Professional Advisor Information

"Fully Insured" Plan

SECURITY MUTUAL LIFE
INSURANCE COMPANY OF NEW YORK
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The information presented in this guide is designed to provide accurate, authoritative information in regard to our fully insured defined benefit plans. It is offered with the understanding that we are not engaged in rendering legal, accounting, or other professional services. If legal or other professional assistance is required, the services of the appropriate professional should be sought.

"Fully insured" defined benefit plans were among the first forms of defined benefit plans in the United States and pre-date ERISA. As a defined benefit plan is, at its heart, a guaranteed periodic check for life and only an insurance company may offer life contingent contracts (i.e., annuities), these Plans are the exclusive province of the insurance community.

Despite the plan's nickname, life insurance must remain an *incidental benefit* of the Plan. The "fully insured" moniker refers to the requirement that the Trustees of the Plan enter into an express, written agreement with an insurance company to guarantee all forms of the benefit.

Despite their long tenure, "fully insured" plans are very much relevant today as they are the only Plans that offer all of the following:

- **No market risk**
- **Guaranteed benefits**
- **Traditional life insurance**
- **Maximum current contributions**
- **Simplicity**

No Market Risk

A "fully insured" plan must place all of its assets with *one* insurance company, which in turn will unconditionally guarantee all benefits. Unlike a 401(k) plan, the Trust assets are not subjected to the volatility of the broad financial markets. Rather, they must be placed into guaranteed, level premium insurance and annuity contracts.

Guaranteed Benefits*

The Plan assumes that the insurance company pays only the contractual guarantees on each contract held by the Trust. Any additional earnings (e.g., dividends) do not increase the future benefits, they simply reduce the future contributions. Therefore, once a "fully insured" election is chosen, the Plan sponsor agrees to pay annuity and life insurance premiums that are sufficient for the insurance company to guarantee the current and future benefits.

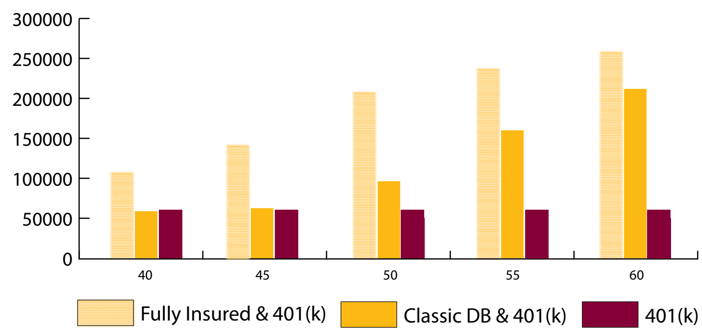
Traditional Life Insurance

For many years, clients have used the guaranteed cash values of whole life insurance contracts to help fund defined benefit plans. However, under new funding rules that began in 2008, adding traditional life insurance may create initial shortfalls in Plan funding as the initial cash values may be low.

As the current benefit of a "fully insured" plan is equal, at all times, to the cash surrender value of the individual life insurance and annuity contracts held by the Trust, there is no funding consequence to the Plan of initially low cash surrender values.

First Year Plan Contributions by Age

Participant with $205,000 Salary



Maximum Contributions

For participants age 40 and older, "fully insured" plans offer relatively large contributions and related benefits. Unlike 401(k) and other defined contribution plans that may be limited to $56,500 or less, the deductible contributions to these plans can be significant. The above chart summarizes the potential required contributions at various ages.

Simplicity

This final point takes on new significance following passage of the Pension Protection Act of 2006. That's because the funding rules for traditional defined benefit plans were significantly changed, with some added flexibility and complexity. Although these new funding rules may create some new planning opportunities, they make traditional plan funding and communication more difficult in many ways.

A "fully insured" plan, on the other hand, is very easy to discuss. Once the future benefit is selected (defined), the Trustees of the Plan simply ask the insurance company to calculate the amount necessary to guarantee this future benefit using level premiums.

*Guarantees are based on the claims-paying ability of the issuing insurance company

Overview

Requirements

In order for a plan to qualify as "fully insured," the requirements of IRC §412(e)(3) must be met. This subsection creates an exception for insurance contract plans from the complex funding requirements found in §412 and §430, and a different set of conditions must be satisfied:

- **The plan must be funded solely by individual or group life insurance and annuity contracts.** [§412(e)(3)(A)]
- **These contracts must provide level premiums for all benefits including benefit increases. Payments begin when the participant enters the plan and extend until the retirement date under the plan.** [§412(e)(3)(B)]
- **All plan benefits must be provided by these contracts and be guaranteed by an insurance company to the extent that premiums have been paid.** [§412(e)(3)(C)]
- **The contracts must not lapse due to lack of payment for the current or prior years.** [§412(e)(3)(D)]
- **No rights under the contract may be subject to a security interest.** [§412(e)(3)(E)]
- **Participants may not take loans.** [§412(e)(3)(F)]

IRS Guidance. In Rev. Rul. 2004-21, sponsors were reminded that the non-discrimination requirements of §401(a)(4) prohibiting discrimination in favor of the "Highly Compensated Employees" must be followed. Participant contracts should have inherently similar contract features, rights and benefits. For example, it may be discriminatory to provide whole life insurance contracts for the owners of the business and term life contracts for the other participants.

In Rev. Rul. 2004-20, the Service restated that the insurance contracts used to fund pension and annuity plans must have reasonable costs to be deductible. [Treas. Reg. §1.404(a)-3(b)]

A non-variable annuity and a whole life contract clearly satisfy the requirement to have guaranteed level premiums until Normal Retirement Age. There has been no Revenue Ruling or other guidance by the IRS that supports the use of non-traditional life insurance products. Therefore, we do not allow Variable Annuities, Universal Life, or Variable Universal Life in our plans.

These requirements are easily satisfied using a properly designed plan document funded by products designed for this marketplace. Security Mutual Life has developed products that are well suited for use in a "fully insured" plan and offers sample defined benefit plan and trust documents through Security Administrators, Inc. (SAI), our wholly owned subsidiary.

Advantages

A "fully insured" plan can provide substantial retirement benefits under a simple and secure program. The accrued benefit for participants is simply the cash surrender value of the insurance company contracts. The Plan may provide a maximum current tax-deductible contribution for the business. Some of its other advantages include:

- **No investment market risk; all benefits are fully guaranteed by the insurance company.**
- **There can be no over-funding, and therefore, no 50 percent excise tax (under IRC §4980) on any reversion of excess assets to the sponsor.**
- **There can be no under-funding, as the contributions are based solely on the guaranteed provision of the level premium contracts.**

- **No actuarial certification (and expense) is required under ERISA §404(b)(2).**
- **No variable component PBGC premiums are due. Only the fixed $35 per participant (in 2012) needs to be paid to insure the participant benefits.**
- **Substantial administrative savings due to the use of an approved plan document and simple formula. SAI, a pension administration subsidiary of Security Mutual Life, provides a special program for "fully insured" at a reasonable fee.**

Disadvantages

The "fully insured" plan is not the ideal plan for all situations and businesses. Given large, required contributions that must be made each year, it works only when the business is established and highly profitable. It works best when there are very few employees (less than five) where the owner is age 40 or above and is several years older than any of the firm's employees. In brief, disadvantages include:

- **Very large, required contributions for employees.**
- **No policy loans can be made.**
- **No flexibility in investments. The plan must be funded exclusively through insurance and/or annuity contracts that guarantee all benefits.**

Client Profile

"Fully insured" plans are ideally suited for a mature small-business owner who is successful, may have delayed saving for retirement, wishes to avoid investment risk and can make a multi-year commitment. Because the cost of the guaranteed benefits can be quite high, suitable clients typically have no more than three employees for every highly compensated participant or owner.

It does not matter what business form your client operates under. A retirement plan can work equally well for sole proprietors, partnerships, S or C Corporations and Limited Liability Companies (LLC). However, care must be taken to ensure that coverage and participation requirements are met for controlled and affiliated service groups. See Related Employers on pages 13-14.

Typical Sponsor Profile:

- **Age 40 and above;**
- **Fewer than five employees;**
- **Employees are younger than the owner;**
- **Stable, predictable income, profitable;**
- **Desires more than $55,500 contribution;**
- **Risk averse; or**
- **Seeks added safe money diversification**

Don't overlook a traditional defined benefit plan for sponsors that may be willing to trade the guarantees of a "fully insured" plan for greater investment flexibility or lower employee benefit costs. We can provide side-by-side comparisons to evaluate the most suitable plan design.

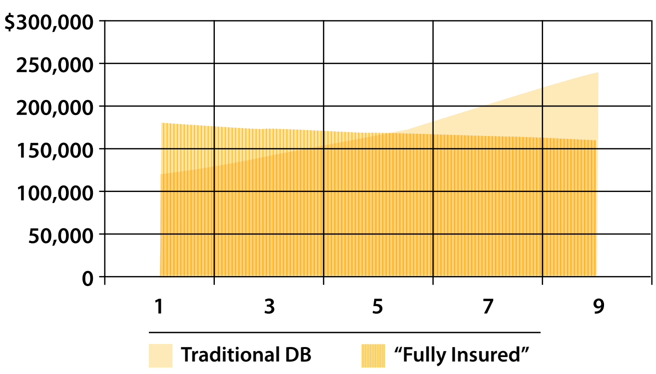
Security Mutual Life Insurance Company of New York is one of the few insurance companies that have offered plan documents, products and service for "fully insured" plans since ERISA was enacted in 1974. Our policyholders and agents benefit from this experience. This professional advisor's guide presents a detailed discussion of these Plans and incorporates recent IRS and Treasury guidance for the appropriate use of these plans. For your convenience, we have highlighted this guidance and commentary.

How They Work

Unlike a traditional defined benefit plan which places its assets into an unallocated investment pool, a Security Mutual Life "fully insured" plan allocates its assets into individual annuity and life insurance policies that guarantee the benefits of each participant. Assuming the Plan sponsor pays the requisite premium, these allocated contracts will, at all times, have a value equal to the benefit due each participant.

Whereas a traditional defined benefit plan's trust will fluctuate with actuarial and investment experience, a "fully insured" plan will not. That's because the initial required contributions are predicated solely on the projected ***guaranteed*** values of each policy purchased by the Plan.

Projected Cost Over Time



As depicted in the chart, the initial cost may decrease over time if the company credits higher returns to the annuity or pays dividends on any life insurance contracts used to fund survivor benefits. This contrasts with a traditional defined benefit plan whose ***funding target*** is the present value of the accrued benefit and will generally rise over time as participants near retirement age.

Employee Cost

Although a "fully insured" plan will often work best when there are no employees eligible to participate in the Plan other than the owners and their family members, many small business clients will have other employees.

A review of the exhibit above reveals that the cost of each employee's benefit is directly related to their age. That's because all defined benefit plans are "age-weighted" vehicles that are geared toward accumulating enough assets by a specified retirement age. The shorter the accumulation period, the higher the necessary annual contributions.

The goal of many small-business owners is to make sure that the employee cost is reasonable and that the owners and other "preferred" employees receive the bulk of the Plan benefits and contributions. Our experience reveals that when the preferred group receives 85 percent or more of the contributions and benefits, then the Plan is likely to be adopted.

Initial (First Year) Plan Cost Comparison					
Position	Age	Salary	"Fully Insured" Max. Lump Sum*	"Carve-Out" Plan	Highly Compensated Employee Status
1. Owner (P)	55	$255,000	$338,771	$338,771	HCE
2. Spouse (P)	50	50,000	45,412	—	HCE
3. Sales	45	115,000	71,950	—	HCE
4. Sales	40	75,000	33,959	—	
5. Sales	35	75,000	25,712	—	
6. Sales	30	75,000	19,837	—	
7. Sales	25	75,000	15,518	—	
8. Admin	45	35,000	21,802	21,802	
9. Admin	35	35,000	12,028	12,028	
10. Admin	25	35,000	7,275	7,275	
Plan Totals			$592,264	$379,876	
Percent to Preferred (P)			57.2%	89%	

* All contributions are assumed to be made at the end of the Plan Year

Eligibility

Qualified plans must satisfy strict coverage and participation requirements that will generally allow full-time employees that are at least age 21, and have performed more than one year of service, to enter the plan. A full-time employee is generally considered one who works at least 1,000 hours per year (20 hours per week).

Employers may exclude members of a collective bargaining unit whose retirement benefits are subject to good faith bargaining. They may also exclude non-resident employees that have no earned income in the United States. [IRC §410(b)]

"Carve-Out" Plans

Although eligible employees need to be considered for coverage and participation testing, a Plan may be established that covers only 70 percent of the rank-and-file employees that would otherwise be eligible. This is known as the ***ratio percentage test***.

The ratio percentage test allows the ratio of rank-and-file employees covered to be only 70 percent of the ratio of "highly-compensated employees" (HCE) that are included. Thus, if there are three potentially eligible HCEs and only one is covered by the Plan, the ratio of HCEs covered is 33 percent. Thus, the ratio of rank-and-file employees need only be 70 percent of this—or 24 percent.

One final rule that must be satisfied by any defined benefit plan is termed the ***participation*** rule. Although there are many parts of this requirement, the rule essentially states that a defined benefit plan must benefit 40 percent or more of the otherwise eligible employees. [IRC §401(a)(26)]

Great care should be exercised when recommending "carve-out" plans because the coverage and participation tests must be satisfied each year. If the group is small, the plan may work for one or two years and then fail testing because one employee leaves or is hired.

A "fully insured" plan is subject to the same benefit limitations as a regular defined benefit plan. These include "top-heavy" provisions and maximum retirement benefit limitations. Let's examine each of these in greater detail.

Top-Heavy Benefit

Like any other qualified retirement plan, a "fully insured" plan must satisfy the "top-heavy" requirements of IRC §416. A plan is considered "top-heavy" if more than 60 percent of the accrued benefits are earned by Key Employees (generally defined as greater than 5 percent owners and other highly compensated officers.) In the small-business market, plans will most likely be "top-heavy." Hence, a "fully insured" plan must normally provide a minimum benefit of 2 percent of compensation per year of service up to 10 years (i.e., at least 20 percent for more than 10 years of service).

Since this minimum benefit accrues rapidly, level premium contracts (with low early cash surrender values) may not have sufficient cash values to guarantee the payment of accrued benefits in the early years. Security Mutual Life provides a solution to this problem through plan design by suggesting a formula that is normally much higher than the minimum top-heavy requirements.

In some cases, an additional lump-sum contribution may be required if a non-key employee terminates employment relatively early and is vested.

Retirement Benefits

A few Code provisions have a bearing on the benefits paid at retirement. The first is a favorable ruling concerning the definitely determinable benefit under IRC §401(a). Rev. Rul. 78-56 allows a "fully insured" plan benefit to be increased if the actual annuity rate is more favorable at retirement, without violating the "definitely determinable benefit" rules.

The overall plan benefit limit is known as the "415 limit." IRC §415 applies to all defined benefit plans in the same way. It dictates the maximum retirement benefit that can be paid from the plan. In 2012, this provision limits a defined benefit plan to a maximum of $200,000 of annual benefit. [IRC §415(b)(1)]

This amount is reduced if the actual retirement age is less than age 62 and is increased if retirement age exceeds age 65. [IRC §415(b)(2)(C)-(D)]

OBRA '87 further modified the maximum 415 benefit limit by requiring at least ten years of participation in the plan to receive the full benefit. This adjustment is made fractionally. For example, a participant with only six years of participation (6/10) may receive only 60 percent of the maximum benefit. [IRC §415(b)(5)(A)]

Normal Retirement Age is sometimes confused with actual retirement age. The former is selected in the Plan Document and provides us a non-discriminatory destination for all participants. It is theoretical, however. Many participants will leave earlier, some will leave later. In all instances, the Present Value of the Accrued Benefit (PVAB) for the "fully insured" participant is the cash surrender value of the underlying life and annuity contracts.

Lump Sum Distribution

A defined benefit is most often expressed as a benefit at Normal Retirement Age (e.g., 100 percent of pay, not to exceed $205,000 at NRA 62). However, many participants may desire to receive a Lump Sum benefit instead of a life annuity. This and other optional forms of benefit can be offered, but must satisfy the requirements of IRC §415(b)(2). Although the present value of accrued benefits of a "fully insured" plan is equal to the cash surrender value, if a Lump Sum benefit is desired, it must satisfy this Code section as well.

The IRS has recently taken the position that all forms of the benefit must fall within the 415 limit. As the lump sum calculated under IRC §415(b)(2) is often smaller than the accumulation required to guarantee the maximum annual benefit (e.g., $205,000 in 2013) a "fully insured" plan may provide a smaller guaranteed monthly benefit but an equivalent lump sum benefit compared to other defined benefit plans. Plans that seek to guarantee a lump sum that exceeds this limit may be deemed by the IRS to be noncompliant.

Retirement Benefits Taxation

A participant will be taxed on any distribution received as cash under a retirement plan upon termination or separation from service (IRC §402).

Distributions are taxable when received. However, if a participant wishes to defer taxation, they may roll the "fully insured" cash value distributions to an IRA.

Note that owners of more than 5 percent need to take Minimum Required Distributions (MRD) at age 70 1/2, even if they are "active" participants in the plan. Thus, if our life insurance policy is still held in the profit sharing plan, any MRD would be taken from other plan assets.

Life Insurance Taxation

Any life insurance policy, however, requires special treatment if it is to be maintained. Upon separation from service, or retirement, the life insurance policy used to provide the pre-retirement survivor benefits must be removed from the plan. Unlike an annuity, it cannot be rolled over to an IRA.

If the participant wishes to defer taxes on the life insurance policy, the life insurance and annuity may be transferred to a profit sharing plan as a rollover distribution. [Rev. Rul. 73-338, 1973-2 CB 20]

The taxable gain from any distribution of the life insurance contracts to a participant will be reduced by the cumulative "PS 58" costs previously declared as income.

IRS Guidance. Recently, the IRS finalized changes to the Code regarding the value of life insurance contracts when distributed from a qualified retirement plan. Specifically, §402(a), 79 and 83 were amended to specify that the Fair Market Value of the life policy is the measure of any taxable gain when a policy is distributed to the participant. This taxable gain is reduced by the "PS 58" tax basis, if any.

If death occurs prior to retirement, the plan will pay a survivor benefit to the named beneficiaries of the participant. This beneficiary election is filed with the plan Trustee. It should be noted that spouses of the participants have a right of election for most death proceeds, unless waived.

Often the annuity contract balance is rolled to an IRA (either decedent or spousal) so that taxes may be deferred or "stretched" at the option of the beneficiary. Life insurance death benefits are treated differently. As the "PS 58" cost was either taxable income (to employees) or not deductible (owners of non-incorporated businesses), the amount of pure insurance will be received free of income tax under §101(a) of the Code. [Treas. Reg. §1.72-16(c)(4)] The cash surrender value of the policy will be taxed as ordinary income if received by the beneficiary. This taxable event is reduced by the "PS 58" cost that was already declared as taxable income (if applicable). [Treas. Reg. §1.72-16(b)]

Life Insurance Limits

To maximize the available benefits of a "fully insured" plan, life insurance will typically be used to fund the "pre-retirement survivor benefits" offered by the plan. The guaranteed cash values and guaranteed premiums of our whole life insurance contracts are well suited for funding a "fully insured" plan.

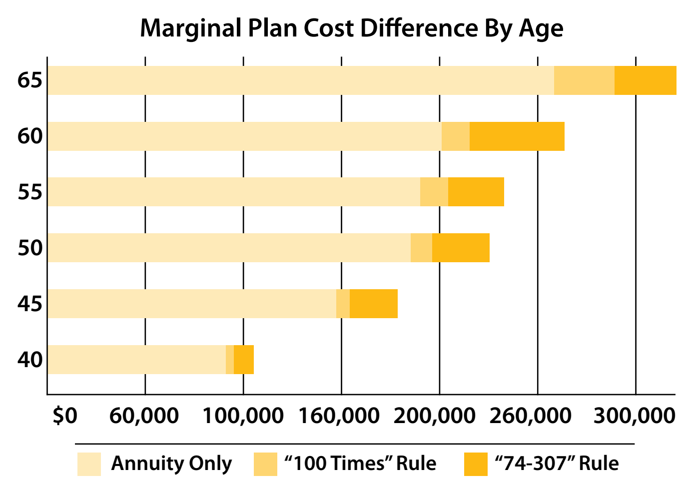
Life insurance in all qualified retirement plans must comply with the "incidental death benefit" rules discussed in Treas. Reg. §1.401-1(b)(1)(i). These provisions limit the amount of life insurance that may be purchased under the plan. Generally, a defined benefit plan can provide no more than 100 times the projected monthly retirement income as a pre-retirement survivor benefit. An alternative under Rev. Rul. 74-307 allows up to 66 2/3 of the "theoretical level premium" to be used to purchase life insurance contracts within a defined benefit plan. In practice, this rule translates to using no more than 50 percent of the contribution for most participants, but varies by age.

IRS Guidance. As the "product is the Plan," insurance contract suitability is critical for a compliant "fully insured" design. Perhaps because of its nickname "fully insured," some planners suggested that a Plan could be funded exclusively with life insurance contracts. As discussed in Rev. Rul. 2004-20, this is not allowable. Life insurance must be incidental to the basic purpose of the Plan, which is to provide retirement benefits.

Rather, the "fully insured" nickname simply describes that an insurance company must guarantee the benefit, which is expressed as a series of equal and periodic payments for the life of the participant. In other words, an annuity or a settlement option of an incidental life insurance contract. Violating the incidental death benefit limit may result in the Plan engaging in a listed transaction for the purposes of §1.6011-4(b)(2) and must register as a "Tax Shelter."

As the following chart reveals, adding life insurance to fund these survivor benefits causes a fairly modest increase in the overall contribution, particularly at younger ages. This "marginal cost" can be calculated by comparing the cost of providing the retirement benefit with an annuity alone vs. the cost of funding the same retirement benefit plus the enhanced survivor benefits.

Adding A Survivor Benefit



Adding an enhanced survivor benefit to a defined benefit plan does not alter the retirement benefit. Rather, the marginal cost of the survivor benefit is calculated and is added to the tax-deductible contribution. The marginal cost may be pennies on the dollar at younger ages and is still quite reasonable even for advanced ages. The policies must, however, be funded until participants retire for the plan to work as illustrated.

While life insurance does not need to be offered under a "fully insured" plan, it can provide important additional benefits for each participant. If there is an insurance need, the participants may obtain the benefits of life insurance on a pre-tax basis. For highly profitable, closely held businesses, there often exists a substantial insurance need for the owner(s). A "fully insured" plan can both maximize the current contribution, and meet these insurance needs by funding some of the benefits with life insurance contracts.

Case Study

Let's look at a case study and compare each design alternative for a 55-year-old participant using the current benefit limits discussed earlier, assuming a guaranteed minimum of 3.0 percent for the annuity and our Pension Customizer WL guaranteed values to provide the incidental survivor benefits within both the "100 Times" and "Rev. Rul. 74-307" rules.

Of course, the amount of added survivor benefits offered by the Plan could be tailored to meet the needs, goals and budget of the plan sponsor. Our client in this case study may select a formula that provides life insurance from $1.6 Million to $5 Million and all points in between. However, once the formula is selected, each eligible participant should receive the specified level of life insurance benefits.

IRS Guidance. In Rev. Rul. 2004-21, the service cautioned that life insurance contracts used to fund the benefits for each eligible participant must have a nondiscriminatory availability of benefits, rights and features. The availability of life insurance must, at a minimum, satisfy the coverage requirements of IRC §410(b).

Our plans will require that the same whole life and annuity series be offered to each participant. Our Plan Document only makes exceptions due to insurance availability (e.g., a non-insurable participant does not need to receive coverage). Substandard/rated participants are best handled by selecting the Rev. Rul. 74-307 death benefit which specifies a fixed percentage of the amount of theoretical contribution used to buy life insurance (0 – 66 percent). Rated participants will therefore receive less life insurance for the same premium. The impact on Plan cost is thus marginal.

"Fully Insured" Survivor Benefit Alternatives

	"Annuity-Only" Plan	"100 Times" Rule	"Rev. Rul. 74-307" Rule
1st Year Contribution:			
Annuity	$282,019	$ 251,381	$ 192,345
Whole Life	0	51,717	151,225
Total Plan	282,019	303,098	343,570
Lump Sum Benefit at NRA 65	$3,330,019	$3,330,019	$3,330,019
Monthly Benefit at NRA 65*	17,083	17,083	17,083
Added Survivor Benefits	0	1,708,300	5,000,000
Marginal Cost of Survivor Benefits	—	21,079	61,551

* All contributions are assumed to be made at the beginning of the year.

"PS 58" Cost

When life insurance is included inside a pension plan, the participants must recognize the cost of the "current economic benefit" provided by the plan (IRC §72(m)(3)(B), Reg. §1.72-16(b)). Each participant is taxed currently on the cost of the "pure" life insurance benefit. This then enables the "pure" life insurance benefit to be received by the beneficiary free of income tax. The cost of this current benefit is commonly referred to as "PS 58" cost. That's because the cost was determined by using the one-year term rates published as Pension Service Table 58 in Rev. Rul. 55-747 (1955-2 CB 228).

So that you can better understand this change, let's look at the economic benefit cost per thousand at select ages:

Age	PS 58	Table 2001	SML ProValue ART*
35	3.21	.99	.32
45	6.30	1.53	.70
55	13.74	4.15	1.63
65	31.51	11.90	4.47

* ProValue ART premiums include a per thousand charge and a $75 policy fee. (Policy Form Nos. 2081, ICC10-2081, Series 2081-G)

Although life insurance may add a small amount of additional taxable income to each participant, the "PS 58" cost becomes "basis" and may be recovered upon distribution of the proceeds for most participants. An exception would be owner-employees of non-incorporated businesses (e.g., a sole proprietor). These individuals do not declare the "PS 58" cost as taxable income. The end tax result is similar. The client's tax advisor should be prepared to guide them in accounting for this cost properly.

IRS Action. Table PS 58 was formally revoked by IRS Notice 2001-10 and a new interim rate was provided as Table 2001. Although IRS Notice 2002-8 modified much of this initial guidance, Table 2001 was retained as an interim measurement of the economic benefit cost for life insurance sold within a qualified or other employer-sponsored plan.

However, if the company's one-year term rates are lower, the participant may use these lower published rates for policies issued prior to January 28, 2002. To use alternative term rates after this date, the insurer's rates must meet added conditions.

Life Insurance – Beyond Retirement

The life insurance contracts held by the "fully insured" Trust are used to secure the "pre-retirement survivor benefits" of the plan. However, when a participant retires or separates from service with a vested benefit, the life insurance contracts must be removed. [Rev. Rul. 54-51, 1954-1 CB 147]

The participant can choose from the following options:

- **The contract may be surrendered for its cash value and used to pay the promised benefit. This is the option that is assumed when the "fully insured" plan is implemented.**
- **The plan can sell the contract to the participant or certain Trusts for its cash surrender value. If this value equals the Fair Market Value (FMV), there is no taxable event. However, if the cash surrender value is less than the FMV, the difference will be imputed income to the participant.** [PTE 92-6, 57 Fed. Reg. 5189 (1992)]
- **The policy may be distributed from the plan. The participant is taxed on any gain above the tax basis from any previously declared "PS 58" cost.** [Treas. Reg. §1.72-16(b)(4)]
- **The policy itself may be transferred to a successor defined contribution retirement plan. However, an amount equal to the "PS 58" basis (if any) is returned to the participant and not rolled over.** [IRC §402(c)(2)]
- **The policy may be exchanged for a new policy outside the plan at a rating class substantially comparable to that of the original policy, regardless of the health of the participant. If the proceeds from the surrender remain inside the plan or are rolled to an IRA, there is no taxable event.**

This last option is a contractual provision that is somewhat unique to Security Mutual Life. The face amount of the new policy is based on the policy's net amount at risk as determined by the Company at the time of the exchange. This amount is generally the face amount of the original policy less any accumulated cash value.

By exercising one of the many options available, the participant can continue permanent life insurance protection beyond retirement or separation from service.

Case Study

As discussed previously, "fully insured" funding is based solely on the contract guarantees. Any excess interest or dividends paid by the insurance company will serve to reduce future contributions. Returning to our prior case study, let's take a look at what the projected funding may be if the client selected a Plan with a $1.6 million life insurance policy, the annuity earned 3.5 percent interest and all else remained constant.

"Fully Insured" Plan Funding Projection										
		FLEXIBLE PREMIUM ANNUITY (Policy Forms 1917-G, 1917-B-1) *Non-Guaranteed Rider Values*				PENSION CUSTOMIZER WL* (Policy Form 2087-U) *Non-Guaranteed Base Policy Values*				COMBINED *Rider & Base Policy*
Att. Age	Year	FPA Rider Premium	Prior Year Excess Interest	Adjusted FPA Rider Premium Outlay	FPA Rider Accumulated Value @ 3.5%	Annual Premium	Dividend to Reduce	Net Premium Outlay	Cash Surrender Value	Net Premium Outlay
56	1	$245,254	$ 0	$245,254	$ 253,838*	$50,458	$ 0	$50,458	$ 0	$295,712
57	2	245,254	1,269	243,985	515,247*	50,458	0	50,458	36,883	294,443
58	3	245,254	2,576	242,678	784,452*	50,458	0	50,458	74,350	293,136
59	4	245,254	3,922	241,332	1,061,686*	50,458	0	50,458	112,617	291,790
60	5	245,254	5,308	239,946	1,347,189*	50,458	0	50,458	151,733	290,404
61	6	245,254	6,736	238,518	1,641,207*	50,458	383	50,458	191,850	288,976
62	7	245,254	8,206	237,048	1,943,994*	50,458	1,367	50,075	232,967	287,123
63	8	245,254	9,720	235,534	2,255,812*	50,458	3,200	49,092	275,133	284,626
64	9	245,254	11,279	233,975	2,576,929*	50,458	5,483	47,258	317,950	281,233
65	10	245,254	12,885	232,369	2,907,624*	50,458	8,083	44,975	361,033	277,344
				2,390,639				494,148		2,884,787

* Surrender charges apply during years 1-10. "Prior Year Excess Interest" is the difference between the non-guaranteed and guaranteed FPA Rider interest earnings. Dividends are not guaranteed.

IRS Guidance. The Service grew concerned about the nondiscriminatory availability of benefits, rights and features regarding life insurance in qualified plans. In Rev. Rul. 2004-21, they caution that the right of the policy to be sold to the participant must be granted to each participant and should satisfy the prohibited transaction class exemption described by the Department of Labor in PTE 92-6, 57 Fed. Reg. 5189 (1992). This exemption allows for the sale of a policy to the insured, to a relative of the insured, to the employer or to another Plan and certain trusts. The following conditions must be satisfied:

1. The participant must be the insured;
2. The relative must be the beneficiary of the participant;
3. The plan would surrender the policy if it were not otherwise sold;
4. If the sale is to someone other than the participant, the participant is informed of the sale, given the opportunity to purchase the policy and consents in writing to the sale; and
5. The amount received by the plan for the policy is equal in value to the amount that the plan would have received had it surrendered the policy.

The service also stated that any "bargain element" received by the purchaser as the result of a sale for less than the Fair Market Value of the policy would be taxable to the participant. Thus, the sale is allowed to occur at cash surrender value, but if the Fair Market Value is higher, there will be imputed income to the participant.

Flexible Premium Annuity (FPA) Contract or Rider

A defined benefit or "fully insured" plan provides, by definition, a predetermined income stream at retirement, guaranteed for life. This also happens to be the definition of a retirement annuity contract. Alternatively, an annuity contract may be used as a retirement accumulation device only, with guaranteed income distributed in the form of a lump sum distribution or rollover to an Individual Retirement Annuity (IRA).

Our Flexible Premium Annuity (FPA), or FPA Rider, is an ideal vehicle which can provide for guaranteed accumulation of retirement assets and also offer guaranteed retirement income if desired. It features:

- **A guaranteed minimum interest rate of 3 percent.**
- **A one year guarantee on new monies deposited into the contract from the date of receipt.**
- **A bailout provision if the interest rate drops 2 percent or more from the rate for the prior 12 month period.**
- **A 10 percent withdrawal feature after the first policy year.**
- **The contract may be converted to a guaranteed periodic income at any time.**

The FPA Rider to the Pension Customizer series contracts solves the major problem that many insurance contract plans have: how do you pay the life insurance premium that is due within 31 days of the due date when the client has the right to delay funding the Plan until his or her tax-filing date, including extensions?

Recall that premium loans may not be used in "fully insured" plans. However, the FPA Rider can be used to pay the base life insurance policy premium without the imposition of a surrender charge. This allows the sponsor to take advantage of tax extensions without the life insurance policies lapsing.

Pension Customizer WL Series

We offer a unisex whole life insurance policy that can provide nondiscriminatory survivor benefits as determined by the Plan formula at the election of the Plan sponsor. Some of its many features include:

- **Guaranteed level premiums and cash values.**
- **Non-guaranteed dividends that are used to reduce the premium.**
- **Reduced-Paid-Up option**
- **An innovative policy exchange rider.**

Attained Age Exchange Rider

This last feature warrants extra attention as it allows life insurance coverage to continue beyond retirement without a current tax. Each unisex policy we issue includes this Rider that allows the base policy to be surrendered for its cash value. If all assets remain inside the Plan or are rolled to an IRA, there will be no taxable event.

We will then issue a new policy, outside the Plan, for the net-amount-at-risk (face amount less cash value) without evidence of insurability. Although the new policy will be at attained age, the underwriting risk class will be substantially the same as the original policy, even if there was a change in health.

FPA Surrender Charge Schedule (Contract-Year Based)

Contract Year	**1**	**2**	**3**	**4**	**5**	**6**	**7**	**8**	**9**	**10**	**11+**
Surrender Charge*	7%	7%	6%	6%	5%	5%	4%	3%	2%	1%	0%

* Percent of Annuity Accumulations

Plan Funding

Should a defined benefit plan fail to comply with IRC §412(e)(3), it is not automatically disqualified. It may be amended to a regular defined benefit plan under §412. Due to the large contribution and conservative assumptions, conversion may result in the plan becoming over-funded, at least for several years.

One technique that some businesses will use is to adopt a "fully insured" plan while the owner is earning a very high income. The retirement definition may be selected to recognize the "best" three consecutive year period to get average income. If the preferred participant's income is expected to decrease, as he or she gets older, at some point the "fully insured" plan is converted to a "fully funded" defined benefit plan.

Contributions may be eliminated or greatly reduced using this approach, ensuring maximum current contributions in the highest income years and lower or no contributions as the owner approaches retirement and is perhaps working fewer hours. This flexibility is a significant advantage of an insurance contract plan for particular situations.

Life Insurance Contracts

To avoid potential Department of Labor objections to large amounts of life insurance in ERISA pension plans, the advantages of life insurance should be documented. Ideally, if the sponsor is incorporated, the reasons should be stated in the corporate minutes, formally adopting the plan. Remember, as with any pension funding using insurance, any agent compensation earned must be reported to the plan sponsor and is reported on Schedule A, IRS form 5500. [PTE 77-9, 42 Fed. Reg. 32 (1977)]

Before we will issue contracts to fund a "fully insured" plan, an Agreement for IRC §412(e)(3) "Fully Insured" Plans (0004874) must be reviewed and signed by the plan trustee. This Agreement becomes part of the Plan Document.

Our turnkey Plan will often include comparative illustrations that contrast a "fully insured" plan with a defined contribution and/or a regular defined benefit plan. A copy of the illustration is to be forwarded to Security Administrators along with any desired changes or further documentation. The Plan is not exempt from the Title I and IV of ERISA regarding reporting, disclosure and fiduciary provisions, and, where applicable, ERISA §101 to 111 and 401 to 414. In particular, §404(c), which deals with suitability of investments and due diligence, should be emphasized by the investment advisor.

Related Employers

Perhaps the largest issue in making sure that a qualified plan satisfies nondiscrimination testing and remains compliant is the inclusion of all "related employers" as joint sponsors of the plan. That's because many small business owners may indeed own or control more than one enterprise. It is tempting to adopt a "fully insured" plan to benefit one group of employees, and not cover all the related employees, but this may not be possible under current pension law as a plan must meet specific coverage and participation rules. [IRC §410(b) and §401(a)(26)]

Generally, all the employees of businesses under common control are aggregated for nondiscrimination testing, vesting and top-heavy rules. Also the §415(a) contribution and §415(b) benefit limits are applied as if all the employees worked in one single employer.
[IRC §414(b)]

Presented next are definitions of the "controlled" and "affiliated" service groups that the professional advisor must consider before recommending adoption of any qualified retirement plan.

Parent-Subsidiary Controlled Group

1. One business must own at least 80 percent of another business.
2. If the businesses in item 1 together own 80 percent of a third business, the third business is also a member of a parent-subsidiary group.

Brother-Sister Controlled Group

1. Five or fewer persons own in combination at least 80 percent of the stock of each business, AND
2. The same persons own more than 50 percent of each business counting only identical ownership in each business.
3. A person's stock ownership is not taken into consideration for the 80 percent test in item 1 above unless the person owns some stock in each business. [IRC §1563(a)]
4. Attribution rules for stock ownership of spouses and certain family members may apply. [IRC §1563(d)]

Example:

Owner	Business 1	Business 2
A	50%	40%
B	30%	60%
C	20%	0%

Result: **Businesses 1 and 2 are members of a Brother-Sister Controlled Group because A and B own at least 80 percent of both businesses and more than 50 percent of both, counting only up to 40 percent ownership for A and 30 percent ownership for B. Because C owns no stock in Business 2, C is disregarded for the 80 percent ownership test.**

Combined Group

1. Consists of three or more businesses, each of which is a member of a parent-subsidiary or a brother-sister group; and
2. One company is both a parent of a parent-subsidiary group and a member of a brother-sister group.

Affiliated Service Group

1. Consists of a service organization (e.g., medical practice, law firm or other service business) and an affiliated organization (e.g., employs nurses or paralegals) which is at least 10 percent owned by highly compensated employees of the organization, AND
2. The affiliated organization performs services for the service organization, which account for at least 5 percent of the gross receipts of the affiliated organization. [IRC §414(m)]

Example: Dr. Smith owns 100 percent of Medical Practice. She also owns 20 percent of Nurses, Inc., a firm whose employees provide nursing services to Medical Practice. 50 percent of Nurses, Inc.'s gross receipts are on account of services provided to Medical Practice.

Result: **Medical Practice and Nurses, Inc. are members of an Affiliated Service Group.**

These descriptions of Controlled and Affiliated Service Groups are only general. The actuations under the Code are much more complex. In simple situations where "bright-line" indicators exist, SML and SAI can determine whether related employers must be treated as one employer for qualified plan purposes. However, in complex situations, such a determination becomes legal advice. Since SML and SAI cannot offer legal advise, the client is best served by consulting a legal advisor.

Administration Implementation

To formally adopt a "fully insured" plan, certain steps must be taken. These include:

1. **Establish the plan in writing prior to the last day of the client's tax year (execute the Plan Documents).**
2. **Adopt the plan with a Board of Directors resolution (if applicable).**
3. **Provide a Summary Plan Description (that describes the plan) to participants.**
4. **Fund the plan by the tax filing date, including extensions (apply for and fund the individual annuity and life insurance policies).**

We provide comprehensive service to allow the smooth implementation of a plan. Security Administrators, Inc. (SAI) can be retained by the plan sponsor to draft the plan documents. SAI will also conduct a quality review of the program to help ensure the accuracy of any plan design and to verify census and other administrative data.

If life insurance is called for in the plan, applications should be submitted so that an underwriting decision can be made. Recall that substandard ratings may effect plan contributions and benefits.

The owner and beneficiary of each annuity or life insurance policy should be the Plan. The Plan would then pay any death or retirement benefits as defined in the Plan document. Dividends must be applied to reduce the premium.

Annual Service

Each year required contributions for the "fully insured" plan must be recalculated and required government reporting completed. The services of a Third Party Administration (TPA) firm, such as SAI, are essential. An outline of the process that SAI uses follows:

1. **Annual Information Request. Each year, SAI sends a request to the plan sponsor to update census and other important information.**
2. **Policy Valuation. SAI will check with the insurance company to record the value of the annuity and life insurance contracts and determine any excess interest earned or dividends paid.**
3. **Current Cost Calculated. The cost for the current year's benefit accruals is calculated by comparing the census and plan data to the policy valuation and benefit formula.**
4. **Fund the Plan. Once the current cost is calculated, the plan must be funded by the tax filing date (including extensions).**
5. **Required Reporting. Each year the plan is required to file an Annual Return/Report of Employee Benefit Plan (IRS Form 5500 series). SAI will draft the form for review and execution by the plan sponsor.**

Should the goals of the plan sponsor change, the Plan can be amended (or terminated) at any time. However, if benefits have already been accrued for the year, reductions in the plan contribution may not be possible until the next year. Most of our plans will specify that a benefit is accrued after 1,000 hours of actual service is performed by each eligible participant.

Conversions

It is sometimes desirable to convert a classic defined benefit plan to a "fully insured" plan. However, this conversion must be accomplished within 30 days of the first day of the plan year. Once converted, all future benefits will then be guaranteed by insurance contracts. The accrued benefits of the existing defined benefit plan must also be guaranteed by annuity contracts from the same insurer. This is accomplished by converting all the existing plan assets to a Flexible Premium Annuity whose guaranteed interest and annuity purchase rates will be used to fund the benefit.

As you can imagine, converting a classic defined benefit plan to a "fully insured" requires some rigorous actuarial calculations and should not be approached casually. Most firms, including SAI, will provide this calculation on a fee-for-service basis only.

Over-Funded Plans

Due to the record investment returns experienced by many plans in the 1990s, some defined benefit plans may still be over-funded. When a plan is very over-funded, no contributions may be made. Should an over-funded plan be terminated, a likely prospect when the small-business owner retires or dies unexpectedly, any excess assets may be subject to a 50 percent excise tax in addition to income taxes. By converting to a "fully insured" plan, the over-funding problem may be cured in some cases and a current tax deduction restored.

However, some plans may be so severely over-funded that converting to a "fully insured" plan may not immediately solve the problem. By adding a large amount of life insurance to fund a survivor benefit, should the owner die and the plan terminate, the additional life insurance protection may be more than sufficient to restore the values lost to excise and additional income taxes.

Under-Funded Plans

Due to wide swings in the market of the past few years, some defined benefit plans are now under-funded, or plan costs have become less predictable. Some sponsors may be concerned about the added liability (and PBGC costs) associated with an under-funded plan. By converting to a "fully insured" plan, the uncertainty can be removed and all plan benefits guaranteed.

Because future benefits may have a higher initial cost, the plan may be amended (with benefits reduced) to keep future employer costs reasonable. Past benefits are protected; they can't be reduced. As the past benefits must now be guaranteed by the insurance company, it is likely that a conversion to a "fully insured" plan will require a substantial financial commitment. This large contribution is required to be made within the first 30 days of the plan year. A client should therefore be very careful when converting a severely under-funded classic defined benefit plan.

A "fully insured" plan is fairly simple and maybe the ideal plan for the owner of a small business or professional enterprise that desires to maximize his or her current tax deduction and secure guaranteed retirement income. The contributions are, by design, quite large in the early years of the plan and may be less appealing as the number of plan participants increases.

Unlike a classic defined benefit plan, an insurance contract plan holds its Trust assets in annuity or a combination of annuity and incidental life insurance policies. The funding model presumes that only the contractual guarantees will be paid. Excess annuity interest and whole life dividends simply reduce future plan contributions.

Introducing life insurance to fund a portion of the retirement benefit will provide increased initial contributions and an additional pre-retirement survivor benefit for each participant. Existing plans may benefit by converting to a "fully insured" design, providing substantially higher current benefits and reduced exposure to excise taxes.

Security Mutual Life's "fully insured" plan can take your client to the "Next Level" of retirement savings and security. We offer everything you need to design, adopt, fund and service a plan.

How Can We Help?

- **Questions. Call the Retirement Planning team at the Home Office at 800.346.7171. If you are in the New York City metropolitan area, you may call our Regional Office at 212.268.9440.**
- **Design Studies. To review how a "fully insured" or traditional defined benefit plan can work for your client, fax us a confidential Retirement Plan Fact Finder (0010297) to 607.772.6726 or 212.268.9410.**
- **Support 24/7. Visit www.SMLplans.com for a wealth of resources, downloads and support, 24 hours a day, seven days a week.**

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All examples shown within the document are hypothetical and provided for educational purposes only. Actual results may vary depending on the particular facts and circumstances.

There are various income, gift and estate tax consequences of utilizing life insurance within a qualified plan. A decision to purchase life insurance within a qualified plan should be made after considering the tax results and your client's non-tax needs for insurance. We recommend that your client discuss their situation with tax and legal counsel before purchasing an insurance product within a qualified plan.

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