Don't let these mistakes ruin your retirement dreams

The IRS will wreak havoc if it disqualifies your plan. And it's a lot easier for a plan to be disqualified than most doctors imagine.

By David J. Schiller, J.D.

"So I'd have to put the coat-check girl into my pension plan?" asked the OB/Gyn. "That's the last straw."

I've often found it tough to explain to my clients the mysterious ways in which the IRS works its wonders–but this case was a real lulu.

Dr. Martini (not his real name) had inherited his family's thriving restaurant business. Soon, the doctor was having a wonderful time acting as *il padrone*. He'd often bring in associates and patients, order up special dishes, conduct kitchen tours, and generally play the restaurateur to the hilt.

It fell to me to burst the bubble. In reviewing Martini's situation, I realized that as the owner of two businesses–his practice

THE AUTHOR heads Schiller Law Associates, Norristown, Pa., and is an editorial consultant to this magazine.

and the restaurant–he'd have to include the employees of both in his retirement plans. If not, those plans would be subject to disqualification.

When a plan is disqualified, all past contributions and all the investment earnings on those contributions are immediately taxable to the plan participants. Penalties are also usually levied.

True, not many doctors suddenly find themselves employing dishwashers and doormen. But the trap that caught Martini is wide enough to catch plenty of physicians. And it's only one of the traps out there, with consequences equally drastic.

Moreover, in recent years the IRS has been checking up more than ever: The number of plans it examined doubled in 1988 and then nearly doubled again in 1989. So more than ever, it's crucial to know how you might be putting your plan into jeopardy.

Mistake 1: Only medical employees really count

Say you're an orthopedist who owns a therapy center. In determining who's eligible for your retirement plans, you have to consider the employees of the center in addition to your practice staff. That's true whenever you have ownership and control of more than one entity.

The rule's broad application can surprise you, though. It certainly surprised Martini. "How the hell can anyone say I have 'affiliated' groups?' " Martini wanted to know. "My technicians take X-rays; my waitresses take orders for pasta. And I don't 'control' the restaurant, either. I'm not involved in its management."

But the IRS can regard unrelated businesses as affiliated, I explained, simply because the same person is the owner of both. Moreover, since Martini owned more than 50 percent of the restaurant, he did have legal control, and that's what counts.

"My aides take X-rays," said the OB/Gyn. "My waitresses take pasta orders–at the restaurant I own. And the IRS says I have 'affiliated' groups?"

"If my parents had known, they could have left some stock to my children," the doctor said. "Hey, maybe I could transfer it now?"

No help there, I told him. The IRS looks at the total ownership picture, and may consider what's owned by your immediate family and even by business associates.

So if your spouse talks of opening an antique store, or if your partner's eyeing a chicken farm, better first find out whether your plan will be endangered.

In Martini's case, when he figured out how much he'd have to contribute for all "his" new employees, he saw two choices: terminate the plans or sell the restaurant. Reluctantly, he sold.

Mistake 2: We doctors will handle all that for you

Some plans permit separate accounts, and allow participants to manage their own plan money. In such situations, I often find that doctors direct their own investments individually, yet don't offer that option to staff members.

In fact, the employee funds are often stashed away in money-market accounts or other low-earning investments. The doctors usually tell me they're doing the noble thing. "We're being prudent," they'll say. "We're protecting the employees' money."

But the IRS won't be impressed. The doctors' motives might be seen as mixed, since lumping those em-

ployee accounts simplifies physicians' administrative chores. And if some participants–the doctors–can direct their own accounts, then all must be given that choice. Otherwise, the plan doesn't provide uniform benefits. Sometimes that's blatantly apparent. In one recent case, the doctors' accounts were earning from 11 to 40 percent, while the employees' money showed 6 percent growth. That plan was disqualified.

Letting staff members run their accounts means giving them fully equal treatment. If you and your colleagues can change investments every day, then employees must have the same right. And what if the bookkeeper starts playing the market hourly? You can set things up so that each account pays its own brokerage fees and make sure employees know about the provision. That should minimize hassles.

Mistake 3: Cutting off those who leave

Let's say that in 1991 your calendar-year plan included you, your partner, and three full-time staffers. Last November, the receptionist left. Should you make a 1991 contribution for her?

The well-known rule used to be that a participant who left your employ was not entitled to any contribution for the final year of employment. But that tended to hurt lower-paid employees, because there's usually more turnover at the lower levels of the employment ladder. So three years ago, the rule was changed.

Here's the current formula: You need to contribute for 70 percent of employees who were eligible during the year. (That's "non-key" employees, so doctors don't count.) Without a contribution for that departing receptionist, you'd flunk the test because you'd be covering only two-thirds of your eligible staff. So you do have to put 1991 money in for her.

The doctor was exasperated. "Why should I pay for revisions that won't affect any of my plan's participants, just as I'm about to shut the whole plan down?"

Mistake 4: Saving a fee by skipping the wrap-up

I terminated more plans in 1990 and 1991 than in my previous eight years of practice. It's not surprising. With increased regulations and tightening squeezes on how much can be put in or taken out, qualified plans have lost much of their glitter for doctors. But that's meant I've gone through all too many conversations like this:

"We're about to do the final paperwork on your plan, doctor," I'll say. "Including the revisions."

"Revisions? What revisions?"

"Your plan's out-of-date in relation to the 1986 tax law. That involves the waiting period for eligibility, the distribution choices. . . "

"But none of that stuff affects anyone. Nobody's come into our plan, or left, since 1985," a doctor may say. "If we're closing the plan down, why bother with all that now?"

My client knows there'll be additional fees, which might be $1,000 or more, and wonders if all this is truly necessary. Sorry, but it is. Generally, a plan must follow current rules–retroactively, if necessary–every day it's in existence, including the final day. And plan documents also must be amended to reflect the law. When the plan is submitted to the IRS for review, they'll check for that, you can be sure.

So if your adviser is terminating your plan without doing such an update, don't rejoice; ask about

it. You may be dealing with someone who's unaware of the rules on this point–and that could mean disqualification.

Mistake 5: Find a neat way to make a plan disintegrate

Dr. Pennywise decided to take over her own plan administration three years ago. Like many plans, hers permitted integration with Social Security, which allowed her to receive a greater percentage of compensation as a contribution than her staff members. And as is often the case, the integration formula was set up to shift as the Social Security tax rate changed.

In her efficient manner, the doctor telephoned the Social Security office and learned that the 1989 rate was 7.51 percent. Sitting down at her computer, she used that number in creating a spreadsheet of contributions for her plan's participants.

What the doctor's computer couldn't tell her, though, was that she was wrong to work with the full Social Security tax rate. For integration purposes, the disability-income portion doesn't count. As a result, her figures for staff contributions were too low.

Her goof surfaced at the worst possible time: during an audit. Luckily, the mistake didn't greatly affect the numbers, so the IRS didn't disqualify the plan. But the doctor had to make up the extra amounts owed to staff members, plus interest. And all that came out of her own share of the plan. She also had to pay her advisers $1,500 to analyze and explain her blunder.

If the mistake had changed the figures more substantially, would the government have sought disqualification? "Certainly," the agent told me.

Mistake 6: First do the deal. Then check it out

During the building boom of the mid-'80s, a doctor who managed his plan's assets used some of them to buy a half-interest in a local office building. A few years later, a major tenant left, leaving a big hole in the building's cash flow. Coincidentally, the doctor was looking for a site for a satellite office. A light bulb went off over his head: He took the space himself, solving two problems at once.

Sixteen months later, as I prepared the tax forms for his plan, I discovered this rental setup. I got the doctor on the phone right away. "Your practice is doing business with your plan," I said. "That's self-dealing, which is usually a prohibited transaction."

"Hold it," came the reply. "We're paying fair market rent–after all, someone else owns half the building. So there's no problem, right?"

Wrong. *Any* dealing that you or your practice may have with your plan is technically a prohibited transaction, unless you've gotten an exemption in advance from the Department of Labor. Getting such an exemption after the fact can be very tough.

The doctor certainly didn't want to sell his interest in the building during the current real estate slump. (That might have made him liable in another way, too, for handling plan assets badly.) He had to find another tenant, and move his satellite elsewhere.

Mistake 7: I'll just take care of No. 1

Sometimes the early bird blows it. Doctors whose plans have segregated accounts will often fund their own portions early in the year. In February of this year, for example, a doctor on a calendar-year plan might have thought this way: "I made $150,000 in 1991, and clearly I'll do at least that well again. So I'll just put in my $30,000 maximum for 1992 right now." That maximizes tax-deferred growth, so it's a smart move, and one that's often recommended.

But even good advice can backfire when you don't fully understand how to apply it. That same doctor may think it's too much trouble to calculate what 1992 staff contributions will be. So he figures he won't put that money in until just before the 1992 return is due.

That's asking for trouble. The doctor would get the advantage of extra growth, while his employees miss out on it. That's clearly discriminatory, and it's easily spotted.

Mistake 8: Unfair slicing of the pie

Suppose an employee is leaving, and you're making a plan distribution. You calculate the vested amount and write a check for that figure. But when your partner moved to another state last year, he took *his* distribution in the form of rapidly appreciating stock owned by the plan. That's hardly equal treatment.

Some plans require that individ-

ual distributions all be made in cash, so that issue won't arise. But you certainly have to deal with it when you terminate a plan. Again, it's common–and probably discriminatory–for employees to receive cash distributions while the doctors get the plan's securities and real estate.

Even if you do attempt to divide assets fairly, you'll have to be careful. Suppose your plan owns several $5,000 certificates of deposit, and when you distribute them, the doctors get the ones paying 12 percent while the employees wind up with the 8 percent ones. Again, that's discrimination.

The solution? If you distribute assets in kind, start with the best knowledge of current values that you can document, then proceed as equitably as possible. Safest of all, though: Give everybody cash.

Mistake 9: Mishandling the insurance premiums

The surgeon was plainly exasperated. "That insurance in my plan has been nothing but a headache," he said. "I feel like just canceling the policy."

He'd had his plan pay the premiums. That made sense: The plan owned the policy, and the cash buildup would take place inside the plan. But the death-benefit portion of a policy is different, says the IRS. That's a current benefit, since your family gets the protection from the policy's start. Because the surgeon didn't pay for that benefit, he received

"You can give me that diet, but I'm going to do a line item veto."

additional compensation–in other words, taxable income. The doctor didn't understand that, though, so he hadn't counted it in his gross income.

Then the doctor learned of his mistake. To correct it, he was prepared to start paying the premiums himself–but if he did that, he'd fall into a disqualification trap. By paying a premium most of which went to build up the insurance's cash value in the plan, the surgeon would, in effect, be making an extra contribution. But since he was already putting the maximum of $30,000 into his plan, he'd be over-contributing.

The upshot: I persuaded the doctor to keep the insurance in the plan and just pay income tax on the current value of his insurance. The moral for other doctors: If your plan owns insurance, learn the special ins and outs that apply.

Are you concerned about previous transgressions? Then you may find that a recent regulation will help: If you've accidentally left an eligible employee out of your plan, you now have nine and a half months after the plan year to correct the oversight. And for certain violations, a new IRS program may provide other amnesty (see below). The best course, though, is to know the rules ahead of time and follow them. ■

Here's a switch: good news from the IRS

Worried that your pension plan could be disqualified? The IRS says it has good news for you.

"With certain kinds of violations, there was no legal action we could take in the past short of disqualification," explains Martin Slate, director of employee plans at the Internal Revenue Service. "That could mean hurting innocent plan participants. The new Closing Agreement Program addresses that problem, by allowing us more flexibility."

Under CAP, you can correct certain plan violations retroactively, according to Slate. "Whether to correct is not negotiable, but the details of correction required may be," he says.

If employee contributions have been too small, for example, all the money must be made up. But where taxes are concerned, the maximum liability might not be imposed–though you should be aware that "deterrent payments" (the IRS doesn't call them fines) may well be required in some cases.

How leniently you'll be treated under CAP will turn largely on questions of fairness. In fact, you may not even be eligible for CAP if the violation is serious enough. "If it was egregious, intentional, or involves substantial discrimination," says William Posner, the IRS's assistant director of employee plans, "the plan will simply be disqualified."

The Department of Labor also has jurisdiction over your retirement plan, especially concerning "prohibited transactions." The Labor Department itself doesn't disqualify plans or assess excise taxes, but it will notify the IRS if it discovers prohibited transactions.

So contact the Labor Department before transacting any business with your plan, either individually or through your practice. Such "self-dealing" is generally prohibited, unless authorized by a Department of Labor exemption. "If it's a good business deal for the plan and the necessary plan safeguards will be in place, an exemption is often granted," explains Peter Straub, chief of Labor's division of exemptions. "But you should contact us *ahead* of time; it's unlikely you can get an exemption afterward, even in a deal you might defend as reasonable and arm's-length."

Straub says it typically takes four or five months to process exemptions involving "plain vanilla" transactions–such as simple loans or sales of property. For complex deals, he cautions, it may take a year or longer.

Labor Department employees will be glad to answer questions by phone, Straub stresses. "We can usually tell you if it's going to fly, before you pay to have an attorney or other plan adviser get it approved." Call any of the following numbers, all in the (202) area code: 523-8881, 523-8883, 523-8194.

But first consider this warning from David Schiller, a Norristown, Pa., pension attorney and author of the accompanying article: "Before you approach any government agency directly, confer with your advisers. Your plan may have violations you're not even aware of."