

SMALL-BUSINESS OWNERS SHOULD BE CAUTIOUS ABOUT PUTTING LIFE INSURANCE INTO RETIREMENT PLANS

Small-business owners should think carefully before establishing a defined-benefit retirement plan funded partially or exclusively by life insurance, caution many financial planners. The Internal Revenue Service is cracking down on what it calls abusive tax-shelter versions of these highly touted plans.

Section 412(i) plans have been around for many years but have become especially popular since the recent bear market sliced deeply into traditional retirement plans such as 401(k)s. The employer funds the 412(i) exclusively with tax-deductible contributions for annuity contracts or a blend of annuities and whole life insurance for selected employees and the owner. If the employer wants to buy life insurance, it must be an “incidental” amount—no more than 100 times the plan’s monthly retirement benefit under IRS guidelines. Returns are a guaranteed minimum—typically in the one and a half to three percent range.

Proponents view 412(i) plans as an attractive alternative to more traditional small-business retirement plans for owners whose business produces relatively high stable income, employs few workers, and who are over the age of 50 with a need to quickly and heavily fund their underfunded retirement nest egg. Because a 412(i) plan uses a low guaranteed return product, it allows higher annual tax-deductible contributions than many alternatives (potentially as high as \$200,000–\$300,000 annually).

The recent IRS scrutiny and its issuance of new rules focus on the “overzealous” promotion of life insurance in these plans. In particular, some sponsors have promoted

412(i) plans using “springing cash value” life insurance, or using only life insurance under questionable interpretation of IRS rules.

Briefly, the concept is to have the qualified plan buy a whole life insurance policy on the life of the owner(s) (the self-employed also can set these up) and the lives of other highly compensated employees, while buying insurance or annuities for the rank and file. The employer heavily funds the life policy in its early years with large tax-deductible premiums while the participant pays annual income tax only on the “cost” or value of the pure death benefit protection. Critics argue that this tax offsets some of the benefit of the plan and they claim that putting the tax-free build-up of permanent life insurance inside a tax-deferred retirement plan may be redundant.

But here’s where proponents argue that the real value of the strategy shines: after making the initial large pre-tax premium payments with comparable tax benefits, the plan distributes the life insurance policy to the owner or employee while the cash surrender value is still low – much lower than the total of the premiums paid. The participant pays tax on the low cash surrender value, even though the policy is worth much more. Subsequently, the cash value “springs,” or balloons, in value, from which the participant can take income-tax-free loans for retirement. Some insurance companies have even allowed participants to exchange or convert the policy into other policy types designed to earn higher rates of return.

Too good a deal, says the IRS. In a series of rulings, it has effectively wiped out the excessive tax benefits of the springing cash value strategy by declaring that participants must now pay taxes based on the policy’s full fair market value at the time of transfer (instead of the artificially suppressed surrender value). It also reiterated that the employer cannot buy “excessive” amounts of life insurance and that 412(i) plans cannot discriminate in favor of highly compensated employees and owners.

Legitimate uses for 412(i) plans remain, but business owners need to be wary of 412(i) marketing schemes that seem too good to be true. They also need to carefully scrutinize with their financial advisor the economic viability of even legitimate 412(i) plans versus comparative alternatives.

For example, some critics of 412(i) contend that proceeds from life insurance held in an irrevocable trust are generally exempt from estate tax, as well as income tax, while a policy held inside a retirement plan will likely be included in the owner's estate.

Proponents counter that a 412(i) can be a good avenue for someone who wants large, immediate income-tax deductions as well as to buy life insurance but whose resources to pay for that insurance may be otherwise limited.

-30-

June 2004— This column is produced by the San Diego Chapter of the Financial Planning Association™. We can be a continued resource for your personal finance coverage. If you use this column in whole or part, please credit the chapter or one of our CERTIFIED FINANCIAL PLANNER™ members.