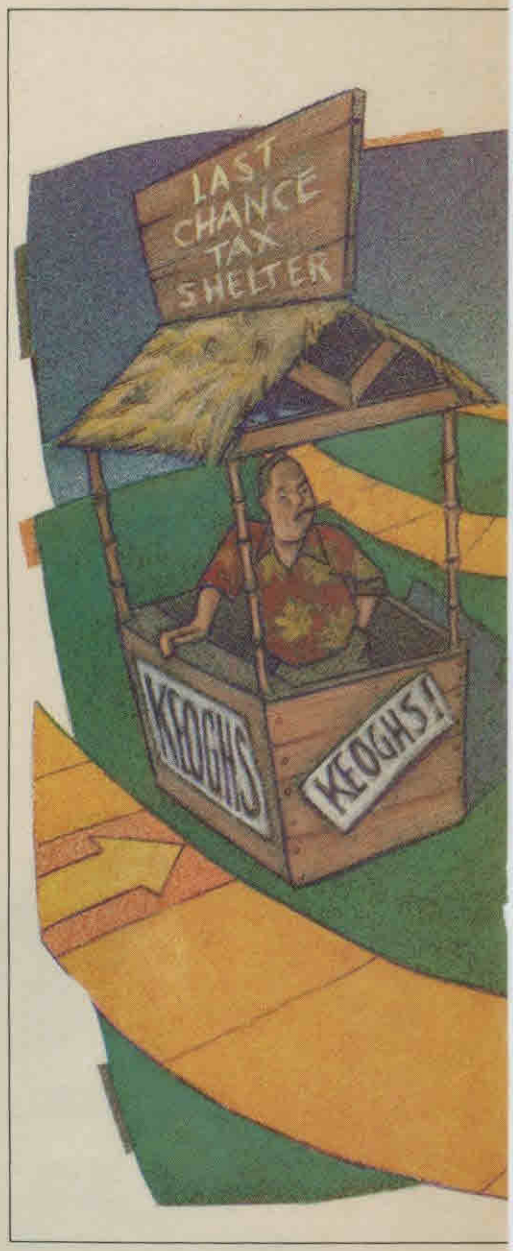
# Retirement Plans for Professionals




BY DAVID J. SCHILLER

Retirement plans are the best tax shelter left after the Tax Reform Act of 1986. Practices that don't take advantage of them will miss a golden opportunity to save on taxes while setting money aside for the future. Here's how to select the right plan for your practice.

Since ERISA was enacted in 1974, many practices have adopted plans for many reasons, primarily to provide retirement funds for the owners and employees.

Annual contributions to the plans are tax-deductible by employers. Although money is paid in for each participating employee, the employee is not taxed on the funds until he withdraws them—usually on retirement or termination of employment. Just as IRAs grow on a tax-deferred basis, pension funds "snowball" rapidly.

Having a plan also encourages saving. Although it is possible to set aside funds each year without a qualified plan, many of us are not disciplined enough to do this.

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It's rarely too late to adopt a retirement plan. Even professionals 65 and older have established new plans, although only limited benefits can be enjoyed at this stage.

Usually the practice fixes a flat percentage of net income that annually goes into the plan. Other practices might adopt a profit-sharing plan that permits greater flexibility.

In considering whether to adopt a qualified plan, determine how much excess income can be put away for retirement.

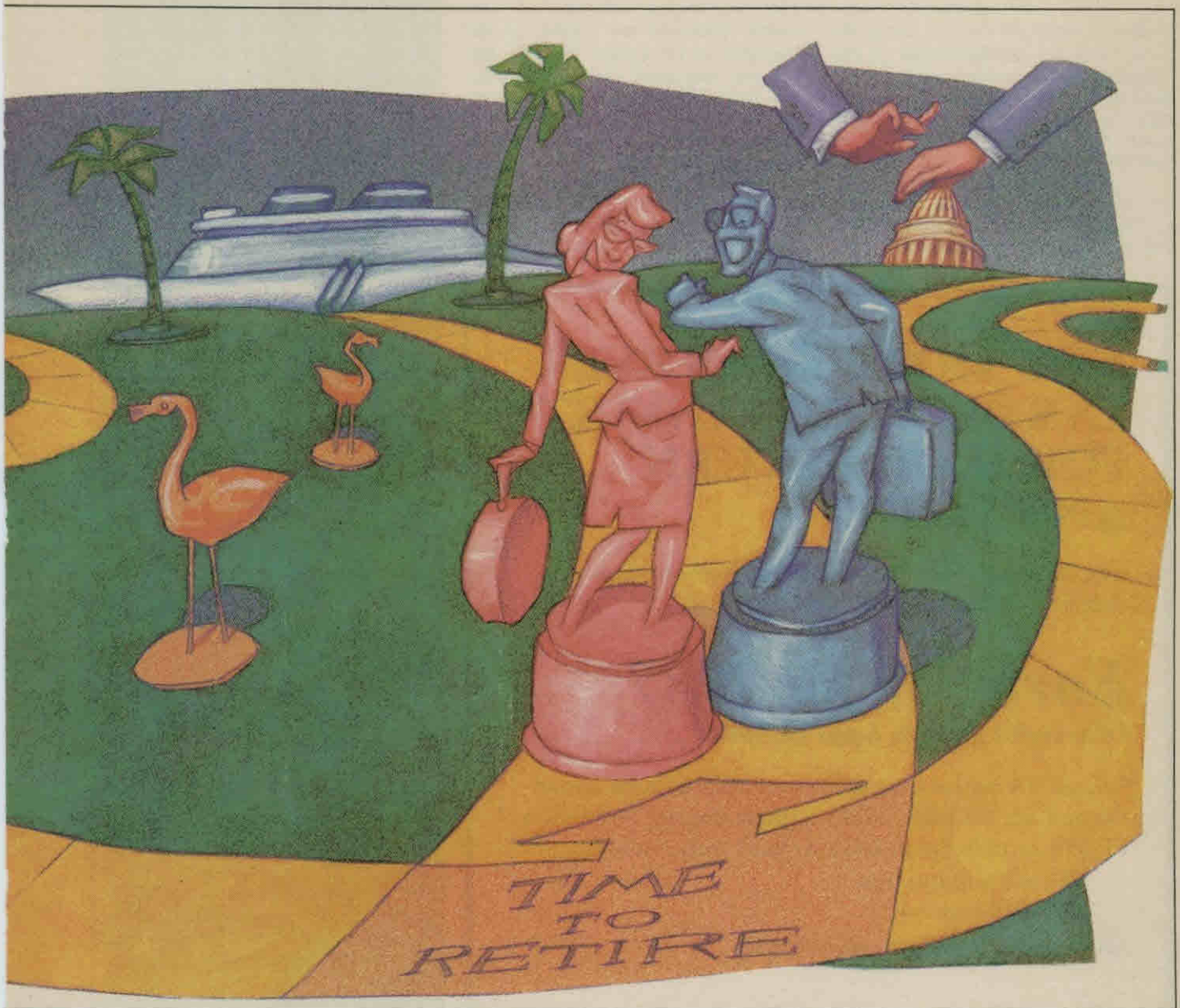
For most practices, a combination of a money-purchase pension plan and a profit-sharing plan is the best choice. Although this requires an annual contribution, it yields the maximum deductible contribution.

To determine the cost of maintaining a plan, first ascertain how many employees will participate and how much the firm will pay. Other considerations are the plan's investment vehicles, its withdrawal mechanisms and its means of distributing benefits.

If you, like most professional firms, are in the "top heavy" classification that allows the professional staff the greatest share of pension benefits, you must allow staff participation in your firm's plan and vest in benefits rather quickly. Although it is possible to exclude some employees according to job classifications, eventually all full-time employees must participate in the plan.

Ordinarily, a three-year wait for participation is best. If you have a high turnover rate, many employees will never become eligible. And those working under 1,000 hours a year can be kept out indefinitely. Many practices hire part-timers for this reason.

Once an employee becomes a participant in a "top-heavy" pension




plan, however, there is a minimum contribution required, even if he works less than 1,000 hours each year.

Note that starting in 1989, you can only require a two-year wait for participation.

**CONTRIBUTIONS**

In most plans, contributions are based on W-2 compensation or "net income" for self-employed individuals. The largest contributions will be made for the professional staff, but by integrating a plan with Social Security benefits, you can minimize contributions for your administrative staff while keeping contributions for professionals quite significant.

The law permits you to contribute the lesser of either 25 percent of compensation or $30,000 per year per employee. A flexible plan allows professionals to vary their contributions rather than tying everyone to the same flat rate. This is achieved by changing the percentage of income on which the contribution is based.

For example, if a lawyer earning $100,000 a year wanted a contribution of only $12,500 rather than the firm's 25 percent fixed rate, the lawyer could elect to have only 50 percent of his income considered as the basis for his contribution.

**IN-HOUSE MANAGEMENT**

Both Keogh and corporate plans may now be "self-trusted"—that is, managed in-house. Self-trusteeship avoids large trustee fees and the frequently poor investment results of "professionally" managed funds. It also ensures that the firm knows what is happening to its money.

The plan should clearly provide that the employer, rather than the plan, will pay administrative and in-

vestment costs. Of course, those expenditures are tax-deductible to the practice, but they do not count toward allowable plan contributions. By not dipping into the plan for operating costs, it can grow and compound to the fullest extent.

**Life insurance.** Plans can pay for life insurance policies for their participants, although generally this is not a good idea. All retirement plan assets eventually are taxable to the decedent or his estate. Because the formerly unlimited estate tax exclusion for retirement dollars has been eliminated, one can no longer transfer wealth to the next generation without estate tax implications.

**Investing.** In most plans, each participant will have his own account. This, like a self-directed IRA, permits participants to choose their own in-



## ABA members' retirement plan

The American Bar Retirement Association (ABRA) was created in 1963 by the Board of Governors of the ABA to provide a master Keogh (H-R 10) plan for members of the ABA. The plan was to be, and is, a distinct benefit to ABA members. During its 23 years of activity, the ABA members' retirement plan has attracted more than 22,000 participants. Its assets are valued at more than $1 billion.

The ABRA program thus far has appealed principally to small law firms and sole practitioners. They use it to provide funds for their own retirement and for the retirement of their employees, while eliminating the burden of technical document drafting, complying with IRS requirements and keeping detailed records. All of this is done in a cost-effective manner, and with substantial tax savings. The program also will appeal to larger law firms, for many of the same reasons.

The program offers a defined contribution master plan which will include a 401(k) option in the near future and will begin offering a defined benefit pension plan designed for the law firm this year. In addition, a larger law firm that has its own plan can adopt the pooled trust sponsored by ABRA and invest in the program.

The Equitable Life Assurance Society of the United States administers the program, and is one of three investment managers of the assets. The assets are managed by Equitable, Capital Guardian Trust Company and State Street Research Management Company. Participants can put their money in any of six investment options.

These investment options include a three- and five-year guaranteed rate account, a money market guarantee account, a growth equity fund, an aggressive equity fund, a balanced fund and a real estate fund.

The ABRA program is available to all regular or associate members of the ABA and to their partners and employees, or the employees of law firms in which they are a partner. Members of state and local bar associations represented in the ABA House of Delegates are also eligible to participate, as are the state and local bar associations and their employees.

If you want more information on the program, call an Equitable customer service representative at (800) 523-1125.

*— Charles M. Walker, ABRA President*

vestments. Although not mandatory, this feature allows maximum flexibility and avoids conflicts.

**DISTRIBUTIONS**

Many complicated laws and regulations control when and how distributions are received from qualified retirement plans. Because retirement plan proceeds are often the largest source of post-retirement income and an important part of the estate, careful planning is necessary to obtain optimum income and estate tax results.

Your plan should allow for lump-sum distributions, equal periodic payments, graded periodic payments, annuities and any other legally permissible form of distribution, with no choice compelled by the plan. The goal is to permit everyone to minimize the tax consequences of their distributions.

Special tax treatment generally is 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 will result in an overall tax reduction.

Like IRAs, a distribution of plan benefits before age 59 1/2 is subject to a 10 percent penalty unless the participant is disabled or deceased. However, the Tax Reform Act of 1986 now permits participants in plans to retire at 55 without incurring 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 he reaches age 70 1/2. If the participant is dead, his account generally will have to be paid out within five years of death.

There are several exceptions that permit 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 amount that you failed to distribute.

To prevent building up excess funds, the new law provides for a 15 percent excise tax if you distribute more than $112,500 (this amount is indexed) in any given year. If you receive a lump sum distribution, the amount cannot exceed $562,500. The purpose of the law also is to require you to start taking distributions early and to help ensure that the funds will provide income during retirement.

It is generally not a good idea to aim for more than $1 million at age 60. If you accumulate substantially more, you will pay the additional excise tax even if you try to distribute quickly.

**DEFINED BENEFIT PLANS**

Most large companies use a "defined benefit" plan. It is generally undesirable in all but the largest of professional practices. Instead of lim-

iting contributions, it requires contributions to fund a predetermined benefit at retirement.

Under new laws, contributions are often limited. They are determined annually by an actuary who juggles complex formulas. An actuary can study your situation to help you decide if this type of plan is right for your practice.

**SURVIVOR BENEFITS**

The Retirement Equity Act of 1985 provides automatic survivor benefits for the spouse of a retiree or surviving spouse of a participant who dies before retirement.

A "pre-retirement 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 his spouse, is the required form of distribution for a participant and his spouse on the participant's retirement, unless the necessary 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.

It also is important that you designate the beneficiary of your retirement plan benefits should you die prematurely. The law requires that your spouse receive all plan benefits unless your spouse waives that right. This waiver may be necessary if you have established a trust for your children or other beneficiaries.

**LENDING**

Unlike Keogh plans that only allow non-owner employees to borrow, anyone can borrow from a pension plan if it is properly structured. A lending provision is worthwhile for flexibility. Fears of constant staff borrowing are simply unfounded.

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. Generally, you use your accrued interest as security for the loan. There is no need for additional personal collateral.

Under the new law, loans to key employees may be made, but interest payments made to the plan are nondeductible. If you need to borrow a lot of money, it makes sense to take a regular home equity loan so that your interest payments are deductible.

Finally, pay attention to details when you choose a plan, making sure that plan advisors have considered all options. In most cases, it is unwise for professionals simply to accept a plan designed for a mass market. Those plans are rarely flexible enough to meet particular needs and allow maximum return. ■