

Chapter 22

DESIGNING THE "RIGHT" RETIREMENT PLAN FOR YOUR PRACTICE

Retirement plans provide "congressionally favored" tax shelters and can be structured to provide significant benefits for the practice owner(s) at a minimal cost for other staff members. In this regard, one reason to own your practice is to retain the ability to adopt and fund your retirement plan within the limits allowable by law.

Retirement plans provide a means of forced savings. For example, a 1993 survey indicated that 43% of physicians save less than \$3,000.00 per year outside of their retirement plans and the median for all physicians surveyed was \$7,500.00. The survey showed how difficult it is for a practice owner to save money outside of a retirement plan. Therefore, by owning your practice, you have ultimate control over the adoption, contribution level and design of your retirement plan and can plan for your future financial independence. In this regard, the smaller number of owners in the practice, the more control you have over all aspects of your retirement plan(s) and ability to retire should you choose to do so at a relatively early age.

Compare the tax effects of a \$35,000.00 contribution to a tax-qualified retirement plan and a \$35,000.00 compensation bonus. The \$35,000.00 contribution to the plan is tax-deductible to the employer. The employee is not taxed until the funds are distributed from the plan. The \$35,000.00 is held in a tax-exempt trust and assuming 10% annual return, at the end of the year, \$38,500.00 would be saved. If a \$35,000.00 bonus was paid, the bonus would be deductible to the practice/employer. The employee would be taxed on the bonus and assuming a 40% blended tax rate (federal, state and local taxes and Social Security/Medicare), the doctor/employee would net \$21,000.00. Of the \$21,000.00, assume the employee saves half, \$10,500.00, and invests it in a funding vehicle with a 10% annual return. Since the 10% return is not in a tax-exempt trust, it is subject to long/short term capital gains tax, assuming a 20% tax rate. Therefore, of the \$2,100.00 investment gain, the doctor/employee would net \$1,680.00, and at the end of the year, the doctor/employee would have savings of only \$12,180.00.

Retirement plans serve two major functions; they provide employee benefits and act as a tax shelter. Even in a plan designed primarily as a tax shelter for the practice owner, the funding of benefits for staff members is crucial in attracting and retaining quality employees in a shrinking applicant pool. Therefore, participation in a retirement plan should encourage staff loyalty and longevity and reduce employee dissatisfaction and turnover. Reduced turnover should increase practice revenues and minimize employee training costs. Furthermore, proper and positive communication to staff members is a key to employee appreciation of retirement plans as well as other tax-favored fringe benefits, e.g., the payment of hospitalization premiums.

Retirement plans provide certain tax benefits. First, employer contributions are deductible in the year made. Contributions are deductible if made prior to the due date for those practices filing corporate tax returns, including extensions. Second, participants are taxed only when they receive payments from the plan/trust. Next, the retirement plan/trust is tax-exempt and the trust funds accumulate income tax free. Fourth, income tax brackets are generally lower at the time benefits are received following a participant's retirement or death. Finally, Social Security taxes

are paid neither on employer contributions to retirement plans nor on distributions to participants from such plans.

Deadline For Updating Plans

Every few years, retirement plans have to be amended to comply with tax law changes which took place over the time period in question. As of this time, plans must be fully amended and restated to comply with the "GUST" amendments before the last day of the first plan year beginning on or after January 1, 2001. Therefore, retirement plans operating on the calendar year must be amended by December 31, 2001. If the year-end for the practice is a month other than December, the amendment will be required in the plan year ending in 2002. For example, a practice with a plan year-end of March 31 will have until March 31, 2002 to be amended. As a general rule if the plan has been amended more than three times, it should be restated as a new plan and trust document. GUST amendments must be part of an amended and restated plan and trust document.

Protection Of Retirement Plan Assets From Creditors

With the exception of Qualified Domestic Relations Orders, divorce decrees and child support orders, and federal tax levies and judgments, a participant's benefits under a tax-qualified plan are insulated from creditors' claims and not attachable in bankruptcy. Unlike qualified plans, however, individual retirement accounts ("IRAs"), simplified employee pension plans ("SEPs") and "SIMPLE" plans are subject to creditors' claims unless protected under state law. Figure 22-1 provides a state by state analysis of IRAs as exempt property.

Owner-only plans without staff participants may be risky. Since 1992, several U.S. Bankruptcy Courts have ruled that assets in a sole proprietor's retirement plan may be attached by creditors if the sole proprietor goes bankrupt. Bankruptcy Courts have held that a pension plan that benefits only the owner of a small business is not "ERISA-qualified". ERISA is meant to benefit employees and a sole proprietor, partner or shareholder is not considered an employee, but an employer.

Entity Considerations

Prior to 1982, retirement plans were a significant factor in deciding whether or not to incorporate your dental practice. Benefits available under tax-qualified corporate plans were substantially greater than under plans of unincorporated entities or Keogh plans. After 1982, the tax laws eliminated the special limitations for Keogh plans and enacted parity for deduction and contribution limits between corporate and non-corporate plans. Therefore, since that time, retirement planning is "essentially" tax-neutral as to the entity in which you operate your practice.

Some differences still remain in the treatment of retirement plans sponsored by corporations and those maintained by other entities. For example, the maximum contribution for an owner-employee of an unincorporated entity is 20% of earned income, rather than 25% of the shareholder's W-2 compensation.

Prior to January 1, 2002, plan loans to owners in non C-corporate practices are "prohibited" transactions under ERISA and are subject to a penalty tax. Thus, owners in an S-corporation, a sole proprietorship, a partnership or an LLC or LLP were not permitted to obtain loans from an employer-sponsored retirement plan. Effective January 1, 2002, loans to such "owner-employees" are no longer prohibited transactions. Although plan loans to an owner/participant entail numerous restrictions, plan loans up to \$50,000.00 are still permitted.

Social Security Integration

Social Security integration allows the employer/practice owner to receive an additional plan allocation beyond the contributions received by rank and file employees. First, all eligible employee/participants under the retirement plan receive a contribution as an equal percentage of their compensation, e.g., 5.7% of compensation. Next, employees with compensation above the integration level, e.g., the taxable wage base, receive an additional allocation as a percentage of compensation, e.g., 5.7% in excess of the integration level. The participants with compensation below the taxable wage base do not receive the additional contribution. Thus, the practice owner receives a skewed or disproportionate benefit significantly greater than staff employees. The goal of Social Security integration is to raise the practice owner's contribution as a percentage of the contribution for all plan participants to the highest possible.

Distribution Rules

There are three basic rules in distributions from retirement plans. First, the not-too-soon rule imposed a 10% excise tax on distributions prior to age 59-1/2. Second, under the not-too-late rule, distributions must commence by age 70-1/2 from IRAs and for 5% owners from qualified retirement plans. For non-5% owners in qualified plans, distributions must commence at the later of age 70-1/2 or actual retirement. Finally, under the not-too-little rule, benefits must be at least amortized over the life of the participant or joint lives of the participant and the participant's designated beneficiary, commencing at age 70-1/2.

Compensation Limits

The limit on compensation from which contributions can be made is \$170,000.00 for plan years commencing in 2001, \$200,000 for plan years commencing in 2002. It should be noted that the family member aggregation rule for purposes of the compensation limitation has been repealed for plan years commencing after December 31, 1996. For the 1997 plan year and thereafter, a husband and wife employed by the same employer/practice are not subject to a joint compensation limit.

Eligibility And Vesting

A retirement plan may exclude anyone who works less than 1,000 hours a year and who is under age 21. The plan can have either a one or two year eligibility period. If the plan has a two-year eligibility period, the participants in the plan are 100% vested after such period. If the plan has a one-year eligibility period, the plan can have a graded vesting schedule, generally over a maximum six-year period. For example, with a six-year graded vesting schedule, a participant who leaves the practice after three years would only be 40% vested. Therefore, if the participant

had \$1,000.00 in his or her account, the participant would be entitled to \$400.00. The other \$600.00 would be allocated to the remaining participants.

Types Of Qualified Plans

There are two types of tax-qualified retirement plans; defined contribution plans and defined benefit plans. A comparison of types of tax-qualified plans is included in Figure 22-2.

Defined Contribution Plans

Defined Contribution Plans do not fund a guaranteed benefit at a certain age. Contributions are made to each participant's individual account under the plan, and the income, expenses, gains and losses from plan investments affect the value of the participants' individual accounts and the level of benefits ultimately received by participants.

For all defined contribution plans, the maximum annual additions (which includes employer contributions, forfeitures and employee contributions) under IRC Section 415(c) for 2001 is the lesser of 25% of compensation or \$35,000.00. For plan years commencing in 2002 and thereafter, the limitation is the lesser of 100% of compensation or \$40,000, adjusted for cost of living increases after 2002. Therefore, contributions and forfeitures allocated on behalf of a participant cannot exceed these limitations.

Defined contribution plans include profit-sharing plans, 401(k) plans, money purchase pension plans and target benefit pension plans.

Profit-Sharing Plans

Profit-sharing plans were greatly affected by the Economic Growth and Tax Relief Reconciliation Act of 2001. For plan years commencing after December 31, 2001, the employer/practice owner can contribute any amount between zero and 25% of the annual compensation for the covered employees. Prior to the tax law change, the contribution was between zero and 15% of annual compensation. Therefore, in order to obtain the maximum contribution of the lesser of 25% of compensation or \$35,000.00, the employer/practice owner had to adopt a second retirement plan, typically a money purchase pension plan which required a fixed contribution. Under the new law, the employer/practice owner can contribute as much under one plan as could previously be contributed under two plans without the requirement of a fixed contribution.

Profit-sharing plans are the most flexible of all qualified retirement plans because the employer/practice owner is not obligated to make contributions to the plan each year. However, the IRS requires that contributions to a profit-sharing plan be recurring and substantial. Although an employer does not have to make contributions every year, the employer's contributions must be more than single or occasional. The Treasury Regulations provide that a plan may be considered to be terminated if no contributions have been made for five consecutive years.

Cross Tested Profit-Sharing Plans

Cross testing may significantly raise the practice owner's contribution relative to the contribution made on behalf of staff employees so that the portion of the contribution allocated is 80+% of the total contribution. A cross-tested profit-sharing plan considers age and other factors in the calculation. Although the additional benefit to the practice owner can be much more significant than under a traditional profit-sharing plan, the annual administrative and actuarial fees to adopt and maintain a cross-tested profit-sharing plan can also be significant. Therefore, these costs should be weighed against the additional benefit to the practice owner(s). As a general rule, the average age of the owners must be at least 5 years greater than the average age of the non-owner for a cross-tested plan to be a viable option.

401(k) Plans

A 401(k) plan is a type of profit-sharing plan under which employees may elect to defer a portion of their compensation to the plan. For plan years beginning January 1, 1999 and thereafter, 401(k) plans can now provide a significant benefit to the practice owner at a relatively low employee cost. Although 401(k) plans allow employees to contribute a portion of their contribution, the practice owner's contribution is limited by the Internal Revenue Code in accordance with the level which employees chose to contribute. Often, the practice owner received unreasonably low contributions and had relatively high administrative costs. As a result, 401(k) plans were not typically the most advantageous plan option for dental practices.

However, the complex coverage rules are now simplified by a "safe harbor" rule. In effect, the practice owner or employer may make a contribution equal to 3% of compensation for each non-highly compensated employee who is eligible to participate in the 401(k) plan. As a result, the key employee or practice owner can contribute \$10,500.00 (\$11,000 in 2002, \$12,000 in 2003, \$13,000 in 2004, \$14,000 in 2005, \$15,000 in 2006) to a plan for a safe harbor contribution of 3% of compensation for the non-highly compensated employees. Therefore, for a 3% employee cost, the practice owner can attain a significant contribution with relatively low administrative costs.

The following safe harbor examples illustrate the significant and available benefits to the practice owner. Assume the following: the annual practice revenues are \$425,000.00, staff compensation (chairside and clerical) is \$115,000.00 or approximately 27% of revenues and owner compensation is \$170,000.00 or 40% of revenues.

401(k) plan integrated with Social Security at Social Security taxable wage base.

- (a) The practice owner/key employee has \$170,000.00 compensation.
- (b) $\$170,000.00 \times 3\%$ (safe harbor contribution) = \$5,100.00.
- (c) The practice owner/key employee can defer \$10,500.00 to plan because the safe harbor 3% contribution is satisfied.

- (d) Total for key employee: $\$5,100.00 + \$10,500.00 = \$15,600.00$? $\$170,000.00 = 9.17\%$.
- (e) The employer/practice owner cost for non-highly compensated employees is 3% of compensation or $\$3,450.00$, e.g., $\$115,000.00 \times 3\% = \$345.000.00$.

Under current law, the benefit to the practice owner is as follows: for a staff cost of 3% or $\$3,450.00$, the practice owner receives a contribution of $\$15,600.00$ from a total contribution pool of $\$19,050.00$, or 82% of the total contribution pool. While 82% of the contribution pool is a healthy percentage, remember that the practice owner is probably not contributing enough to the retirement plan to continue his or her current lifestyle after retirement for any length of time. Therefore, consider a $\$40,000.00$ retirement plan contribution in 2002 and thereafter. However, the practice has to maintain sufficient profitability to fund such a contribution, which is why management systems are so crucial to practice operations.

Money Purchase Pension Plans

In this type of defined contribution plan, contributions to the plan are fixed, but not the benefits. Contributions are based on a fixed percentage of annual compensation for all plan participants. Thus, under a 10% of compensation money purchase plan, an employee earning $\$170,000.00$ would receive a contribution of $\$17,000.00$, while an employee earning $\$20,000.00$ would receive a $\$2,000.00$ contribution.

The employer can deduct contributions to a money purchase pension plan up to the total of all annual additions for all participants; that is, of 25% of the combined compensation of all plan participants. Commencing in 2002, the contribution limitation to a profit-sharing plan is also 25% of compensation. Therefore, after 2001 an employer can maximize its contributions without having mandatory contributions to a pension plan.

Target Benefit Pension Plans

A target benefit plan is a type of defined contribution plan containing certain defined benefit characteristics including a targeted benefit geared to commence at the plan's normal retirement date and contributions required to fund the targeted benefit based upon actuarial assumptions. If an employer (the practice owner) desires to weigh contributions in favor of older employees, a target benefit plan may be considered.

Under the Treasury Regulations, target benefit plans must be tested annually to assure that plan contributions do not discriminate in favor of highly compensated employees. Therefore, such plans can be costly to adopt and maintain. However, the costs should be viewed in light of the contribution to the practice owner.

Defined Benefit Pension Plans

Under a defined benefit plan, the level of benefits is fixed and contributions are determined by an actuary to provide adequate funding to furnish those benefits at retirement. In effect, defined benefit plans may allow "mega" contributions in excess of the defined contribution limitation, the lesser of 100% of compensation or \$40,000.00. For this reason, defined benefit plans can be extremely useful for the practice owner, typically age 50 or older, who has not made significant contributions to a retirement plan and now desires to do so. These plans work best where the practice owner is older than other staff members.

Under a defined benefit plan, the maximum benefit that can be funded is expressed in terms of an annuity of the lesser of \$90,000.00, adjusted, or 100% of an employee's annual compensation. IRC Section 415(b). For year 2001, the maximum benefit is \$140,000. For 2002, the maximum benefit is \$160,000. Benefits for participants with fewer than ten years of participation under the plan must be proportionately reduced.

Although there can be many variations in selecting a formula for a defined benefit plan, the formula is based on such factors as a fixed percentage of compensation over a fixed number of years of service, a flat dollar amount payment, or a flat dollar amount or percentage of compensation for each year of service of a participant.

Defined benefit plans are again becoming useful because the IRC Section 415(e) rules are eliminated for plan years commencing after January 1, 2000. This means that funding limitations for those employers which previously had a defined benefit plan in effect are removed. For example, an employer who previously had a fully funded defined benefit plan in effect in the past may now fund a profit-sharing or other retirement plan after January 1, 2000.

Although defined benefit plans can work very well for the practice owner over age 50 with a younger group of employees, a drawback is that such plans are more difficult and expensive to establish, operate and terminate than other retirement plans.

Cash Balance Plan

A cash balance plan is a defined benefit plan which defines an employee's benefit as the amount credited to an account. The account receives allocations, usually expressed as a percentage of pay, as the employee works. The account is also credited with interest adjustments until it is paid to the employee.

A cash balance plan differs from a defined contribution plan in that a cash balance plan defines an employee's retirement by a formula and the employee's retirement benefit does not depend either on the employee's contributions to the plan or the investment performance of the plan's assets, as it would in a defined contribution plan.

A cash balance plan differs from other defined benefit plans in that a cash balance plan defines an employee's benefit as the amount credited to an account, while other defined benefit plans typically define an employee's benefit as a series of monthly payments commencing at normal retirement age.

Employee Census

To determine the most appropriate retirement plan option(s) for your practice in light of anticipated growth, complete an employee census and authorize your pension attorney, accountant and/or financial advisor to perform an analysis of the benefits under each retirement plan option. The analysis should be reviewed in light of your objectives and the anticipated administrative, actuarial, adoption and maintenance costs. This analysis is effective and may be completed at a relatively low cost.

The employee census should include the following for each employee, including the practice owner: (a) name; (b) date of hire; (c) annual compensation; (d) age; and (e) the number of hours worked annually.

A Final Thought

Once you are aware of the anticipated benefits of a retirement plan in light of the costs of adopting and maintaining it for your practice, you can effectively plan when and how you can retire. You cannot change your age, but you can plan your future given sufficient time to make contributions.

Before deciding upon the adoption or amendment of your retirement plan(s), meet with your advisory team to determine your retirement needs. Then determine the yearly contributions necessary to meet those retirement needs in light of your and your spouse's anticipated life expectancies; probably much longer than you think. You will probably find that there is insufficient practice cash flow to fund those anticipated needs. In this case, consider some planning.

First, seek the necessary practice management training and assistance to sufficiently increase your cash flow to make the necessary and continuous retirement contributions.

Second, your advisors may well have the capability to restructure your debt (both practice and personal) to increase cash flow for planned contributions which will allow you to meet retirement plan and financial goals and live in the manner which you and your spouse choose.

Finally, be prepared to make the necessary lifestyle changes to fund your retirement objectives.