

Update On 412(i) Audits



As many of you know, the IRS is aggressively pursuing abusive 412(i) plans and is to be applauded for doing so. Generally, these are the plans that involved springing cash value insurance products with artificially low values to allow a minimum tax on the buyout of the policy from the plan. Many also involved exceeding the incidental rules for the purchase of insurance with as

much as 100% of the contribution used for the life insurance purchase. And, many ignored the nondiscrimination rules by issuing life insurance on the owners and annuities on the other participants.

However, in their zeal to attack these plans, the IRS appears to be going overboard and attempting to find something wrong with even legitimate plans. Some are finding the IRS attacking, in particular, the plans that are funding for an amount in excess of the lump sum limit allowed to be paid out of any defined benefit plan. This is known in the industry as the “GATT limit” as it came about in the GATT legislation many years ago.

By attacking this GATT limit in legitimate plans, it amounts to “creating law” by limiting the payout allowed in section 415 of the Code. Let’s assume, for example, that the GATT limit for a lump sum payout is currently 2 million dollars. Let’s say the insurance companies guaranteed annuity purchase rate to produce the maximum \$15,000 monthly payout at age 65 requires an accumulation of 3 million dollars. The law clearly allows a participant to receive a \$15,000 benefit and clearly requires the accumulation necessary to achieve this guaranteed payout. Thus, a participant desiring a guaranteed monthly payout of \$15,000 would need to accumulate 3 million dollars in the plan.

The IRS, by stating you should not be able to accumulate more than the current GATT limit of 2 million dollars is effectively saying that the participant could only achieve a monthly payout of \$10,000 from the plan at the guaranteed rates. Thus, by changing the allowable limit to \$10,000, they are creating their own law that does not currently exist. Therefore, the companies that have always run legitimate plans based on existing law are up in arms that the IRS, in audit situations, can find fault with the accumulation of amounts necessary to correctly fund the current limit allowed by law.

There are no IRS guidelines regarding this limit. There are no rulings, notices, procedures, etc., that have ever addressed this. It appears to only be coming out upon audit, and the client then has to argue their case at that time with the IRS.

Organizations such as the American Council of Life Insurance and others are now communicating with the IRS to stop this hassle of legitimate plans. As this goes to print, nothing has been officially decided, but certainly it is hoped that they will put a stop soon to this kind of attack on legitimate plans.

Companies running legitimate programs have used the same procedures for 30 years and have never been attacked on this basis. There seems to be no precedent in law to allow the attack on this basis. We will keep you informed.

So what does this mean to the current 412(i) marketplace? Until this is straightened out, our procedure at American National will be as follows:

Even though we don’t agree with the IRS standpoint on this GATT limit, we prefer not to put you or your clients in a position of having to argue the point with the IRS. Therefore, we will “back off” the full limit in these plans and fund for the current GATT limit. Those that want to fund for the full 415 limit allowed in these plans may do so by signing a “disclaimer” indicating they understand the current IRS stance in audit situations and prefer not to acquiesce to the IRS stance.

Now the good news. The Pension Protection Act of 2006 made changes to the rules for funding traditional defined benefit plans. The rules, in many situations, make the funding more appealing than a 412(i) plan anyway. We have our own enrolled actuary and have always written and administered traditional defined benefit plans - so we anticipate simply writing more traditional plans.

Additionally, we will soon be on the street with Cash Balance defined benefit plans which, in many cases, is more appealing than 412(i) plans or traditional defined benefit plans. We will keep you posted on the progress of these plans and will also explain them in more detail in future articles in this newsletter.

If you have questions, please contact the Pension Sales department at 1- 888-909-6504.



*American National
will be closed
Wednesday, July 4th
in observance of
Independence Day*