

## IRS TARGETS 412(i) PLANS

*By Bruce Ashton*

The IRS is aggressively auditing 412(i) plans – that is, defined benefit pension plans funded exclusively with insurance contracts. It is seeking to curb what it believes to be abuses in the establishment and funding of some of these plans. As a practical matter, most of the targeted practices are found in smaller plans (1 to 15 participants). If the IRS is successful in attacking these practices, taxpayers that established these types of 412(i) plans in the last few years will face substantial taxes and penalties unless they properly present their positions in the audit process.

Over the past several years, the IRS has systematically escalated its challenge to “abusive” 412(i) plans. The chronology:

- Beginning in the early 2000s, IRS officials began giving speeches at benefits conferences expressing the Service’s concern that 412(i) plans were being funded in a way that did not meet the letter or the spirit of the Internal Revenue Code. The officials commented that the IRS intended to take steps to prevent misuse of insurance products in qualified plans. The plans which seemed to generate the most IRS attention were those funded exclusively or almost exclusively with life insurance (as opposed to annuities or a mix of life insurance and annuities). This was especially true of plans using policies designed to have low initial cash surrender values and high premium costs for a fixed number of years. The IRS was also concerned about the sale or distribution of these policies from the plans to key employees, where artificially suppressed values were used.
- In February 2004, the IRS issued 412(i) guidance. The guidance covers: plans that discriminate in favor of the high paid through the types of insurance contracts held by the plan for their benefit; deductibility of premium contributions; and life insurance contract valuation issues. This guidance also placed certain plans on the IRS list of abusive tax transactions – that is, plans funded with life insurance with a policy death benefit exceeding the permissible legal limits by \$100,000 or more. Taxpayers who engage in “listed transactions” are required to report them to the IRS or face substantial penalties (\$100,000 in the case of individuals and \$200,000 in the case of entities). In addition, “material advisors” to these plans are required to maintain certain records and turn them over to the IRS on demand.
- Then, in October 2005, the IRS invited those who sponsored 412(i) plans that were treated as listed transactions to enter a settlement program in which the taxpayer would essentially rescind the plan and pay the income taxes it would have paid if it had not adopted the plan, plus interest and reduced penalties. (Altogether, 20 different types of employee benefit structures were included in this settlement initiative.)
- Finally, in late 2005, the IRS began an audit campaign targeting 412(i) plans. A sample of the types of information the IRS is requesting in these audits is attached. The following are some key areas of concern:
  - Whether the plan has been funded to produce benefits that exceed the maximums under Code section 415. In defending an audit, it is essential for the taxpayer to obtain actuarial assistance in order to demonstrate that the benefits fall within the 415 limits;
  - Whether the plan complies with the February 2004 guidance, especially the non-discrimination rules;
  - Whether the plan document conforms with current legal requirements;
  - Whether the plan sponsor has complied with applicable deduction limits; and

- Whether the plan has been operated in accordance with its terms.

We have been told in several of the audits we are handling that if the plan contains qualification defects (such as a failure of the plan document to be timely amended for EGTRRA), the plan is not eligible for correction under the IRS Audit CAP program – even if the defects do not fall within the areas which the IRS considers abusive. Other IRS officials have stated a different view; but the fact that we are getting mixed messages from the Service emphasizes the need to proceed with great care in these cases.

Given the substantial taxes and penalties that may be assessed if the IRS concludes that a 412(i) plan has not been properly structured or administered – and especially if it concludes that the plan is a listed transaction and the taxpayer failed to file the proper notice – it is imperative that taxpayers obtain expert assistance from

the outset in the handling of an audit. With competent preparation, analysis and presentation, it may be possible to substantially mitigate the damage.

The fact that the IRS is auditing 412(i) plans does not mean that every 412(i) plan is abusive. Indeed, a properly structured and administered 412(i) plan (sometimes called a “safe harbor” plan) can be a valuable structure for many employers. Distinguishing between abusive plans and those that are proper will be the challenge in this audit initiative.

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Please feel free to contact any of our benefits attorneys if you have any questions about this audit initiative.

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