Choosing Your Firm's Retirement

by David J. Schiller

Do you have a Keogh or corporate retirement plan covering your practice? Retirement plans are the best available tax shelter left after the Tax Reform Act of 1986. Firms not using plans are missing out on a golden opportunity to save on taxes while setting aside money for the future.

Retirement plan law is a combination of tax law and labor law. Since ERISA in 1974, many law practices have adopted retirement plans for a variety of reasons. The primary purpose of a plan is to fund for your and your employees' retirements. Money is set aside each year so an income stream is available upon retirement.

Contributions are tax deductible by the employer when made. Although money goes into the plan for a particular employee, each employee is not taxed on the funds until they are withdrawn, usually upon retirement or termination of employment. Similar to an IRA, the funds grow on a tax-deferred basis and can "snowball" quite rapidly. Although it is possible to set aside funds each year outside of a qualified plan, many of us are not disciplined enough to do this and a plan acts as "forced" savings.

GOALS IN DESIGNING PLANS

In considering whether to adopt a qualified plan, you must determine if there currently is excess income—income that is not needed for current expenses. How many dollars can be put away for the "golden years"?

When considering what type of plan to adopt, you first must determine how much money you wish to contribute each year. This will control the type of plan you adopt. For most law practices, a combination of a money purchase pension plan and profit-sharing plan will be most appropriate. Although this requires a contribution each year, it often permits the maximum contribution deductible under tax laws. The practice may predetermine a fixed percentage of the net income or W-2 compensation that will go into a pension plan each year. Practices not willing to commit to a fixed contribution might, instead, adopt only a profit-sharing plan, which permits flexible contributions each year while not *requiring* any contributions.

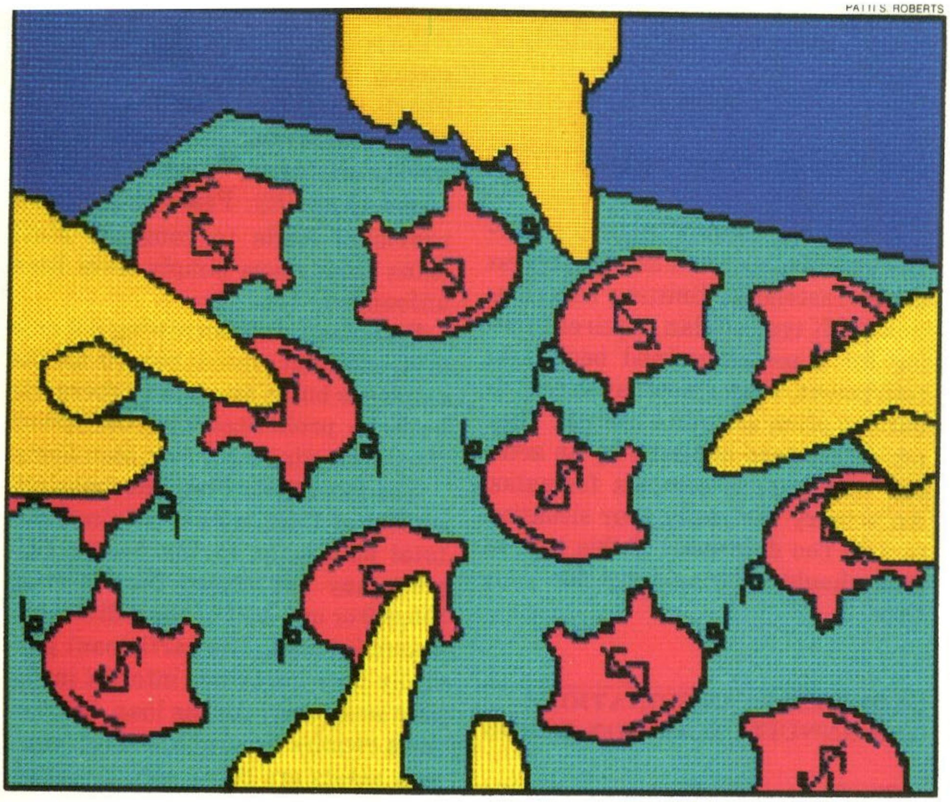
As most law firms are in the "top-heavy" classification under the law, the participation and vesting requirements are somewhat restrictive. To determine the cost of maintaining a plan, it is important first to ascertain how many of your employees will participate and the desired level of contributions. In designing a plan, you should try to achieve maximum benefits, allowing the owners of the practice to determine the contribution each year, how the funds are invested, and plan withdrawal availability and distribution alternatives. Plans can be tailored to your practice's particular situation.

It is rarely too late to consider adopting a retirement plan. While some lawyers age 65 and older have established new plans, only limited benefits can be enjoyed at this late stage.

ELIGIBILITY/PARTICIPATION

Since most law firms are in the top-heavy classification (Internal Revenue Code, Section 416), they must permit their staffs to participate in the plans rather quickly. Although it is possible to keep out some employees by disallowing participation of specific job classifications in special cases, generally all full-time employees must be permitted to participate eventually. It generally is most advantageous to require a two-year wait for participation. This means that an employee will have to work

PATTI S. ROBERTS



Plan

for two years for the employee to become eligible to participate in the plan and will actually start to participate in the third year of employment. As law firms often have significant staff turnover, this will help you reduce the cost of your pension plan.

Those employees working less than 1,000 hours a year may be kept out of your plan indefinitely. Many practices elect to hire part-timers to reduce the number of employees in their retirement plans.

CONTRIBUTIONS

In most plans, contributions are based on W-2 compensation or "net income" for self-employed individuals. Obviously, contributions made for attorneys are larger since contributions are based on a percentage of compensation per employee. However, by integrating a plan with Social Security retirement benefits, your staff cost can be further reduced while keeping your own contributions quite significant. The law generally permits you to contribute the lesser of 25 percent of compensation or $30,000 per year per employee.

INVESTMENT AND MANAGEMENT

Both Keogh and corporate plans may now be self-trusteed. Self-trusteeship is generally preferable in order to avoid large trustee fees and the often poor investment results from "professionally" managed funds, as well as to ensure that the participants know how their funds are being invested.

In most plans, each participant will have his "own" account. A plan may permit each participant to decide on his own investments, similar to a self-directed IRA. Each participant may determine his own "risk factor" and make the appropriate decisions. This feature, although not mandatory, allows maximum flexibility and avoids conflict.

The plan should clearly provide that the employer, not the plan, may pay for administrative costs incurred in operating the plan and trust. Such expenditures are, of course, tax deductible to the firm, yet they do not count as allowable plan contributions. This allows maximum plan contributions to grow and compound without diminishing plan assets through administrative costs.

Although generally not a good idea, a plan may permit the purchase of life insurance for participants. Note that all retirement plan assets, including life insurance proceeds, are eventually taxable to you or your estate. Although there was formerly an estate-tax exclusion for retirement dollars, this has been eliminated, and you no longer can transfer retirement plan wealth to the next generation without estate-tax implications.

DISTRIBUTIONS

Many complicated laws and regulations control when and how distributions are received for qualified retirement plans. Since retirement-plan proceeds will possibly be your largest source of post-retirement income and an important part of your estate, careful planning and retention of flexibility must be emphasized to obtain optimal income and estate tax results. There is no set formula or correct answer to the method and timing of distributions; a sound decision can be made only after exploring all available avenues.

Many distribution alternatives exist. Your plan should allow for lump-sum distributions, equal periodic payments, graded periodic payments, annuities and "any other legal permissible forms" of distribution, with no choice compelled by the plan. The goal is to permit each participant to receive a distribution most tax-favorable to that individual. Special tax treatment is generally available if you take your benefit as a lump sum.

Five-year averaging permits you to treat the distribution as though you received one-fifth each year for five years and assumes no other income. Often, this can result in an overall tax reduction.

Similar to IRA's, unless the participant is disabled or deceased, distribution of plan benefits before age 59½ generally subjects one to a 10 percent penalty for "early distribution." However, the Tax Reform Act of 1986 now permits an exception to this rule for plans that have an early retirement age of 55. If you "separate from service" at that age or thereafter and receive a distribution from a corporate plan, you avoid the 10 percent penalty. This exception may not apply if you have a Keogh plan, because it is uncertain whether the owner of an unincorporated practice can have a separation of service.

The latest a participant may start to receive benefits is April 1 following the year in which the person reaches age 70½. If the participant is not living, the individual's account will generally have to be paid out within five years of death. However, there are several exceptions to this rule, permitting a payout to one's spouse over a longer period of time. If you fail to withdraw the proper amount as required by law, there is a 50 percent penalty on any required amount that wasn't distributed.

To prevent you from "overutilizing" your plans and building up excessive funds, the new law provides for a 15 percent excise tax if you distribute in excess of $150,000 in any given year. (This will be adjusted upward in future years.) If you receive a lump sum distribution, the amount cannot exceed $750,000 in order to avoid the excise tax. The purpose of the law is to prevent you from building up too much, to require that you start taking distributions early and to help assure that the funds will provide income during retirement. It generally is not a good idea to aim for more than $1 million at age 60. If you accumulate substantially more, you will pay this additional excise tax, even if you try to distribute quickly at that time.

DEFINED BENEFIT PLANS

A "defined benefit" plan is generally undesirable in all but the largest firms. Instead of limiting contributions, this type of plan requires funding for a predetermined benefit at retirement. Under new laws, contributions often are quite limited. They are determined annually by an actuary who juggles complex formulas. An actuary can study your situation to help you determine if this type of plan should be considered for your firm.

BENEFICIARY DESIGNATIONS AND ANNUITY ELECTION FORMS

The Retirement Equity Act of 1984 imposes automatic benefits for the surviving spouse of a participant who dies before retirement.

A "preretirement survivor annuity," which gives the spouse of a participant an annuity for life, is the required distribution form if the participant dies before retirement. A "joint and survivor annuity," which provides an annuity for the life of a participant and spouse, is the required form of distribution for a participant and spouse upon the participant's retirement *unless* an election is made. In general, an annuity is not the most desirable form of benefit. In order to be permitted to elect other forms of distribution, both you and your spouse must "elect out" of the annuity form of distribution.

It also is important that you complete a beneficiary designation, designating the beneficiary of your retirement plan benefits should you die prior to their receipt. The law requires that your spouse receive a portion of plan benefits, unless the spouse waives this right. This waiver may be necessary if you have established a trust for your children or other beneficiary. By designating a beneficiary, plan assets escape the time-consuming probate process.

BORROWING

Corporate plans can permit borrowing by all plan participants, yet Keogh plans can permit borrowing only by *nonowner* employees. A borrowing provision is worthwhile for added flexibility. Fears that such a provision leads to constant staff loans from plans simply have been unfounded.

Permitted staff borrowing not only is an excellent no-cost benefit for the employee but it also shows there has been no prohibited discrimination, thus protecting your own plan loans.

The Tax Equity Fiscal Responsibility Act of 1982 (TEFRA) requires that total plan loans to any one participant may not exceed the lesser of $50,000 or one-half of the individual's vested interest. The participant generally uses his or her interest in the plan as security for the loan, but new rules require spousal approval, since plan assets are being used as collateral. There is no need for additional, personal collateral. Under the new law, loans to key employees (lawyers, generally) may be made, but interest payments made to the plan are nondeductible. Therefore, if you need to borrow a lot of money, it makes sense to take a regular "home equity" loan so your interest payments are generally deductible.

* * *

The retirement plan you choose should be designed to contain those choices that best suit your firm and its members. It should be designed to give the group the maximum flexibility as time passes. The various elements of the plan should be drafted with care for this desired flexibility. It pays to read the fine print and be sure that plan advisers have considered all available options. Reviewing actual plan documents against the foregoing list should help assure a well-structured retirement plan providing maximum benefit. In most cases, it would be unwise for law firms simply to accept a plan document for a mass market. Such plans are rarely flexible enough to meet your particular needs nor do they allow you to take advantage of appropriate cost-saving aspects. LPM

David J. Schiller is the principal in Schiller Law Associates, 530 Swede Street, Norristown, Pennsylvania 19401.

LAW PRACTICE MANAGEMENT

APRIL 1990

Section of Law Practice Management
American Bar Association

THE CLIENT SERVICE EDGE