is determined by the plan's benefit formula. This amount is calculated for each year as a participant completes an additional year of service with the plan sponsor.

For defined contribution plans, the *accrued benefit* is the balance of an individual's account. This balance includes the sum of participant and/or employer contributions and investment returns (gains or losses), dividends, and capital gains (or losses) attributable to those contributions. Also, the account balance is less any administrative expense that incurs to maintain the account.

For defined benefit plans, the plan formula determines the rate at which the accrued benefit grows on a yearly basis. DB plans express accrued benefits as an annuity and are required to have the option of receiving benefits as an annual benefit for life, beginning at retirement, or the plan's normal retirement age. Participants must however work for a certain period of time in order to earn their accrued benefits under the terms of the plan. This is called **vesting**. If a benefit is paid as an amount other than an annual benefit commencing at normal retirement age, the plan sponsor must pay the accrued benefit as a lump sum in current dollars. A lump sum distribution is the present value of the annuity benefit payment stream. Lump sum benefit payments must be (actuarially) equivalent to the annuity benefit that the participant has accrued to date under the plan's benefit formula. Lump sum distributions may be paid only if they are provided for under the terms of the plan, and the departing participant elects this form of payment.

Defined Contribution plan benefits accrue when contributions are allocated to individual participant accounts. However, participants are only entitled to the contributions they have made (and any investment returns on those contributions) and not those that have been made by the employer until they meet certain requirements. Similar to db plan participants, defined contribution plan participants may have to work for a certain period of time in order to earn a right to their employer's contributions. With respect to a participant's contributions, the accrued benefit is the portion of the account balance that is attributable to his or her contributions and investment returns.

How may defined benefit and defined contribution plans pay benefits?

Defined benefit plans may pay benefits as annuities or lump sum distributions, while defined contribution plans may pay benefits as annuities, lump sum distributions, or installment payments. Married participants who receive annuity payments are required to receive a joint and survivor annuity.

Defined benefit and defined contribution plans typically pay out accrued benefits at retirement (i.e., at the plan specified normal retirement age – commonly age 65), early retirement (usually between the ages of 55 to 62) or when an employee separates from service.

Plan sponsors must meet certain requirements regarding when they must pay benefits to participants and when participants may request to begin receiving benefit payments. (*Rules regarding when participants must receive benefit payments are referred to as minimum distribution rules. Other rules define certain distribution events, or circumstances under which plans may pay benefits to participants.*) Both defined benefit and defined contribution plans may pay benefits as both annuities and as lump sums.

For both plan types, married plan participants who receive accrued benefits in the form of a joint and survivor annuity, the annuity guarantees the surviving spouse will continue to receive payments after the plan participant dies. The pension income that a surviving spouse receives from a qualified joint and survivor annuity must be at least equal to one-half of the annuity benefit payment the retired participant received. The spouse may waive his or her right to a joint and survivor annuity.

Plans that provide lump sum distributions promote benefit portability by allowing participants to take their benefits when they leave the plan prior to retirement such as a job change. For defined benefit plans, the lump sum must be at least equivalent to the present value of the accrued benefits as calculated using actuarial assumptions specified in the IRC.

For defined contributions, the lump sum distribution is based on the employee's contributions and the investment earnings. If the participant is vested, the lump sum includes the employer's contributions and the investment earnings.

Participants who receive lump sum amounts may or may not preserve these assets for retirement income purposes. For example, he or she may elect for the lump sum and may or may not reinvest into another tax-qualified plan. If a departing participant prior to age 59 ½ years, elects to not transfer the amount directly into an IRA or another qualified plan, the distribution is subject to an excise tax of 10% in addition to ordinary income taxes. To avoid paying taxes on the distribution, the participant must deposit the funds in a qualified plan within 60 days of receipt. Also, the employer is required to withhold 20% of the lump sum amount if the participant elects to receive it directly.

An employer has the option – without consent – to pay benefits as a lump sum when a terminating employee has accrued benefits that are less than \$5,000. Also, if the distribution is \$1,000 but less than \$5,000 the distribution is automatically rolled-over into an IRA unless the participant elects otherwise.

Participants have a third option of receiving benefits at retirement as a series of periodic withdrawals, which are determined by the plan. These periodic payments are referred to as installments.

The Role of ERISA

Following is a description of how the *Employee Retirement Income Security Act of 1974* protects private pension participants. This section highlights standards that define the obligations of individuals who run plans and requirements that govern the investment of plan assets.

For more information on pension plan participants' rights and the role of ERISA, go to <http://www.dol.gov/dol/topic/retirement/index.htm>, and go to <http://www.dol.gov/pwba/pubs/youknow/knowtoc.htm> for a Department of Labor brochure on workers' pension rights.

Among other things, ERISA does the following with respect to private pension plans:

- Requires plans to provide information to participants and the federal government about the plan including information about plan features, such as benefits they provide, summary financial information, and information about how the plan is funded (these requirements are discussed in more detail later in this section);
- Sets minimum standards regarding who can participate and when they can participate, how long they must wait to begin accruing pension benefits and how long they must wait before they have the right to benefits that cannot be taken away (vesting), how much must be set aside each year to provide benefits when they are due;
- Sets responsibility standards and requires accountability for the people who run or provide investment advice to plans (plan fiduciaries);
- Allows participants to sue for benefits when those who provide investment advice to the plan fail to meet their duties and obligations;
- Guarantees payment of certain benefits if a defined benefit plan is terminated without sufficient assets to pay accumulated benefits, through a federally chartered corporation, known as the Pension Benefit Guaranty Corporation, which provides insurance protection (subject to certain limits) to plan participants; and
- Gives the Secretary of Labor the authority to bring legal actions to enforce title I of ERISA.

Title I of ERISA, among other things, prescribes standards for information that participants are entitled to receive, obligations for plan fiduciaries, and participants' right to sue for breaches of fiduciary duty. Title I also prescribes minimum standards for participation, benefit accrual, vesting, and plan funding. These provisions concern who can participate and when they can participate, how long a participant must wait before they have a right to benefits that cannot be taken away, and how much must be set aside each year to provide benefits when they are due.

ERISA's title I standards apply to most private pension plans. However, there are certain pension plans that are not covered by title I, such as pension plans sponsored by governmental agencies and churches.

Who is the plan fiduciary?

A plan fiduciary is a person who has discretionary control or authority over the management or administration of the plan, including management of plan assets.

Any person who makes investment decisions with respect to a qualified plan's assets is a plan fiduciary. The duties a person performs for the plan, rather than his or her title, or office, determines whether that person is a plan fiduciary.

The employer and its officers and directors may be considered plan fiduciaries to the extent they act or serve in a capacity by performing functions that are covered in ERISA's definition of a plan fiduciary. Plan fiduciaries include plan trustees, plan administrators, investment managers, and members of a plan's investment committee.

How do the fiduciary provisions of ERISA protect participants?

The Employee Retirement Income Security Act protects participants from mismanagement and misuse of assets by requiring accountability on the part of those who administer plans.

Fiduciaries must perform their duties with respect to the plan solely in the interest of plan participants, run plans for the exclusive purpose of providing benefits, act prudently and may pay only reasonable expenses of administering the plan. They must diversify the investments in order to minimize the risk of large losses and must follow the terms of plan documents consistent with ERISA. A fiduciary may appoint a qualified investment manager to manage all or part of the plan's assets.

What is a trust, and what requirements govern trusts?

A trust is a legal arrangement that holds title to the plan's assets. ERISA provides that one or more trustees must hold all assets of an employee benefit plan in trust for the exclusive benefit of participants and beneficiaries.

Contributions to a qualified plan and the plan's assets in a qualified trust are immune from the claims of the plan sponsor's creditors (including from an employer's bankruptcy) because plan assets must be used for the exclusive purpose of paying benefits.

A trustee may be a bank, a broker-dealer, trust company, or group of individuals with exclusive authority and discretion to manage and control the plan's assets.

The trustees of the plan hold the legal title to all plan assets whether they are responsible for the investment of plan assets or such responsibility has been delegated to a named fiduciary or an investment manager.

Are plan fiduciaries responsible for investment decisions made by plan participants?

If the plan sponsor meets certain ERISA requirements, plan fiduciaries are not responsible for investment decisions made by participants. Certain special fiduciary rules apply to plans with “participant directed” investments.

Among other requirements, plans must offer participants at least 3 investment options, information about and investment instructions with respect to each of the investment options, and allow participants to exercise independent control over their investments. When a plan satisfies the special requirements, the plan fiduciary receives limited liability from the results of the participant’s investment decisions. **Employers can provide investment education and advice to plan participants.**

What kinds of information are plans required to report to the federal government?

ERISA requires plan administrators to report certain information to the Department of Labor, Pension Benefit Guaranty Corporation and Internal Revenue Service, the agencies that administer the federal pension laws. The **Form 5500 Annual Return/Report** is a three-agency form to be used by plan administrators and employers in order to satisfy their annual reporting obligations. Plan administrators must also submit certain schedules, depending on the features of the plan that accompany the Form 5500. Filing requirements for these schedules differ for plans with 100 or more participants and plans with fewer than 100 participants.

The IRS also requires plan administrators to file returns in certain instances. For example, plan administrators must file certain forms that disclose changes to the plan that the sponsor wants to make. These changes include combining plans after a company merger or consolidation, or in some cases when terminating a plan. IRS also requires plans to file forms that relate to reporting or paying additional taxes.

Finally, the Pension Benefit Guaranty Corporation requires that plans file forms that are used to report and pay their premiums to PBGC.

What kinds of information are employers required to disclose to plan participants?

The Summary Plan Descriptions include such information as:

- Name and type of plan,
- Eligibility requirements,
- Benefit description and when participants have a right to them,
- Statement if the plan is maintained pursuant to collective bargaining,
- Whether the plan is covered by the Pension Benefit Guarantee Corp.,
- Source of contributions and calculation methods,
- Provisions governing termination of the plan,
- Procedures regarding claims for benefits, and
- Statement of rights available under ERISA.

Internal Revenue Code Provisions on Plan Coverage and Benefits

What are the rules for employee eligibility and participation in pension plans?

Plan sponsors may define the groups of employees that are eligible to participate in the plan and when these groups may begin to participate subject to certain requirements.

What rules govern employee coverage in pension plans?

Tax-qualified plans must satisfy coverage requirements that are designed to ensure a minimum proportion of rank-and-file employees are covered by and are benefiting under the plan.

What are the nondiscrimination rules that private plans must satisfy?

Nondiscrimination Rules provide that private employers who sponsor tax-qualified plans must meet certain requirements regarding how benefits or contributions are distributed between rank-and-file employees and highly compensated employees, such as company executives and owners.

What are the “top heavy” rules and when do they apply to private plans?

Top-heavy rules, like the rules on nondiscrimination, address how benefits and contributions are distributed, as well as when participants have rights to their accrued benefits (vesting). A private plan is considered top-heavy if it fails testing; that is the firm’s top employees receive more than 60 percent of its benefits or contributions. Plans that provide the required top-heavy minimum contributions or benefits, and vesting, do not have to apply the top-heavy test.

To what extent can accrued benefits be reduced or eliminated?

A participant’s accrued benefit may not be reduced or eliminated by amending the plan. The general prohibition on reducing or eliminating accrued benefits is known as the anticutback rule. This rule applies only to benefits that have accrued to date. Plan sponsors may reduce the rate of future benefit accruals.

What rules govern age discrimination in the provision of pension benefits?

Two types of age discrimination are prohibited: (1) plan sponsors may not reduce or cease benefit accruals on the basis of age, and (2) may not deny the opportunity to participate on the basis of age.

412(i) Fully Insured Defined Benefit Pension Plan for the Small Business

A type of defined benefit plan exists that is a very viable plan design for the “right” small business situation. What follows is a description of this plan and a discussion to help identify the right type of situation where this plan will have appeal. The plan is called the 412(i) defined benefit plan, It is also referred to as an insurance contract plan. It will be referred to here by its third common name, the fully insured defined benefit plan.

This discussion will focus on the problems created by legislation for the traditional defined benefit plan and why the fully insured defined benefit alternative offers a solution to many of these problems. The fully insured approach is not for everyone, but small businesses with very few employees should be aware of this alternative. It can produce appealing results and solve some big problems in the right situation.

The business should have a steady cash flow. The best situation is one in which there has been no previous plan in existence. Establishing a new fully insured plan can mean substantial deductions for the business and meaningful retirement benefits for the participants.

Over-funding and Over-regulation of Traditional Defined Benefit Plans

Many existing traditional defined benefit plans may have become over-funded due to tax law changes in the last few years. In some situations, conversion to a fully insured plan may restore deductible contributions to the plan and eliminate penalties for reversion of excess assets upon plan termination.

Fully insured defined benefit plans are not a recent innovation, so why should this approach warrant closer consideration today? The reason is related to what might be termed “over-regulation” of the traditional defined benefit plan in the small business. The Employee Retirement Income Security Act of 1974 began an era of massive regulation of retirement plans. Originally, the goal was to end abuses in the funding of plans and to more adequately secure the rights and benefits of plan participants. Through the years, much of the regulation has seemed to be directed more at raising revenues than curbing abuses. At any rate, the end result of years of changing the rules for defined benefit plans, limiting benefits, cutting deductions, and attacking plan actuarial assumptions, has served to add confusion and complexity, and has increased administrative costs for the small business. The knockout punch for defined benefit plans came with the passage of the Omnibus Budget Reconciliation Act of 1987 (OBRA '87). The changes for defined benefit plans mandated by this Act have caused many small businesses to re-think the viability of the defined benefit plan. These changes will be discussed below, along with the reasons why the fully insured plan counters most of the problem areas.

Specifically, OBRA '87 contained mandates for defined benefit plans, which included:

- quarterly contribution requirements with penalties for the improper amount or timing of the contributions.
- penalties on the reversion of excess assets to the employer at plan termination
- a new full funding limit substantially reducing or completely eliminating deductions in some situations; and
- new mandates that each actuarial assumption be reasonable standing alone and no longer reasonable “in the aggregate.”

Since these and other complex, confusing, and limiting factors for defined benefit plans are contained in IRC Sec. 412, the solution is to utilize a plan that is exempt from the funding requirements of IRC Sec. 412. If a plan meets the requirements of IRC Sec. 412 (i), it will be exempt from the section's funding rules. For this reason, the 412(i) or fully insured plan deserves a closer look.

IRC Sec. 412 (i) Requirements:

A defined benefit plan will meet the requirements of IRC Sec. 412 (i) if:

- 1 The plan is funded exclusively by the purchase of individual insurance contracts.
- 2 Such contracts provide for level annual premium payments to be paid extending not later than retirement age for each individual participating in the plan, and commencing with the date the individual becomes a participant in the plan.
- 3 Benefits provided by the plan are equal to the benefits provided under each contract at normal retirement age under the plan and are guaranteed by an insurance carrier to the extent premiums have been paid.
- 4 Premiums payable for the plan year, and all prior plan years, under such contracts have been paid before lapse or there is reinstatement of the policy.
- 5 No rights under such contracts have been subject to a security interest at any time during the plan year.
- 6 No policy loans are outstanding at any time during the plan year.

In a nutshell, if the plan invests entirely in acceptable insurance company contracts and does not allow loans, it can qualify as a 412(i) or fully insured plan, and is exempt from the funding requirements of IRC Sec. 412.

The advantages of being exempt from IRC Sec. 412 funding requirements need to be fully understood. This is the appeal of the fully insured plan. Let's explore these advantages in detail.

Advantages of the Fully Insured 412(i) Defined Benefit Plan

The fully insured plan is not subject to the requirement of making quarterly contributions. In a traditional plan, these contributions are usually a nuisance for the small business. The correct amount of quarterly contribution is not always known soon enough to make the first quarterly contribution. If it is not made, the participants need to be informed or penalties will be incurred. If the contribution is too small, there will be interest penalties. If it is too large, a nondeductible contribution penalty may be incurred. The calculation of the full funding limit may mean no contribution can be made, but that may not be known until later in the year.

The mathematical results of the full funding limitation test may be the biggest problem of all for the small, defined benefit plan. These annual calculations can cause the plan costs to fluctuate greatly. There may be little or no deduction in one year and then relatively high cost may be required the following year. Suddenly, the small business loses any handle on what the future cost pattern for the plan may be. Certainly, unknown costs are an undesirable trait for a small business retirement plan. Fully insured plans are not subject to the full funding limitation.

Inadvertent over-funding can occur in a traditional plan for various reasons, including higher than anticipated earnings, new changes in the law limiting benefits, and plan forfeitures. This can create excess plan assets. If the plan is terminated with excess assets that will revert to the employer, the plan will pay a 50 percent excise tax on the excess, in addition to income tax on the reversion to the corporation. The nature of the funding method of a fully insured plan should not create excess assets so there would be no reversion to be taxed and penalized.

Fully insured plans should not have the actuarial assumptions attacked since the assumptions are mandated to be the guaranteed rates in the insurance company products. If the benefits must be guaranteed by the contracts, the funding of the contracts must be based upon the guaranteed rates.

A fully insured plan is not required to file a Schedule B so the service of an enrolled actuary are not necessary for attesting to the funding of the plan.

Additional advantages of the fully insured plan include:

- It is more understandable since the participant's accrued benefit at any point is simply the amount of funds in the insurance company contracts. Historically, participants find it difficult to understand the pro-rata service or participation accrual definitions of the traditional defined benefit plan

- Larger overall deductions are allowable because the funding assumptions are based on the contract guarantees. The lump sum equivalent of the monthly benefit is higher than in a traditional plan and the preretirement interest assumption is lower. The plan still benefits from current earnings, however, as the dividends of the insurance company contracts serve to reduce the next year's required contribution. The chart at the end of this article illustrates the initial level of deductions possible in a fully insured plan compared to the traditional defined benefit plan.

In total, these advantages are too important for the small business to ignore. The investment options are more limited but can be worth the trade-off. If the overall objective of the small business is a large deduction, a secure promise of benefits, a reasonable market rate of return on investments, more stability, and less complexity, then the fully insured plan has merit.

The cost of the plan remains a relatively known quantity in a fully insured plan. The traditional defined benefit plan may experience undesirable fluctuations under the full funding limit calculations. This handle on plan costs enjoyed by the fully insured plan can be one of the most important advantages of all for the small business.

Speaking very generally, traditional defined benefit plans have fallen into disfavor for the very small business for the reasons stated above. Unless the owner is at least 45- 50, a defined contribution plan may have more overall advantages – particularly the New Comparability profit sharing plans now allowed under nondiscrimination rules.

There is still a need for the defined benefit plan for the very small business. Many times, only a defined benefit plan can meet the objectives of the business owner. In these cases, the advantages of the fully insured plan deserve close consideration.

There are relatively few insurance companies that fund and administer fully insured plans. One reason is that usually standard products would not normally be allowed to fund a 412(i) plan. A new product would have to be designed, or existing products would need to be amended to comply with the specifics of the 412(i) funding. Additionally, not many insurance companies market and administer plans for the small business situation. Usually the funding options for a 412(i) plan would be to totally fund the plan with a fixed annuity, or to fund the plan with a combination of fixed annuity and whole life products. Variable annuity and universal life products generally do not have the necessary guarantees to accommodate the funding and benefit requirements of a fully insured plan.

Conclusion

To summarize, the future plans of choice for the small business may well be the new comparability profit sharing plan as the defined contribution option and the 412(i) fully insured plan as the defined benefit option. All small businesses and their advisors should be aware of both types of plans and the advantages of each.

Commonly Asked Questions:

What is a 412(i) defined benefit pension plan?

A 412(i) defined benefit pension plan, referred to in IRS regulations as an “insurance contract plan”, is the only defined benefit plan that is exempt from the minimum funding requirements of Section 412 of the internal revenue code. This type of plan, therefore, enjoys certain advantages over the traditional defined benefit plan and is worth exploring if you are the owner of a small business.

These advantages create a plan that, compared to a traditional defined benefit plan, will produce:

- larger initial deductions
- more stability in the contribution level,
- simpler plan administration, and
- a secure promise of future benefits guaranteed by an insurance company.

What are the advantages of a 412(i) insurance contract plan over a “traditional” defined benefit plan?

A 412(i) insurance contract plan:

- does not require an enrolled actuary;
- is not subject to the full funding limitation tests of a defined benefit plan;
- is required to use the contract guarantees as funding assumptions, thus shielding them from IRS attack as unreasonable funding assumptions;
- can be designed to eliminate the potential of excess plan assets that, in a traditional plan, would be subject to taxes and penalties of 80% or more upon termination of the plan;
- produces an understandable accrued benefit since it is simply the cash value of the contracts funding the participant’s account;
- creates larger initial deductions than a traditional plan since the funding assumptions are required to be much more conservative; and
- provides retirement benefits that are guaranteed by the insurance company and not just the financial strength of the particular employer providing the plan.

What requirements must be met to qualify as a 412(i) insurance contract plan?

The major requirements under Section 412(i) of the Internal Revenue Code are:

- The plan must be funded exclusively with annuity products, or a combination of life insurance and annuity products, issued by an insurance company.
- The benefits provided each individual must be equal to the values provided in the contracts and guaranteed by the insurance carrier.
- Life insurance dividends and excess annuity interest must be used to reduce the following year's plan contribution.
- No policy loans are allowed under the contracts.

How does the initial deductible contribution required in a 412(i) plan compare to a traditional defined benefit plan?

Generally, a plan funded with only annuity contracts may DOUBLE the deductions allowed under a traditional plan. A plan funded with both annuity and the maximum life insurance allowed may TRIPLE the deduction allowed in a traditional defined benefit plan. See the appendix page that illustrates the maximum first year contribution levels for a 412(i) plan funded with ANICO products. These contribution levels are shown from ages 35 to 65. Comparisons are made for plans funded entirely with annuity contracts and those funded with a combination of annuity and the maximum amount of life insurance available under the incidental insurance rules for qualified plans.

Are 412(i) plans new to the retirement planning marketplace?

No. These plans have been around since ERISA (in 1974) or even before. They were referred to as "fully insured defined benefit plans". In past years, before the demise of retirement endowment contracts, they were fully funded with a retirement endowment contract issued with a face amount equal to 100 times the normal retirement benefit. They are not a "gray area" of the law and are, in fact, a very conservative approach to retirement plan funding. An insurance company guarantees all benefits.

Where do you go to find a 412(i) plan?

Generally, you will go to an insurance company that sells these types of plans. The funding must be in insurance company products and the company must guarantee the benefits. There are very few insurance companies who market and administer small business retirement plans so there are very few companies that market 412(i) plans. That is why it is a plan that is somewhat unfamiliar to most CPA's and small business owners.

Why does American National market these plans?

We believe it is a market that is under-served. We specialize in the small business retirement plan marketplace. We design, administer, and fund plans for the small business. It is, therefore, natural that we market 412(i) plans. These are specialized plans that create large deductions. In the right situation, there is no other plan that will meet the needs of the small business owner. If a traditional defined benefit plan does not create sufficient deductions, there is nowhere else to turn but to a 412(i) fully insured plan.

What products are utilized at American National for these plans?

We have a Whole Life product, which was modified to fit this market, and we have both an individual and group fixed annuity for this marketplace.

Do the contributions remain level forever?

The contributions will gradually decrease since the excess interest earned over the guaranteed rate must be used to reduce the following year's contribution. The dividend payable on the life policy will also be used to reduce the following year's contribution. However, if the deduction decrease becomes a problem, it is likely the plan benefit can be increased to compensate for that since the maximum benefit levels are subject to annual cost of living increases declared each year.

What does American National charge to administer these plans?

We charge \$200 to establish the plan, which includes providing the plan, and trust document and providing the plan trustee with a manual including all documents and administrative forms that may be needed in the future. Annually, we charge \$600 to provide full administration (\$500 if a one person plan). The full administration includes all IRS and DOL forms and the plan valuation and 5500 forms required. The forms will be prepared and ready for the trustee to sign and mail each year to the proper government agency. Note that for new plans established in 2002 and thereafter, the new tax law (EGTRRA) allows a 50% tax credit for the first three plan years for administrative expenses (up to the first \$1,000 of expenses).

What is necessary to see if a plan is feasible for you?

American National will provide a FREE feasibility study to see if a plan fits your situation. All that is needed from you is a census of all employees of the firm.

Who is the best prospect for this type of plan?

Generally, it will be a firm with 5 or less employees where the owner is at least age 50 and earns a very high, consistent income. The ideal prospect is an independent contractor with no employees.

What could I say to spark interest in a prospect?

The new tax law (EGTRRA) contained more than 60 provisions intended to encourage the establishment of small business retirement plans. *Have you reviewed the opportunities for your business in light of the new tax law? Or ... if a plan already exists ... have you reviewed your plan in light of the new tax law to verify you have the most efficient plan design to benefit yourself?* Because the new tax law allows larger deductions and creates more ways to specifically benefit you, the owner, *it may be costing you money by not having a plan. All I need from you is a census to give you a free look at what a retirement plan would look like for your particular business.*

PENSION DISCUSSION QUESTIONS FOR PROSPECTS AND CPA'S

IF PROSPECT DOESN'T HAVE A PENSION OR PROFIT SHARING PLAN:

- When was the last time you explored the possibilities of a pension or profit sharing plan?
- Have you looked at a plan lately – after all the recent tax law changes?
- Have you ever heard of a cross-tested profit sharing plan?
- Have you ever heard of a 412(i) defined benefit plan?
- Did you know you might be able to get a very large share of your company's plan contribution now after the recent tax law changes?
- You wouldn't object to a free look at what a plan could do for you and your business, would you?
- Do you realize it may be costing you money NOT HAVING a plan?
- Which of your employees would you most like to benefit?
- All I need is a census and I can supply a free pension plan feasibility analysis.

IF PROSPECT HAS AN EXISTING PENSION OR PROFIT SHARING PLAN:

- What kind of plan do you have?
- How long have you had this plan
- Who is doing the administration?
- Are you satisfied with the administration – and the administrative fees?
- Have you reviewed your plan to see if you are getting your fair share of the contribution after all of the recent tax law changes?
- Did you know that all plans now have to be amended and restated to incorporate all the new tax law changes affecting pension and profit sharing plans?
- Is someone lined up to review and amend your plan document before the approaching deadline?
- Are you satisfied with your plan investments?
- What do you like best about your current plan?
- What do you like least about your plan?

QUESTIONS FOR A CPA:

- Do you work with small business owners and closely held corporations?
- How many employees does your average client have?
- Do most of your clients have a qualified plan? If not, why not?
- If so, what kind of plan do most of them have?
- Do you currently have a plan?
- Are your clients getting the most out of their plans?
- Are you familiar with the large deductions available in 412(i)

Defined Benefit plans?

- Are you familiar with New Comparability profit sharing plans that could potentially give a very large share of the contribution to the business owner? Do you have a sample client on whom you would like a free feasibility study?
- Are you aware of the increased deductions, new portability, and increased flexibility after passage of the new tax law in 2001?

PENSION PROVISION HIGHLIGHTS OF “EGTRRA”

THE ECONOMIC GROWTH AND TAX RELIEF RECONCILIATION ACT 2001 (SIGNED INTO LAW JUNE 7, 2001)

- \$2,000 IRA contribution limit raised to \$3,000 in 2002: \$4,000 in 2005 through 2007: \$5,000 in 2008, then indexed in \$500 increments
- an IRA “catch up” contribution will be allowed for people age 50 and older of an additional \$500 in 2002 through 2005, and an additional \$1,000 thereafter
- \$10,500 401(k) elective deferral limit raised to \$11,000 in 2002, then increased \$1,000 each year until \$15,000 in 2006, then indexed in \$500 increments
- \$6,500 SIMPLE plan limit increased \$1,000 each year beginning in 2002 until \$10,000 in 2005, then indexed in \$500 increments
- \$140,000 maximum defined benefit dollar limit increased to \$160,000 in 2002, then indexed in \$5,000 amounts
- no actuarial reductions to the maximum defined benefit limit will be required for normal retirement ages between 62 and 65
- \$35,000 maximum defined contribution dollar limit raised to \$40,000 in 2002, then indexed in \$1,000 increments
- \$170,000 maximum salary limit raised to \$200,000 in 2002, then indexed in \$5,000 increments
- plan loans for sole proprietors, partners, and Sub-S shareholders allowed beginning in 2002
- 401(k) elective deferrals no longer count toward the employer’s deduction limit
- new small employer plans will not have to pay a user fee for a letter of determination
- the profit sharing deduction limit will be increased to 25% in 2002
- a tax credit will be allowed for the start-up costs for a new small business retirement plan
- a 401(k) "catch-up" provision will be allowed for people age 50 and older of \$1,000 in 2002, then increased each year by \$1,000 until \$5,000 in 2006, then indexed in \$500 increments
- the 25% of compensation limit in defined contribution plans is increased to 100% in 2002
- many additional pension provisions are included in the Act to encourage the establishment of small business retirement plans

STEP 1 ACTIVITY Identify a List of Prospects

To complete this step, make a list of at least 10 people (businesses). These people may be:

- Existing Clients
- Prospects
- Referrals
- Local Businesses that you Patronize
- Friends, Associates, Family
- Professionals (doctors, lawyers, etc.)
- CPAs

The goal of this activity is to create a list of potential prospects that you can talk to about Small Business Retirement Plans. As you develop your list, focus on successful individuals (companies) that have good, steady incomes and are probably looking for ways to plan and save for retirement while reducing their tax obligations.

Prospecting Methods

You can make initial contact with targeted prospects/clients in several ways:

- Call the decision-maker by phone and follow up with a letter
- Call and follow up with a personal visit
- Send a letter or e-mail and follow up by phone
- Send a letter or e-mail asking for a response or appointment

Decide how you want to approach each prospect, based on prospecting methods that have worked best for you in the past. Be flexible, because some companies have preferred methods of handling inquiries or proposals. If one method doesn't work, you may want to try another. One goal of your initial prospecting contact is to obtain enough information from a decision-maker to decide which of four categories a company falls into:

1. A qualified prospect for plan business now
2. A qualified prospect for plan business later
3. A qualified prospect for other types of business
4. Not qualified, and no need to keep contacting

STEP 2 Develop & Mail Pre-Approach Letters

To complete this step, create your pre-approach letter(s) by using the samples provided. If you do any editing or personalization of the included sample letters, be sure not to alter key facts and figures stated in these samples. Mail the appropriate letter to all 10 of the Prospects that you identified above.

You will need to tailor your letter to the intended audience. For example, if your list includes a small business owner that has 5 or fewer employees, the sample pre-approach letter to business owners on 412(i) may be the appropriate version.

If your target audience is a CPA, edit the sample letter to CPAs on either 412(i) or New Comparability.

The goal of this activity is to provide you with an icebreaker with these prospects and a topic of discussion in your **required** follow up phone call or visit.

ACTIVITIES:

1. Create letter (s)
2. Mail letters
3. Follow up with phone call or visit

ICEBREAKER PHRASES & QUESTIONS FOR YOUR FOLLOW UP CONTACT:

"Hello, this is (name) from LIFE BROKERS. I'm calling in regards to the important information I recently sent to you on Small Business Retirement Plans. Do you currently have a qualified plan for your business? (if no) ... With the recent tax law changes, the time has never been better to take a free look at what a small plan would look like for your business. There were over 60 provisions of this new law designed to make these plans more attractive to small business owners like you. In fact, without a plan in place, it is probably costing you money. The plans I propose are all custom designed for your particular business and goals. The focus of these plans is to give you the largest possible deduction or the largest possible share of the contribution. In order to give you your free look at what a plan could do for you, all I need to do is complete a short census or fact-finding form. If you like what you see, we can talk more about a custom designed plan for you. If you don't like what you see, we simply throw the plan proposal away – with no obligation or cost on your part. Would (Tuesday morning) or (Wednesday afternoon) be better for you?"

STEP 3 Contact Prospects for Initial Interview

The purpose of this activity is to present the idea to the prospect that:

- 1 *if he does not have a plan, he needs to take a free look at what a plan could do for his business; or*
- 2 *if they have a plan, has it been reviewed in light of the recent tax law changes?*

In either situation, the majority of the time, you will have something to talk about. *(Remember, it is estimated that over 80% of small businesses do not have a plan.)*

ACTIVITIES:

1. **Develop a script for your phone or in-person contact**
2. **Use this exercise to:
 set the initial
 interview
 pick up a
 completed CENSUS**

Development of *YOUR SCRIPT* can be taken from the script text in **STEP 2** above or by referring to the page **PENSION DISCUSSION QUESTIONS FOR PROSPECTS & CPAs** for additional ideas and key phrases for discussion purposes.

The purpose of this step is to conduct the client interview and pick up a completed CENSUS form. You will have to use your already developed prospecting and interviewing skills. This exercise is not to advise your clients/prospects on all the intricate and technical aspects of small business plans, but to ask probing questions and gather enough information from the business to do a *case design* tailored to the specific needs of the business. At this point, you are simply offering a free look at what a plan could do for the business.

Instructions for Completing This Activity

- Select companies on your “A List” of prospects. It’s advisable to select a company that you already know, even one where an existing client or associate works. Select a company where you believe you can succeed.
- Decide which decision-makers you want to contact first and how to approach them.
- Prior to making your first contact, personalize your *script*.
- After making your first contact, assess your prospecting contact (see *prospecting methods in STEP 1*).

STEP 4 Completing the *fact-finding* CENSUS

Completion of this step is filling out the AMERICAN NATIONAL **CENSUS** form in preparation to send it to the Pension Department for review and case design.

The form needs to be completed in full. The more information you can provide to the *case designer*, the better he is equipped to design the most appropriate and attractive solution to the client's needs and desires.

An important note when conducting your interview and fact-finding:

At this stage of the interview process, it is suggested that you do not enter into detailed discussions on any one particular plan and oversell a concept that may turn out not to be the best choice for this particular business.

An example would be to conduct your interview extolling only the many benefits and large deductions possible with the 412(i) Defined Benefit Plan. Unless you are comfortable with the criteria that determines the best fit for any given plan, you may want to avoid having to come back with an alternative plan that may be perceived as less attractive.

AMERICAN NATIONAL's Pension Department has the *expertise* to guide you and your clients towards the best possible decisions in small business retirement planning. Utilize this value-added resource to it's fullest potential recognizing they ~~are~~ *part of you* in your business development back office.

A sample of the AMERICAN NATIONAL **CENSUS** form can be downloaded from the website: www.imo.anicoweb.com

Independent Marketing Internet Website URL:

<http://imo.anicoweb.com>

Access to this site is restricted, therefore you must code in the following when prompted:

User name:

imoagent Password:

imoagent1

Clicking on the PENSIONS button leads you to:

Quick e-mail communication hyperlinks and a reminder of our toll-free phone number, along with additional options to view . . .

- [Plan types](#) – contains brief description of various types of qualified plans, just click on the type of plan you want to learn more about.
- [Proposals](#) – census and fact finder form to aid you in requesting a proposal on your prospect
- [Installation](#) – checklist for writing a new plan (copies of adoption agreements and a guide to completing them to be added soon)
- [Administration](#) – a complete service agreement outlining what we do along with our fee schedule
- [Technical](#) – table of maximum benefit limits for the year 2000 (additional technical materials will appear here soon)
- [Brochures](#) – a list of materials available along with their form numbers to assist you in ordering supplies

American National Pension Application Guidelines

Applications for all life and annuity products can be found on the IMO website, www.imo.anicoweb.com then click on the link to [Virtual Forms](#) and follow the instructions on the screen to find the applicable form(s) for your state.

Key points to remember:

The owner and beneficiary of any contract in a plan will always be the Trustee of the plan, for example: Trustee, ABC Company Defined Benefit Pension Plan or Trustee, ABC Company Employees 401(k) Plan.

412(i) Defined Benefit Plans can only be funded with the Group Unallocated Fixed Annuity or a combination of Century Pension Par Whole Life and the Group Unallocated Fixed Annuity.

Profit Sharing Plans and 401(k) Plans will generally be funded with the WealthQuest III Group Unallocated Variable Annuity. Some plans may also use Pension Whole Life or Pension Universal Life on a selected basis.

401(k) and Profit Sharing Plans can either offer the employees the option of directing their accounts or the Trustee of the plan can make the investment elections for all of the accounts on the GUYA application.

The WealthQuest III Group Variable Annuity offers 40 investment choices but the plan can restrict the participants to a limited number of accounts options if they prefer. If they do wish to restrict the accounts contact the Pension Sales Department for a customized enrollment form, otherwise use the enrollment form found on the Installation page of the Pension section of the website.

American National Insurance
Company Pension Administration
Fee Schedule For Plans With 25 or
Fewer Lives

Installation:

Installation.....

.....\$ 200

Annual Administration: Defined

Benefit..... \$ 600

Profit Sharing..... \$

500 New Comparability Profit

Sharing..... \$ 600 Safe Harbor

401(k)..... \$700 Safe

Harbor 401(k) with New Comparability..... \$800

401(k) Profit Sharing.....

\$1,000

American National Insurance
Company Pension Administration
Fees For Plans with 26 to 300 lives
Effective July 1, 2000

PLAN INSTALLATION

Standardized document	\$300
Non-standardized document	\$500 *

*Does not include IRS user fee

ANNUAL ADMINISTRATION

Defined Benefit	\$400
Money Purchase	\$300
Profit Sharing	\$300
New Comparability, add	\$100
401(k) add	\$500
If no ADP/ACP testing, subtract	\$300
All plans, add per eligible participant	\$10

Assumptions

- ADP/ACP Test performed annually after close of year ·
- ANICO prototype document is used · ANICO WealthQuest
- Group Variable Annuity used for funding

401(k) INTERNET ACCESS

“ SAMPLE THE PROCESS ” VIEW THE ACCOUNTS

STEP 1: go to website www.anico.com and click on the *401(k) button*

STEP 2: click on *“access your account”*

STEP 3: input User ID as the *Social Security Number 111111111*
and use the *password 1111*

This sample site allows you to access all account information screens available to participants in ANICO administered 401(k) plans. Each participant can access these screens on any computer 24 hours a day 7 days a week. The participant can view his or her daily account values at any time, transfer funds among the account offerings, and verify contribution levels as well as viewing other vital information relating to the account.

P.S. For those without computer access: A toll free telephone access number accomplishes the same result by giving automated account information on the phone 24 hours a day 7 days a week, and also allows transferring funds among the accounts.

Alternatively, you can input the web address of 401k.anico.com and you will be at “access your account” screen. From here, you can proceed with inputting the “1’s” as the user ID and password as indicated above.

Life Insurance in Qualified Plans

Legal Limitations

Personal Plans

- **IRAs:** IRAs, IRA rollovers, Roth IRAs SEPs and SIMPLE IRA arrangements may not pay the premium for life insurance policies.
- **Tax sheltered annuities:** TSAs may invest in contracts, which provide incidental life insurance protection. See Reg. Sec. 1.403(b)-1(c)(3).

Business Plans

- **Defined contribution plans:** The percentage of the total annual employer contribution, which can be allocated to life insurance premiums, varies with the type of policy. There is no limit on the face amount.
- **Term and universal life insurance:** Less than 25% of the annual allocation.
- **Ordinary whole life insurance:** Less than 50% of annual allocation.
- **Combination:** One-half of the ordinary life premium and the entire term and/or universal life premium must be less than 25% of the total. The face amount of the insurance may not exceed 100 times the anticipated monthly retirement benefit. See Rev Ruls. 61-164 and 1961-2 CB 99. For example, if a \$5,000 per month retirement benefit were anticipated, the maximum amount of life insurance would be \$500,000.
- **Special rule for profit sharing plans:** Allocations which are more than two years old may, in some cases, be totally invested in life insurance. See Rev Ruls. 61-164 and 1961-2 CB 99. For example, if a \$5,000 per month retirement benefit were anticipated, the maximum amount of life insurance would be \$500,000.
- **Alternative rule:** Total premiums for ordinary life must be less than $66 \frac{2}{3}\%$ (or $33 \frac{1}{3}\%$ for term or universal life insurance) of the assumed aggregate contributions that have been made for the participant from the beginning of his or her participation in the plan. See IRS Rev. Rul. 74-307.
- **Other general rule:** Insurance must be made available or purchased on a uniform and non-discriminatory basis.

Life Insurance in Qualified Plans

Continued

Advantages to the Employee

- Because income and estate taxes on the death benefit may be very substantial, the non-income-taxable insurance proceeds may be used to pay the income taxes and/or estate taxes due on the other plan assets or estate assets. Life insurance protects the other noninsurance assets
- It is an easy way to provide additional protection for one's family if death occurs prior to retirement age.
- It frees up other personal dollars now being spent for life insurance outside the plan.
- The majority of the premium for ordinary and universal life insurance is not taxable to the employee.
- The policy can be moved to another plan if the employee changes employment, providing the new plan will accept it.
- At retirement age, the employee may be able to take a fully paid up policy, rather than face the expense of converting his or her group insurance.
- The pure insurance portion (the face amount less the accumulated cash values) of the death benefit passes to the beneficiaries income tax free.
- A waiver of premium may be added which will continue to pay the life insurance premiums should the employee become disabled.
- Uninsurable participants may be able to purchase a limited amount of guaranteed-issue insurance. In larger plans, it may be a substantial amount.
- When a participant in a defined benefit plan is rate for insurance risk purposes (usually for poor health or occupational hazards), the plan can pay the higher premium without increasing the cost to the participant.
- Net investment returns over time can be competitive with other types of investments.
- Table I costs reported as income under group coverage in excess of \$50,000 are not recoverable. Economic benefit costs incurred for the pure insurance portion of policies in qualified plans may be recovered at the time of distribution.
- Ordinary or universal life policies can be used as an annuity at retirement age. The insurer will give the participant the higher of either the rate guaranteed in the contract or the then current rates.
- Traditional financial and estate planning seeks a balanced approach to investment portfolios. Ordinary and universal life insurance policies can represent the fixed side of the program. Variable life and variable universal life policies also offer an equity or stock market option for the cash value portion of the policy.

Life Insurance in Qualified Plans

Continued

Advantages to the Employer

- The premiums are deductible as a part of the plan contribution.
- If the employee has a paid-up policy under the qualified plan at retirement age, he or she may not need to convert group insurance to permanent. With larger, experienced-rated group life contracts, there is typically a charge (sometimes substantial) to the experience when a policy is converted.
- Under a defined benefit plan, if the insurance proceeds equal the entire pre-retirement death benefit and a participant dies, all of the other equity assets can be used to reduce future employer contributions to the plan.
- If participating whole life contracts are used and dividends are used to reduce the premium, the long-term cost in a defined benefit plan may be very favorable.
- In defined benefit plans the employer may be able to make a larger contribution and deduction by including ordinary life insurance in the plan. This is often helpful because of the restrictions on retirement plan benefits and contributions.
- Corporate retained earnings problems may be lessened by increasing the contribution to a defined benefit plan, which provides for life insurance. Pension plan assets do not appear on the corporation's balance sheet.
- Younger employees may look at the protection as a current benefit, whereas retirement age may seem to be a long way off.

Disadvantages

- If there is an estate tax problem, the life insurance proceeds will increase the size of the gross taxable estate. If the surviving spouse is the beneficiary, there will be no immediate death tax payable, due to the unlimited marital deduction. However, the surviving spouse's estate will be increased, thus increasing the potential estate tax at his or her subsequent death. As an alternative, consider having any additional life insurance owned by an irrevocable life insurance trust, designed to keep the proceeds out of the estates of both spouses.
- It is a tax shelter within a tax shelter. Under current law, the buildup of cash values in a life insurance contract are tax deferred and do not need to be in a qualified plan to get this tax advantage.

Glossary of Key Terms

Accrued Benefit – For defined benefit plans, the accrued benefit is the amount that the plan participant will receive annually as a life annuity beginning at the plan's normal retirement age, as determined by the plan benefit formula. For **defined contribution** plans, the accrued benefit is the balance of a participant's individual account. This balance includes the sum of participant and/or employer contributions and investment returns (gains or losses), dividends, and capital gains (or losses) attributable to those contributions.

Annuity – A series of periodic benefit payments (either annual or monthly) that begins at retirement and continues for a certain period of time or the participant's lifetime. Annuities may continue through the lifetime of a participant's surviving spouse.

Blackout – A blackout occurs when a plan sponsor suspends, restricts, or limits – for a period of three or more consecutive business days – the ability of participants or beneficiaries to direct the investment of assets in their accounts, obtain loans, or obtain benefit distributions. Although the plan sponsor has suspended account transactions, benefits continue to accrue. Blackouts may be implemented for a number of reasons such as when a plan sponsor changes administrators or when a plan must perform administrative tasks that require a temporary suspension of account activity.

Cash Balance Plan – A type of defined benefit plan that combines certain features found in both defined benefit and defined contribution plans. Participants' benefits are determined by a formula, like a defined benefit plan, but benefits are expressed as account balances, similar to a defined contribution plan.

Defined Benefit Plan – A type of qualified plan where the plan sponsor provides a guaranteed benefit generally expressed as monthly benefit based on a formula that generally combines salary and years of service. Defined benefit plans express benefits as an annuity, but may offer departing participants the opportunity to receive lump sum distributions.

Defined Contribution Plan – A type of qualified plan that establishes individual accounts for employees to which the employer, participants, or both make periodic contributions. Defined contribution plan benefits are based on employer and participant contributions to and investment returns (gains and losses) on the individual accounts. Participants may be able to direct the investment of the assets in their individual accounts.

Elective Deferrals – Voluntary contributions that a defined contribution plan participant may elect to have made to his or her individual account. These contributions are made from the employee's pretax income, and participants do not include these contributions as taxable income until they receive benefits.

Employee retirement Income Security Act of 1974 (ERISA) – The federal law that sets minimum standards for pension plans sponsored by private employers. These standards govern the management, operation, and funding of the plan. The Department of Labor's Pension and Welfare Benefits Administration enforces these ERISA provisions.

Employee Stock Ownership Plan (ESOP) – A defined contribution plan feature that requires the plan sponsor to invest plan assets primarily in shares of the employer's stock. Through an ESOP, the employer makes tax-favored contributions of company stock to individual participant accounts.

Employer Matching Contributions – Employer contributions made to defined contribution plan participants' accounts only if the participant makes elective contributions to the plan. Matching contributions are generally based on a specified percentage of the employee's salary and the rate at which the participant contributes.

401(k) Plan – A type of defined contribution plan feature that allows employees to reduce a portion of their current compensation for a contribution, on a pretax basis, to a qualified retirement account. Generally, participants may direct the investment of their account balances among a menu of investment options offered by their employer. Many sponsors match a portion of participants' pretax contributions.

Individual Retirement Account -A retirement arrangement authorized by ERISA and the IRC. Banks and other financial institutions may make IRA's available to workers. IRA's allow workers to make tax-deductible and nondeductible contributions to an individual account. For workers who meet certain conditions regarding their income or who are not eligible to participate in their employer's pension, contributions to an IRA receive favorable tax treatment; workers may take a current deduction on the contributions they make to their retirement accounts. Recently, another type of IRA known as the ROTH IRA, that allows workers to make after-tax contributions and provides tax-free withdrawal of assets at retirement has been made available.

Internal Revenue Code of 1986 (IRC) – Establishes requirements that private pension plans must satisfy, including minimum requirements on coverage and benefits, in order to be qualified for tax-favored status. Employers who sponsor tax-qualified plans are entitled to a current deduction (within limits) for the contributions they make to their plans. Also, contributions to a tax-qualified plan are not included in an employee's income until he or she receives benefits. The IRS enforces IRC requirements that apply to tax-qualified plans.

Joint and Survivor Annuity – A type of annuity payment option that provides an annuity benefit for the surviving spouse of a retired plan participant after the participant dies. In a defined benefit plan, the normal form of payment must provide a joint and survivor annuity to married participants. The benefit payment received by the surviving spouse must equal at least one half of the annuity benefit payment that the plan participant had received.

Lump Sum Distribution – The payment of a participant's accrued benefit as a one-time lump sum cash payment. Upon separation from the company, disability, or retirement a participant may be able to elect to receive his or her benefit in this form.

Minimum Funding Requirements - Certain defined benefit and defined contribution plans subject to ERISA must satisfy minimum funding requirements that are intended to ensure plan assets are sufficient to pay benefits when due to participants.

Nondiscrimination Rules – Private employers that sponsor tax-qualified plans must satisfy certain requirements regarding how benefits or contributions are distributed between rank-and-file employees and highly compensated employees such as company executives and owners. These rules are intended to ensure that HCE's do not receive a disproportionate share of the plan's benefits. There is a general nondiscrimination requirement that applies to all benefits, rights, and features of the plan.

Nonqualified Pension Plan – An employer-sponsored pension plan that does not meet the applicable requirements for tax-qualification under the IRC. Employers do not receive a tax deferral on the contributions they make to nonqualified plans. Unlike qualified plans, nonqualified plans typically do not have to satisfy laws and regulations requiring a minimum level of benefits or contributions to the plan.

Pension Benefit Guaranty Corporation (PBGC) – A federal corporation created by ERISA to insure the pension benefits of participants in qualified defined benefit pension plans. The PBGC takes over terminated db plans with insufficient assets to pay the benefits to which participants are entitled, and is responsible for paying those benefits up to certain limits set by law. PBGC does not cover defined contribution plans.

Plan Fiduciary – Defined by ERISA as any person who exercises discretionary control or authority over the management of a private pension plan and/or the plan's assets, has the authority to render advice regarding plan assets in return for compensation, and/or has discretionary authority or responsibility in the administration of the plan. The plan fiduciary is obligated to act prudently and exclusively in the interest of the plan participants and beneficiaries.

Plan Termination – An employer may terminate its plan so long as it meets certain requirements. In certain instances, a plan may not have sufficient assets to pay participants' accrued benefits, and the PBGC may take over the plan.

Qualified Pension Plan – An employer pension plan that receives preferential tax treatment in exchange for satisfying certain requirements established in the IRC of 1986. Under current law there are a number of requirements that private pension plans must satisfy, including non-discrimination, benefit or contribution limitations, and minimum requirements on coverage and benefits, in order to be tax-qualified.

Rollover – A direct transfer of pension benefits received as a lump sum payment to another tax-qualified retirement plan or an IRA free of taxes. Employers who sponsor qualified plans and enable departing participants to receive benefits as lump-sum amounts must give participants the option to have these amounts “rolled-over.”

Trust – A legal arrangement distinct from the plan sponsor where the contributions to the pension plan are deposited with a trustee. The trustees of the plan hold the title to all plan assets, whether they direct the investment of plan assets or the investment of plan assets is the responsibility of an appointed fiduciary or plan advisor.

Vesting – Refers to when a plan participant has earned a right to a benefit that cannot be taken away (i.e., a nonforfeitable right to the participant's accrued benefit). There are certain rules that private plan sponsors must follow regarding the length of time that participants must work in order to be fully vested in their accrued benefits. Participants are 100 percent vested in any contributions they make to a qualified plan, but may have to work for a certain period of time before earning a right to their employer's contributions.