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Professional Corporations and Retirement Plan Fees

An Examination of How Plan Fees May Impact Professional Corporations

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September 19th, 2024

Professional corporations are unique animals with unique challenges. Set apart from traditional corporations, a professional corporation may only be established by licensed professionals such as doctors, dentists, architects, attorneys and accountants. Who can start a professional corporation varies depending on the jurisdiction. Years ago licensed professionals were prohibited from incorporating as their income was derived strictly from their personal services. The birth of the professional corporation changed that with a cost.

Taxes. Like a C corporation, a professional corporation pays taxes on any income not paid out in the form of compensation, benefits or business expenses. Unlike a C corporation the federal tax rate for this income is 35%. This does not include any state or local taxes. Because of these tax challenges there is tremendous incentive to shift expenses to the corporation to greatest extent possible to reduce the firm's taxable income.

Many professional corporations have robust employee benefit and wellness programs to shift income from the corporation and minimize the firm's tax bill. Often when examining benefits offered for retirement plans the focus is on corporate contributions such as profit sharing or matching funds. There may be significant benefits to the shareholders in shifting the plan's costs from the plan's assets where they are a headwind to investment performance, to a deductible expense payable by the corporation.

Asset based fees seems harmless at first. Over ten or twenty years these fractions of a percent may be a substantial headwind for a portfolio's performance. In pure dollar terms asset based fees are particularly vexing in retirement plans. Fees increase in dollar terms not only with the returns on the assets but also with the contributions to the plan. It is not uncommon for plan fees to see a percentage increase by double digits year in and year out when measured by dollars. What would you think if your attorney or accountant increased their fees by 15% per year in real dollars without any material changes to the services they provide? You would probably look for a new advisor. Not many people would think that this was reasonable, but it has been completely accepted almost without question in the financial industry for decades.

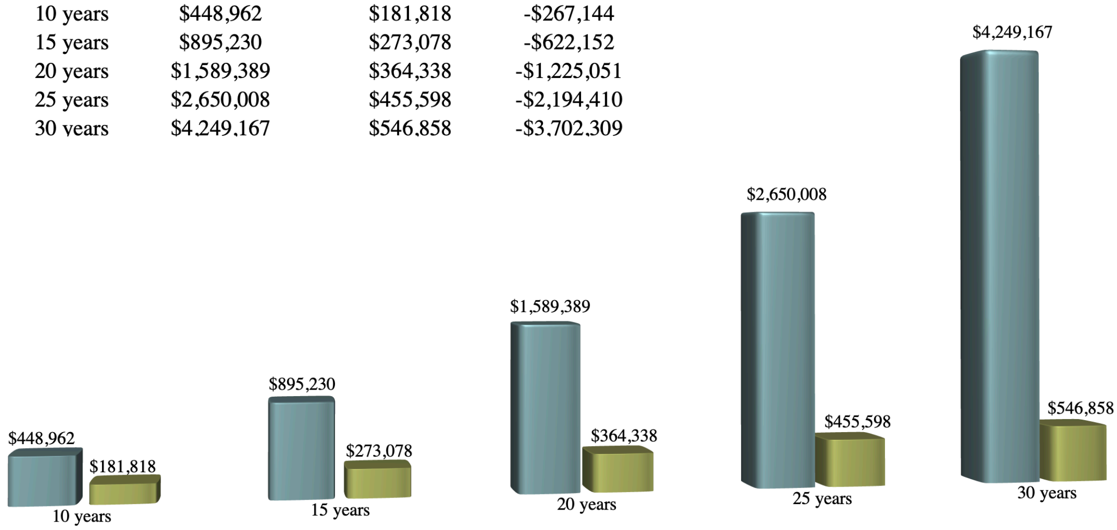
Let's consider a case study. Hypothetical Engineers, P.C. has six partners who all own an equal interest in the firm. Their current retirement plan has $4.5 million in assets and annual contributions of $350,000. Gross returns before any asset based fees are assumed to be 8% with inflation assumed to be 4%. As a professional corporation business expenses are deductible and the tax rate is 35%.

Inflation	4.0%
Rate of Return	8.00%
Balance	$4,500,000
Contribution	$350,000
Tax Rate for Deductions	35%

Currently the firm is paying for services and advice related to the plan with an asset based fee of 0.60%. In real dollars this is $27,000. Eliminating this asset based fee and replacing it with an equal flat fee would result in a significant reduction in the dollars spent on the plan over time. First the flat fee is increasing with inflation not with the growth of the plan's assets combining returns and contributions.

Difference in Plan Fees

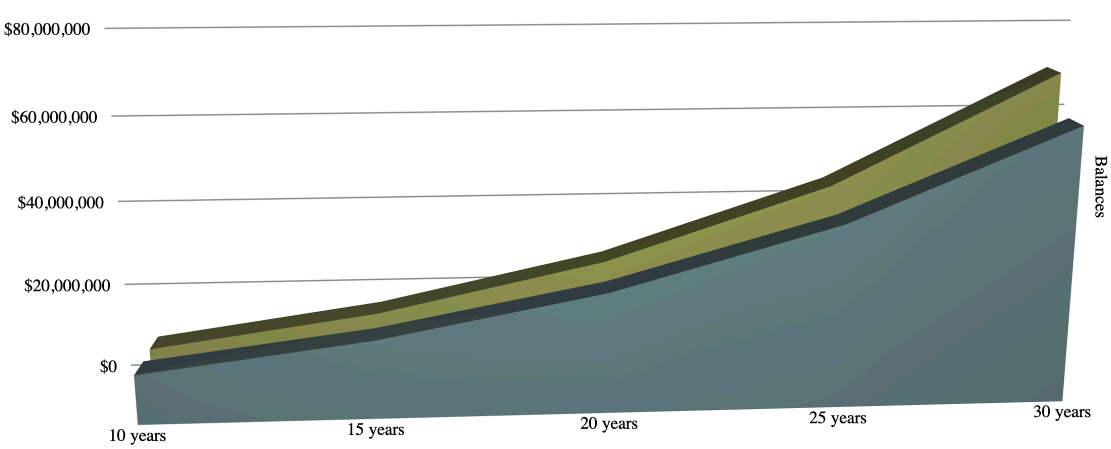
Summary	%	Flat Fee	Difference
10 years	$448,962	$181,818	-$267,144
15 years	$895,230	$273,078	-$622,152
20 years	$1,589,389	$364,338	-$1,225,051
25 years	$2,650,008	$455,598	-$2,194,410
30 years	$4,249,167	$546,858	-$3,702,309



Over a decade the dollar value of the asset based fee would be over a quarter of a million dollars greater than a deductible flat fee. Ten years later it is nearly a million dollars more.

Difference in Plan Assets

Summary	%	Flat Fee	Difference
10 years	$11,197,609	$11,715,669	-$518,061
15 years	$17,671,447	$18,913,440	-$1,241,992
20 years	$27,284,243	$29,857,480	-$2,573,237
25 years	$41,460,906	$46,385,780	-$4,924,874
30 years	$62,254,569	$71,216,233	-$8,961,664



Removing the headwind of the asset based fees should boost returns to the plan. All other things assumed to be equal this shifting of fees from the plan's assets may mean another $2.5 million in plan assets for the plan's participants over twenty years.

Clearly this is of benefit to the plan, but what does it mean to the individual shareholder?

Consider Jane Bridgebuilder an engineer at the firm who owns one sixth of the company. Jane has $450,000 in the plan and with matching and profit sharing contributions is putting $38,800 into the plan annually. Jane's income when combined with her partner's salary puts her in the 32% tax bracket personally. To this add 1.45% for Jane's Medicare payroll taxes.

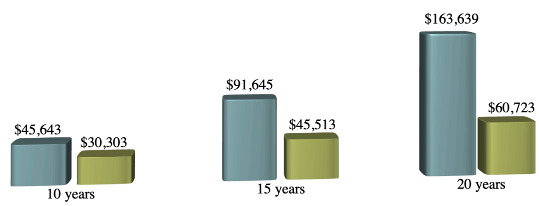
Shifting from an asset based fee of 0.6% to a flat fee, Jane's share of the total fee $4,500 ($27,000/6) has some great benefits for Jane.

Let's review the cost first. Since the firm is paying a flat fee let's assume that this reduces Jane's gross income by her share of the fee of $4,500. After taxes Jane's income would be reduced by $2,995 or not quite $250 per month. If Jane were to invest 100% of these monies net after taxes over twenty years and could earn 6.4% after taxes (this is 80% of the 8% being assumed in this case study and the 20% reduction is assumed to be lost to taxes) Jane would accumulate nearly $115,000 more for the future.

In the same twenty year period by switching to a flat fee Jane's share of plan expenses is lower by over $100,000 and her projected plan balances are greater by more than a quarter of a million dollars. Slightly more than double what she might accumulate in an after tax account using these assumptions. As an aside the scales tip more in favor of a flat fee when the rate cuts for personal income taxes expire in 2025. Most shareholders would probably appreciate more money for their golden years.

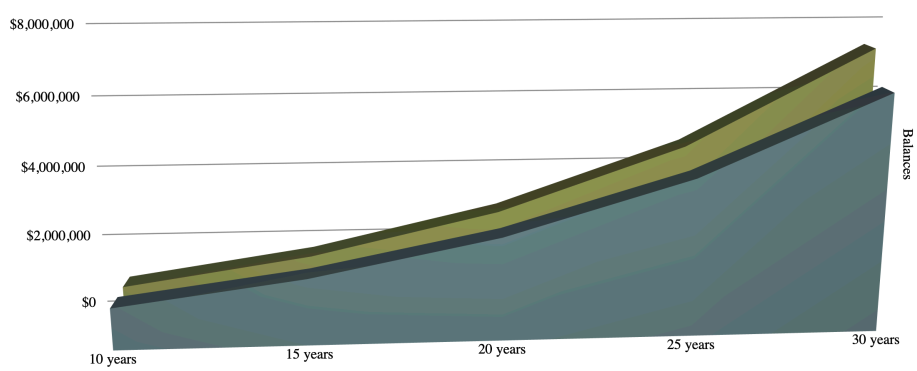
Jane's Share of Plan Fees Compared

Summary	%	Flat Fee	Difference
10 years	$45,643	$30,303	-$15,340
15 years	$91,645	$45,513	-$46,132
20 years	$163,639	$60,723	-$102,916
25 years	$274,131	$75,933	-$198,198
30 years	$441,285	$91,143	-$350,142



Jane's Projected Retirement Balances

Summary	%	Flat Fee	Difference
10 years	$1,148,445	$1,201,100	-$52,655
15 years	$1,826,270	$1,953,187	-$126,917
20 years	$2,834,979	$3,099,062	-$264,084
25 years	$4,325,199	$4,832,383	-$507,184
30 years	$6,514,059	$7,439,613	-$925,553



Is a flat fee strategy optimal for every professional corporation? Absolutely not. This is not a one size fits all world. However there may be significant opportunities when shareholders are bearing the greatest costs under an asset based fee framework and are unable to deduct any fees paid. Plan fiduciaries have a responsibility to ask the question is there a more optimal way for the plan to pay its fees?

How do you know if a flat fee strategy right for your plan? Start by working with an objective and experienced professional to define your plan's service needs. Do a thorough analysis of all of your plan's existing fees to determine which asset based fees may be replaced with a flat fee. With your financial professional model how different fee structures may impact your plan as well as the corporation's shareholders. Clearly defining your fees and services for your retirement plan may make a clear difference for your future.

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About the author: Doug Richards entered the financial industry in 1993. He currently holds the Chartered Life Underwriter, Charter Financial Consultant, Certified Financial Planner and Accredited Investment Fiduciary Analyst designations. In his practice Doug serves a broad spectrum of individual and institutional clients with flat fee consulting and planning services. In 1999 Doug established Crest Financial LLC and in 2015 he began offering flat fee services to corporate retirement plans. Doug lives west of Eugene, Oregon with his wife and partner of almost thirty years, his adult son with autism, two dogs and six cats. For fun Doug loves to go to the coast for a hike or to travel most anywhere where there is sun, sand and surf.

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