RETIREMENT PLANNING UNDER THE NEW TAX RULES

By David J. Schiller, JD

In addition to the numerous and substantial individual and corporate tax changes brought about by the Tax Reform Act, there are also significant changes in retirement plan provisions.

Although Congress has generously provided about 3 years to make most of the necessary changes, some of the provisions became effective January 1, 1986, and others January 1, 1987. Consequently, your retirement plan should be updated—and we recommend that you give it your prompt attention so that valuable opportunities are not lost forever. Here is how some of the most prominent changes may affect you.

Plan loan interest deductions

Traditionally, if you borrowed from your corporate retirement plans, the interest paid was deductible for federal income tax purposes. Now, however, there will be no interest deductions for physicians or other highly compensated employees based on loans taken from retirement plans after December 31, 1986. An exception is made if you have a plan loan outstanding on December 31, 1986, in which case you may continue to deduct a portion of the future interest payments just as you would any other consumer interest. You will be able to deduct 65% of consumer interest in 1987.

If the loan in effect on December 31, 1986, is secured with a lien against your principal or second residence, you have created a "home equity" loan, and you can deduct 100% of the interest.

You will not be able to deduct the interest you pay on any plan loan taken or renegotiated after December 31, 1986, even if you place a lien against your principal or second residence.

Worse yet, any non-deductible interest paid on a plan loan does not create a "basis" in one's plan assets. Therefore, interest payments are effectively subject to double taxation. The interest payments are non-deductible when paid, and are taxed again once they are eventually distributed from the plan.

In general, any retirement

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plan loan may not be paid back over a period longer than 5 years. For all loans taken after December 31, 1986, the exceptions now permitted to this 5-year rule will be limited. Up until December 31, 1986, a loan could be taken in excess of 5 years if the loan was used to acquire or improve a principal residence of the participant or a member of the participant's family.

The 5-year repayment rule will apply to all loans made, renegotiated, extended, renewed, or revised after December 31, 1986. The sole exception to this rule is when the participant borrows to purchase a principal residence for himself.

Voluntary contributions

Most physicians will no longer be able to make voluntary after-tax retirement plan contributions. Previously, we have always encouraged establishing these "tax-deferred savings accounts" because of the opportunity to have earnings grow tax-deferred while knowing that the principal investment can be withdrawn at any time without tax or penalty.

Now, two minor changes in the law kill any motivation to make voluntary contributions. First, prior to January 1, 1987, any participants could contribute (post-tax) at least 6% of their compensation as a voluntary contribution, regardless of the employer contribution. Now, you are not permitted to make a voluntary contribution if the employer contributes the maximum permitted under the law. However, you may still be able to contribute if the employer contributes less than what is permitted under the law.

A second change imposes nondiscrimination rules for voluntary contributions. That is, highly compensated individuals can only make voluntary contributions within permitted ratios of lower compensated individuals' voluntary contributions. Essentially, therefore, if lay staffers make no voluntary contributions, physicians will be prohibited from making such contributions.

Under the "top heavy" plan rules that went into effect in 1984, many physicians imposed a 3-year wait (with 100% vesting) prior to employee participation. The alternative schedule required an individual to wait 1 year to participate in the plan, then vested the employee at a rate of 20% per year until 100% vested (5 years). To reduce employer contributions, as well as the headaches of plan administration, most practices elected to utilize the 3-year wait provision.

Employees vested sooner

Effective January 1, 1989, you may not require an individual to have more than 2 years of service prior to entering your plans, and then he must be 100% vested. Alternatively, you can still utilize the 1-year wait and have him

"SIMPLIFIED" BENEFITS DISTRIBUTION

Effective January 1, 1987, 10-year averaging is repealed for those born after December 31, 1935. In its place will be 5-year averaging, which will possibly be equally beneficial under the revised tax rates.

Physicians born prior to January 1, 1936, will have the option of using the old 10-year averaging rules with 1986 tax rates, or will be permitted to use 5-year averaging—or any other permissible form of distribution, for that matter.

For physicians with pre-1974 contributions, there is a 5-year phase-out of anticipated capital gains treatment of these contributions. In addition, for those born prior to January 1, 1936, there is a grandfathering of the pre-1974 capital gains treatment provisions which are not subject to the 5-year phase-out. For anyone electing to use capital gains treatment on any portion of any distribution after December 31, 1986, there is a flat 20% rate applicable to the capital gains portion, regardless of the maximum effective capital gains rate under present law. Once again, this option must be weighed at the time of distribution. Well, the President did promise Americans that it would be "simple!"

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gain vesting gradually, as described above.

Although the 3-year wait was advantageous, starting January 1, 1989, it will make more sense to use "graded vesting." Graded vesting will save money on staff contributions when staff members leave with less than 5 years of service. If an employee leaves prior to being 100% vested, he will forfeit a portion of his benefits back to plan, which will then be allocated among other participants.

Integration with Social Security

Integrating your plan with Social Security is one of the few forms of legal "discrimination" permitted under this law. Currently, a defined contribution plan may allocate more funds to highly compensated employees so that they receive an additional 5.7% of compensation on salary in excess of a stated amount.

Effective January 1, 1989, physicians may still benefit from plan integration, but the permitted excess contribution rate (up to 5.7%) cannot be greater than the basic contribution rate. Thus, where a plan provides for a contribution of 3% of total pay plus 5.7% of pay in excess of $20,000, the basic contribution would be 5.7% of total pay, to keep the integration at 5.7% of excess pay.

Similar changes have occurred for defined benefit plans, essentially eliminating "excess only" plans. Therefore, if you wish to get maximum advantage of the integration features for the highly compensated, you must now provide certain new minimum benefits for non-highly compensated participants.

After December 31, 1988, an employer may not set a lower compensation level for integration than the Social Security

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wage base ($42,000), if such a level discriminates in favor of highly compensated employees. Our observation has been that setting the integration level at any level below the Social Security wage base is almost always discriminatory in favor of highly compensated employees; so the integration level will rise in most plans and the net benefit of integration will be reduced.

IRAs

Individual retirement accounts (IRAs) and qualified voluntary employee contributions (QVECs) have been essentially repealed as you now know them. As a physician-participant in a qualified retirement plan, you may not deduct your contribution to an IRA or to a QVEC for the year beginning January 1, 1987, and thereafter, for tax purposes. (QVECs were essentially IRAs within a retirement plan in lieu of an IRA outside the plan.)

Despite popular belief, Congress has not actually repealed IRAs. If you or your spouse are an "active participant" in a qualified plan, you may still make an IRA contribution; however, the $2,000 (maximum) contribution will not be deductible.

IRAs will partially fill the void left by the departure of voluntary employee contributions. You may contribute post-tax dollars into an IRA and tax-deferred earnings will accumulate.

The changes affecting plan benefit distributions are numerous, but (fortunately) not all negative for physicians. Congress corrected a mistake made in 1984 when it imposed a 10% penalty on all monies distributed prior to age 59½, but failed to "grandfather" contributions made prior to January 1, 1985, the effective date of this excise tax.

Under tax reform, contributions made prior to January 1, 1985, are not subject to this excise tax, even if they are distributed prior to age 59½.

Even contributions made after December 31, 1984, can now be distributed penalty-free prior to age 59½. If you change your plan to permit an earlier distribution, there is a new provision that will allow a participant who retires following attainment of age 55 to avoid the 10% penalty—but only if the plan provides for a retirement age of 55.

Under another provision, there is a severe excise tax (50%) if you do not withdraw the required amount from your plan, starting no later than age 70½. For those of you who wish to delay distribution as long as possible, the tax law changes require that you start distributing by the April 1st after attainment of age 70½, or you will be subject to the 50% excise tax.

Overfunded plans

Since taxes are deferred on monies placed into retirement plans, Congress has always taken an interest in not permitting any

individual to accumulate too much money in them. Throughout history, there has never been a maximum amount one could accumulate in defined contribution plans; only the contribution (not the accumulation) has been limited. Under tax reform, you will now be penalized if you overaccumulate in your plan.

After December 31, 1988, if you receive distribution in excess of a specified sum (initially $112,500), you must pay a 15% excise tax upon distribution. If you receive a lump sum distribution under the new 5-year forward averaging rules, the 15% excise tax is only imposed on any distribution in excess of a higher specified amount (initially $562,500).

Transition rules allow larger distributions if your benefit on August 1, 1986, would provide a larger distribution. This grandfathering provision will allow you to avoid the excise tax on funds that you have already accumulated, but will not protect future contributions. However, in order to take advantage of this grandfathering provision, it is necessary to file an election with the IRS prior to January 1, 1989.

This new overfunding provision will require planning for contributions, plan growth, and distributions, so certain actuarial computations previously only necessary in defined benefit plans may be required. You cannot even die and avoid this excise tax, for a large plan benefit would be subject to a new 15% "estate" tax equivalent.

Profit-sharing plans

In order to make a contribution to a profit-sharing plan, it has always been necessary to have a "profit," or at least to have retained earnings. This provision in the tax laws was eliminated effective January 1, 1986. Therefore, you can make a profit-sharing plan contribution even if it creates a loss and you have no retained earnings.

The "carry-over" option has also been eliminated. Prior to tax reform, if you did not contribute 15% of compensation to a profit-sharing plan, you would have been able to carry-over the excess and make up the under-contribution in future years. For example, if you contributed only 10% in 1984, you could contribute approximately 20% in 1985. Now, however, you are not permitted to carry over any portion not utilized in prior years, although the law excepts carry-overs that were created prior to January 1, 1987.

Defined benefit plans

Defined benefit plans have been affected much more significantly than money purchase and profit sharing plans. Congress recognized that many physicians and other highly compensated businessmen were starting a defined benefit plan to accumulate a large amount of money over a very short period of time. Using

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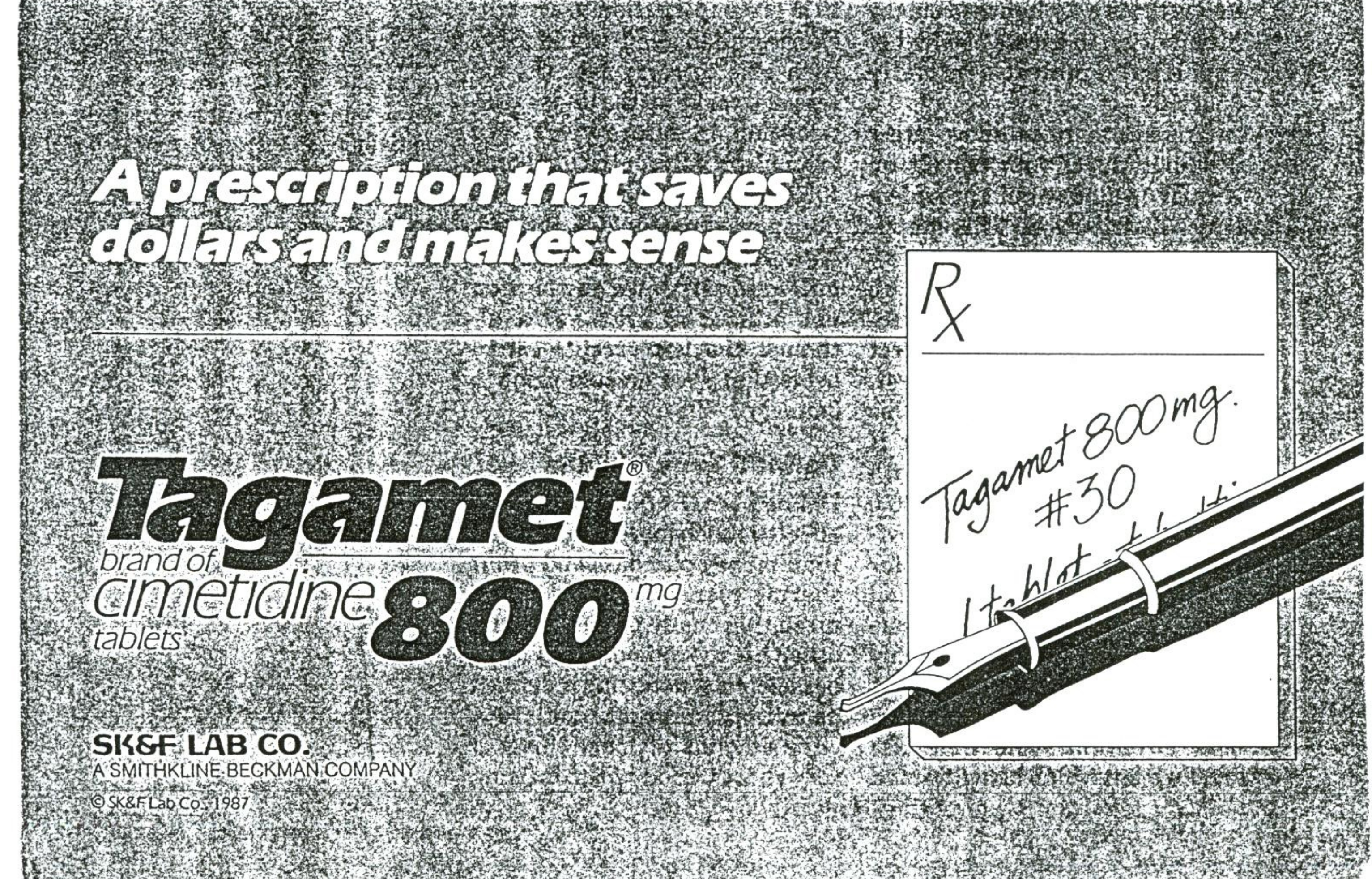
certain actuarial assumptions, physicians were sometimes able to shelter close to 100% of their earnings in their medical practices by utilizing a defined benefit plan.

Congress has now taken large steps to end this practice. Under tax reform, if a plan is overfunded due to actuarial miscalculation (mistakes or aggressive assumptions), there will be a 10 to 30% non-deductible excise tax imposed on the plan. Although accrued benefits have been grandfathered, based upon somewhat reduced limitations, it will be quite easy to overfund your defined benefit plan.

In the past, by assuming an age 55 retirement date, you were still permitted to fund for benefits up to $75,000 per year for each participant. Although physicians rarely voluntarily retire at age 55, this assumption was used to maximize plan deductions. Now, you can no longer fund for a $75,000 benefit at age 55, and must instead fund for a smaller benefit of approximately $35,000 to $45,000.



Another provision will require a reduction of the benefit if you participated in the plan for less than 10 years. For example, if you start a new defined benefit plan at age 63, anticipating retiring at age 65, you will only be able to fund for a very small benefit, not the popular $90,000 per year that you might expect.

With a defined benefit plan, each participant does not have a separate account; everyone's interest is invested as an aggregate. For this reason, practices with more than one doctor often utilize more than one defined benefit plan so that each doctor essentially has his own plan. This is set up so that each doctor can make his own investments and not be subject to the preferences of his partners. However, by December 31, 1988, each practice will be unable to maintain more than two defined benefit plans. The tax law changes also require that at least 40% of eligible participants participate in each retirement plan.

Relatively few physicians have used defined benefit plans in the past, and we anticipate that there will be even fewer in the future, and that they will be used in only the most extraordinary circumstances.

In perspective

Based on the various restrictions under tax reform, and the new low personal tax rates, we believe it will make good sense in many cases to take a larger portion of your practice income as taxable compensation rather than sheltering up to the legal limits in your retirement plans.

Starting in 1988, when many physicians will only be saving 28% or 33% by putting funds into a retirement plan, it will probably make sense to take advantage of the low tax rates and reduce your plan contributions. Especially in light of the excise tax on overfunded plans, you should not want to miss out on low tax rates and later be assessed an excise tax because you sheltered too much.

As some senators involved with drafting the Tax Reform Act of 1986 have stated, tax rates are bound to go up, possibly as early as 1987 or 1988. The motivation to shelter will once again increase if and when these rates do rise.

Despite all of the necessarily sophisticated tax planning, it still makes sense to continue to fund retirement plans for personal security and retirement purposes. A major reason for maintaining plans is to have sufficient assets for personal expenses once you are no longer practicing. Your retirement plans are still an excellent vehicle in which you can build a "forced savings."

In addition, most longer term employees expect and need funds set aside for them. With Social Security reductions, private retirement plans will be more necessary for your staff and should

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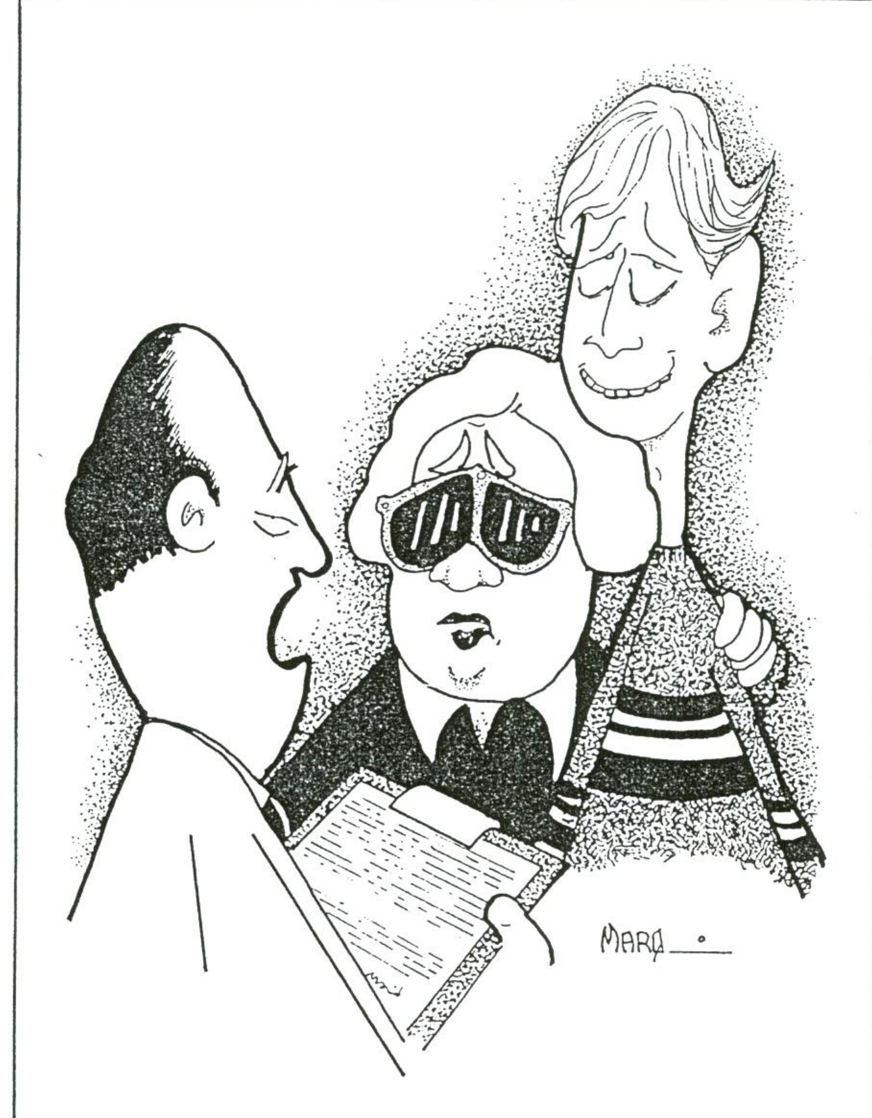
not be totally eliminated. In each of the coming years, it will be essential to continue to evaluate what role your retirement plans should play, so that they are an effective part of your overall finances. Since so many of the changes in the retirement plan laws and other tax laws will greatly affect you, proper time should be invested to plot the proper course. ■



"Our exhaustive tests on your son have all come up negative. . .I'm afraid I'm going to have to agree with his teenage peers. . .He really is just a nerd."