



# 412(e)(3) DEFINED BENEFIT PLAN

Producer Guide



 **TRANSAMERICA**  
INSURANCE & INVESTMENT GROUP

For producer use only. Not for distribution to the public.

# 412(e)(3) Defined Benefit Plans Funded With Transamerica Life Insurance Company and Transamerica Financial Life Insurance Company (“Transamerica”) Products Offer a Variety of Planning Opportunities



With guaranteed values, large tax deductions for business owners, and flexible exit strategies at retirement, it's easy to see why Transamerica's approach to 412(e)(3) is such an attractive option.

As a result of market fluctuations, many clients may not meet all of their retirement goals based solely on investments in stocks and bonds. To solve this problem, many clients use an Internal Revenue Code (IRC) Section 412(e)(3) defined benefit plan (412(e)(3) plan) to provide a guaranteed income stream at retirement. Plans may be funded exclusively with an annuity contract such as TransFreedom® II or TransFreedom® II NY or with a combination of an annuity and life insurance.<sup>1</sup> Financially strong life insurance companies such as Transamerica can help guarantee this retirement income.

This type of plan typically offers larger income tax-deductible contributions in the early years than might be available with a traditional defined benefit plan. In addition, because 412(e)(3) plan benefits are based on product guarantees, they are not

subject to the same minimum funding requirements that apply to traditional defined benefit plans. This simplifies the cost and administration of 412(e)(3) plans.

For those clients with inadequate life insurance protection, a 412(e)(3) plan can offer life insurance coverage on a pre-tax basis. For this need, Transamerica developed TransSecure® II and TransSecure® II NY, interest-sensitive whole life policies for those in the 412(e)(3) market who want to add life insurance protection to a plan.<sup>2</sup> If life insurance is offered in the plan, the insured participant will recognize the term costs (the economic benefit) as additional income on an annual basis, but his/her beneficiaries can then receive the death benefit in excess of the policy cash surrender value federal income tax-free. The policy cash surrender value would be taxable like other distributions from the plan. The following discussion assumes that both a TransFreedom II or TransFreedom II NY annuity and a TransSecure II or TransSecure II NY life insurance policy will be used in the 412(e)(3) plan.

**TransFreedom II** and **TransFreedom II NY** are flexible premium, deferred fixed annuities available for new sales in IRC Section 412(e)(3) defined benefit plans.<sup>1</sup> They offer a guaranteed minimum annual interest rate of 1.5% (1-3%\* in New York), have a seven-policy-year surrender charge period, and offer settlement options based on the Annuity 2000 table, with 2% interest. The 412(e)(3) plan trustee also agrees on a fixed, level premium schedule by an agreement between the plan and Transamerica, as required by IRC Section 412(e)(3).

**TransSecure II** and **TransSecure II NY** are limited pay, fixed premium, interest-sensitive whole life insurance policies.<sup>2</sup> What sets them apart from most whole life insurance products is the option to select a guaranteed premium pay period to meet the objectives of clients. Premium payment periods include a one-pay period and limited pay periods that may range from a minimum of 5 policy years to a maximum period of payment to age 65 or, if later, 10 policy years. The elected pay period will have a fixed premium and will guarantee coverage for life, subject to policy provisions. The products feature a low minimum face amount and a guaranteed level premium, combining some of the best features of whole life and universal life insurance.

*\* For New York a new rate is established for policies issued between 10/1 of that year and 9/30 of the next year. The minimum guaranteed interest rate will be at least 1% but not more than 3% and will apply for the life of the policy.*

## Using a Section 412(e)(3) Plan to Guarantee a Retirement Income Stream

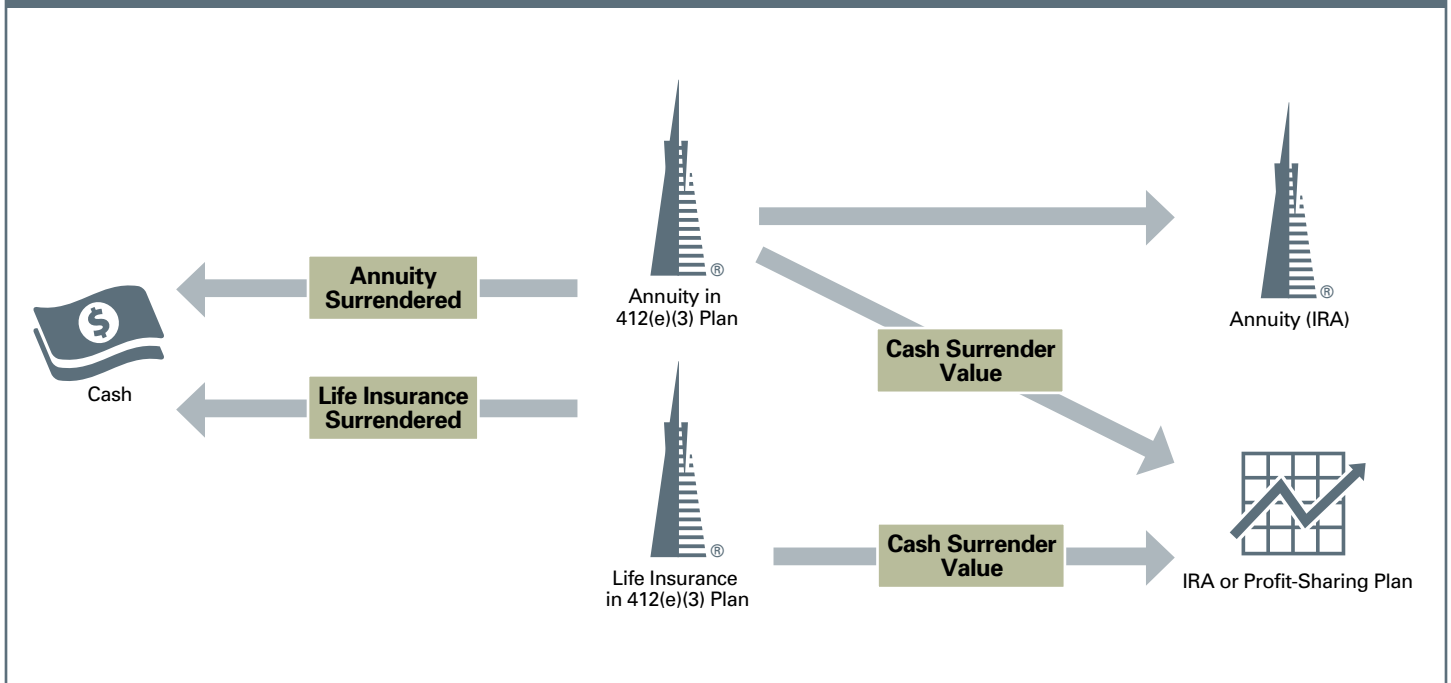
Clients considering a Section 412(e)(3) plan typically would like to guarantee their retirement income. At retirement, the plan participant would receive a monthly income for life or for the lifetimes of the participant and spouse. The contribution needed to fund this monthly income is determined at the inception of the plan using the underlying policy guarantees for interest credits and charges/expenses for **TransFreedom II**, **TransFreedom II NY**, **TransSecure II**, and **TransSecure II NY**. These guarantees, along with potential interest credits in excess of the guarantee, determine the plan's future annual funding requirements.

If the plan's retirement income option is selected, both the annuity and life insurance applicable cash values will be used to provide the income stream, eliminating the pre-retirement life insurance protection. Depending upon the participant's individual insurance objectives, the participant may have to replace the life insurance protection outside the plan using after-tax dollars. The income stream from the plan may be used to pay the premiums. In most cases, the participant must then undergo underwriting for the desired amount of insurance and pay premiums based on his/her current age.

## Section 412(e)(3) Can Offer Other Options

Some plan participants find themselves in the fortunate position of not needing an income stream at retirement or at separation from service. In this case, the plan typically may allow them to select a lump-sum equivalent to the plan's promised income stream. The plan participant can then roll over the lump-sum equivalent to either another qualified plan, such as a profit-sharing plan, or to an Individual Retirement Account/Annuity (IRA). Note that an IRA cannot own a life insurance policy, so if a life insurance policy is involved in the distribution, it cannot be rolled over to an IRA but can generally be rolled over to a profit-sharing plan.

## Plan Participant Retires or Separates from Service— Life Insurance Protection No Longer Needed



This scenario might present some unique planning options, depending upon the client’s individual situation. Let’s review several options that might be available for the plan participant either retiring or separating from service with a fully vested retirement plan benefit. Keep in mind that the plan may require from one to seven years of plan participation or service with the employer before the plan participant will be fully vested. For a 412(e)(3) plan participant, the accrued benefit is equal to the sum of the annuity and the life insurance policy cash surrender values.

### Life Insurance Protection No Longer Needed

If, by the time the plan participant retires or separates from service, he/she no longer needs any life insurance protection, the plan trustee can surrender the life insurance policy, recognizing company-imposed surrender charges if applicable. Alternatively, the plan participant could roll over the

cash from the life policy into an IRA or a profit-sharing plan, if the plan permits. The annuity contract could be distributed to the plan participant or it could be surrendered, subject to company-imposed surrender charges. In addition, with the consent of Transamerica, the TransFreedom II or TransFreedom II NY annuity can be reclassified as an IRA.

The choice of which rollover arrangement to use will depend on a variety of factors, including whether or not the former plan participant is currently employed and if so, whether the entity then employing the individual offers a profit-sharing plan that accepts rollovers. Assuming an IRA is used, the plan participant may choose to keep the current annuity contract (if we consent to recharacterizing the annuity as an IRA) with its minimum contractual guarantees or may elect to rollover the surrender value of the annuity to a custodial account offered by many financial institutions. This can allow the former plan participant to manage the funds within the IRA in a way that meets his/her risk tolerance and objectives.

## When Life Insurance Is Needed

In many cases, former plan participants will still need the life insurance protection that was offered by the 412(e)(3) plan. Upon separation from service and taking the distribution from the plan, the former participant may have several options depending upon the plan document:

### 1 Receive the Policy as a Plan Distribution

In this scenario, the former plan participant would pay income tax on the policy's fair market value at the time of distribution. If the individual has recognized the economic benefit of the life insurance protection as income, he/she could claim this cost as basis in the policy, thus reducing the recognition of income upon distribution.

- Policy ownership transferred as plan distribution
- Income tax paid by participant on fair market value of policy less cost basis

### 2 Roll the Life Insurance Policy to a Profit-Sharing Plan

Under this option, the individual must be employed by an entity that sponsors an active profit-sharing plan which permits the purchase of life insurance policies and accepts rollovers. The life insurance policy cannot be the only asset in the participant's plan account, as life insurance must be incidental to the purpose of the plan, which is to provide retirement benefits.

- Policy transferred directly to PSP
- Not a taxable distribution

### 3 Purchase from the Profit-Sharing Plan

Finally, if the former plan participant is participating in a profit-sharing plan, the policy could be transferred to the profit-sharing plan from the 412(e)(3) plan as a tax-free rollover and then sold by the profit-sharing plan to the plan participant. The purchase is normally a prohibited transaction, but Prohibited Transaction Exemption 92-6 issued by the Department of Labor allows a plan participant and certain other parties to purchase a life insurance policy from a qualified plan for at least its cash surrender value if certain conditions are met.

However, if the party purchasing the policy pays only the cash surrender value for the policy, the difference between the amount paid and the policy's fair market value may be a taxable distribution from the plan to such party or the plan participant. Such taxable distributions may have other effects, including plan disqualification. Thus, the purchase may need to be at the policy's fair market value if that exceeds the cash surrender value. In 2005, the Internal Revenue Service (IRS) issued guidance on the fair market valuation of a policy in a qualified retirement plan.

## Revenue Procedure 2005-25

This revenue procedure, issued April 8, 2005, provides guidance on how to determine the fair market value of a life insurance contract for the purposes of applying the rules of IRC §§ 79, 83, and 402. This notice modifies and supersedes Rev. Proc. 2004-16, issued on February 13, 2004, which initially determined the safe harbor formula for fair market value of a life insurance contract to be “premiums paid, plus earnings, and minus reasonable charges.”

To determine the fair market value of a life insurance contract, Rev. Proc. 2005-25 provides two safe harbor formulas. Final regulations issued by the IRS allow the use of these safe harbor formulas. The fair market value is the greater of:

- The sum of the interpolated terminal reserve and any unearned premiums plus a pro rata portion of a reasonable estimate of dividends to be paid for that policy year based on company experience OR
- The product of the PERC amount (premiums and earnings, less reasonable charges) and the applicable Average Surrender Factor described in Rev. Proc. 2005-25.

Please note that there are differences in the definition of PERC between variable and nonvariable contracts.

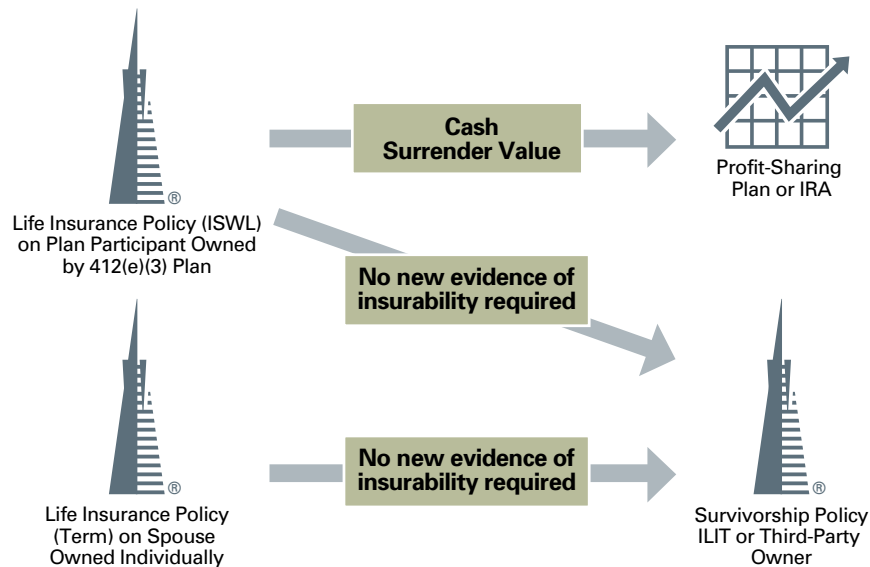
## Change of Policy to Meet New Needs

In some situations, where the individual still needs life insurance protection after retirement, the interest-sensitive whole life policy used in the 412(e)(3) plan may no longer be ideal for his/her situation. With TransSecure II or TransSecure II NY, the policy could be surrendered and, under current company practice a new, current-dated survivorship policy could be issued covering both the insured and his/her spouse for the same net amount at risk (the policy's current death benefit minus the current accumulation value immediately before surrender) without new evidence of insurability on the insured, as is typically required for a new life insurance policy. The non-participant spouse would need to provide evidence of insurability. The company practice is not a contract guarantee and may be changed or eliminated by the company at any time.

### Plan Participant Retires or Separates from Service— Purchases the Policy from Profit-Sharing Plan (PSP)



## Buying Spousal Protection for Estate Planning



### Why Change the Life Insurance Policy?

While participating in the 412(e)(3) plan, the life insurance policy will provide a benefit should the insured die before retirement. However, the life insurance goals of the insured may change once he/she has either retired or is no longer participating in the plan, and an individual death benefit may no longer be ideal for his/her situation.

Instead, the focus might now be on estate planning and the need to have life insurance paid at the second death for estate liquidity. Although not provided in the policy, it is current company practice to protect the individual's insurability for a new survivorship policy and to allow the owner of the survivorship policy to be a third party, such as the insured or an irrevocable trust.

### Buying Spousal Protection for Estate Planning

When a need for survivorship life insurance exists, one planning option is to purchase a term life insurance policy at some time prior to retirement or termination of employment on the non-participant spouse for the same face amount as the TransSecure II or TransSecure II NY policy.<sup>3</sup> When the survivorship policy is needed, under current company practice, no evidence of insurability will be required on the non-participant spouse if the face amount of the survivorship policy is the same or lower than the existing term coverage on the non-participant spouse, subject to maximum conversion age and current underwriting class on the term policy, if available on the survivorship policy.<sup>3</sup> The new policy will be based on the insured's and spouse's current ages at the time of conversion. Again, a company practice is not guaranteed to continue. The Company may change it or eliminate it at any time.

The new survivorship policy will often be owned by an irrevocable trust or the adult children of the insureds. If owned by one of these third parties, gifting strategies would need to be developed.

In order to issue the new survivorship policy, the TransSecure II or TransSecure II NY policy must be surrendered. Then, the former plan participant/insured can roll over the cash surrender value into a profit-sharing plan or IRA and have it managed for future growth, while knowing he/she has a new survivorship life insurance policy that meets his/her current insurance needs.

### Keeping Insurance on the Individual

If a survivor policy does not meet the goals of the former insured plan participant, another option available with TransSecure II or TransSecure II NY is to exchange the policy for a single insured universal life insurance policy under the Coverage Continuation Option endorsement. This new flexible premium policy would provide coverage on the insured without new evidence of insurability.

The new policy will provide insurance with a face amount equal to the face amount of the TransSecure II or TransSecure II NY policy. This election can take place only when the TransSecure II or TransSecure II NY policy is no longer part of a 412(e)(3) plan and beginning in the eighth policy year.

The new policy will have the same policy date as the TransSecure II or TransSecure II NY policy. As a result, the new policy's surrender charges will be "point in scale." Of course, the universal life policy will require new premiums in order to keep it in force.

### Flexibility Is Key

Clients' objectives can change over time and it's important that they have options available when planning for their retirement. By providing these flexible options, Transamerica is delivering valuable benefits to 412(e)(3) plan participants that can even help them with their estate planning goals. For a 412(e)(3) proposal or more information about our products, insurance producers can contact their Transamerica representative.

**Transamerica's Advanced Marketing department is committed to providing you with the consulting expertise and powerful resources to help you serve the goals of clients and grow your business. To access a wide array of planning tools, resources, and human help, visit our TransACT® portal at [www.tatransact.com](http://www.tatransact.com) or call toll-free at 1-877-ADV-MRKT (238-6758) today.**





Transamerica Life Insurance Company

Transamerica Financial Life Insurance Company