



# Finding the right retirement plan Opportunities

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**M**ost physicians count on their retirement plans for the bulk of their financial security. Yet, few of us understand how our retirement plans really work. Nor do we update them regularly to account for changes in tax laws. The result is that many physicians often are not maximizing the benefits they could be receiving from their retirement plans.

This article reviews the most common types of retirement plans available to medical practices and discusses the pros, cons, and specific opportunities of each type.

We also describe some real-life examples of retirement plans that were modified in order to increase the benefits and cost-savings they incurred.

Before beginning, it is important to note that most of these plans are considered "qualified" under current tax laws. Being qualified means that contributions to the plans may be deducted as retirement plan contributions, are allowed to earn income and gains on a tax-deferred basis, and are strongly protected from creditors.

In exchange, however, the Internal Revenue Service (IRS) requires extensive paperwork and



## A GUIDE TO FINDING AN AFFORDABLE SAVINGS PLAN THAT MEETS THE NEEDS OF DOCTORS AND STAFF

mandatory contributions for employees on the lower end of the salary scale.

### SEP-IRA

The Simplified Employee Pension (SEP)-IRA allows contributions of a fixed percentage of salary (up to 25% of W2 income) to individual IRAs of most employees, including the physicians. The upper contribution limits for 2010 are \$49,000, with another \$5,500 "catch-up" contribution for participants aged 49 years and older.

The TRS requires a fixed percentage of compen-

sation be used to calculate the amount of pension contributions, and this percentage must be the same for owners/physicians and other employees. This makes the SEP a relatively expensive plan in terms of employee funding. There is no component of salary deferral by employees, and all plan funding is immediately "vested" (belongs to the employee immediately if they leave employment).

The advantages of the SEP plan include a minimum of paperwork and ease of set up. Generally, SEP-IRA plans are used by small, family-owned businesses with few or no outside employees.

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It does work well for physicians who are independent contractors, such as many emergency room and locum tenens physicians. However, an independent contractor with an income of less than about \$170,000 can put more pre-tax money away in a Self-Employed 401(k) plan (see below).

### SIMPLE IRA

The Savings Incentive Match Plan for Employees (SIMPLE) IRA is another plan that is relatively easy to set up and administer. It allows companies with fewer than 100 employees

to open individual IRA accounts for employees. The employees may defer salary in amounts of \$10,500 to \$13,000 (depending on age), with an employer "match." All money in the plan is immediately vested. The match is generally a dollar-for-dollar matching contribution of up to 3% of the employee's compensation. For example, a practice owner with a compensation of \$100,000 would be able to defer up to \$13,000 (if age 50 or older), and then have the company match up to 3%, or \$3,000 more.

A SIMPLE IRA plan is a good choice for small businesses in which the owners are highly compensated, and few employees wish to defer salary. Its disadvantages are in the immediate vesting for the matched funds, and relatively low total amounts of contributions compared with other qualified plans.

One unusual feature of the plan is that the 3% match has no limits.

For example, a physician with a small group of employees and an annual income of \$600,000 can put away \$13,000 in salary deferrals and another \$18,000 ( $\$600,000 \times 3\%$ ) of match at no employee cost.

### 401(K)/PROFIT-SHARING PLAN

This is by far the most common type of qualified plan in existence. These plans have 3 components:

1) **401(k) salary deferral.** In 2010, employees may defer between \$16,500 and \$22,000, depend-

ing on their age. This money, and earnings on it, are not subject to federal income tax until withdrawn in retirement, and are immediately vested.

2) A "match." This is an optional part of the plan in which an employer may contribute a matching amount to give employees an incentive to participate. Matching funds are usually subject to vesting on a time schedule, and can be of any amount as long as

there is not a defined benefit plan in place.

3) **Profit-sharing.** Like the match, this is a discretionary contribution by the employer of up to 25% of W2 payroll. The profit-sharing

component is usually subject to a vesting schedule to encourage employee longevity. Note that the profit-sharing contribution is not the same as a match. A match is only present if the employee makes a salary deferral, whereas the profit-sharing contribution is independent of employee behavior.

In addition, there is a self-employed 401(k) option for small practices that have no full-time employees other than the physician and spouse. It operates in much the same way as a standard 401(k) plan, but with little expense and much less paperwork.

### DEFINED BENEFIT PLANS

Once common, these plans are now rarely used. They are based entirely on company contributions to a fund (no employee salary deferral) that is actuarially designed to produce a set benefit amount at retirement. All the risk for providing the promised benefit rests with the employer. The advantage of this type of plan is in allowing much higher contributions on a pretax basis, with the disadvantage of higher administrative costs.

These plans work extremely well for high-income businesses employing a single individual (plus or minus a spouse) who is nearing age 50 or over. In addition, physician practices that employ a spouse or physicians of different ages can often use a defined benefit plan in conjunction with a 401(k)/profit-sharing plan to great benefit, as in example 3 in the "Some Real-Life Examples" section that follows.

Note also that maximum contributions to a defined benefit plan preclude contributions for the same business to a profit-sharing plan. While it's possible to make less than the maximum contributions to a defined benefit plan and also some profit-sharing con-

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tributions, this calculation is usually quite complex and changes yearly. However, making the maximum contribution to a defined benefit plan does not preclude a 401(k) salary deferral and match of up to 6% for this deferral.

### DEFINED BENEFIT 401(K) PLANS

Beginning in 2010, employers may elect to provide a plan that offers some of the benefits of both defined benefit and 401(k) salary deferral plans. Not all the details have been worked out yet, but basically the plan seeks to provide funding equal to 20% of an employee's salary. In order to qualify, the employee must contribute at least 4% of his or her salary into a 401(k) salary deferral plan, which the employer then matches equally.

Until the final guidelines on this plan emerge, it is difficult to recommend this as an option.

### USING 2 PLANS

It is sometimes a viable alternative to have both a defined benefit plan for an older physician or physicians, along with a few of the employees. The employee cost of the defined benefit plan is proportionally lower for younger and lower-paid employees. The remaining employees and younger physicians use a 401(k)/profit-sharing plan. This allows the older physicians to ramp up their annual pretax contributions well into 6 figures at a marginally higher employee cost. Note that participants in the defined benefit plan are still allowed to make a full 401(k) salary deferral in addition to a 6% matched contribution.

Another time that multiple plans might be used for a physician's group is when the group owns more than 1 business. A pension expert should

be consulted to determine if the business income sources are suitably "separate," but this is a common practice. For example, a physician may practice on a regular basis, but have a separate consulting firm that involves research or travel/teaching.

Any combination of the above plans can be used to shelter income from both businesses. However, the salary deferral side of any combination of plans must

be aggregated, and may not exceed the annual limit (\$16,500/\$22,000) in 2010, but up to 25% of compensation for W2 income can be put into a profit-sharing

plan in either business to maximize contribution.

For example, an individual participates as an employee or owner in a business with a 401(k) plan. He/she can theoretically use

a full salary deferral and profit-sharing contribution to avoid federal income taxation on \$49,000/\$54,000 in the primary business. If this person also has a consulting business on the side with \$250,000 of other income, roughly 20% of net income, or 25% of W2 income from that business, could be contributed to another profit-sharing plan run by the side business.

### SOME REAL-LIFE EXAMPLES

Now let's look at how some of these tools can be put to use:

1. Jim L., an endocrinologist in private practice, employs his wife as office manager and has 4 other employees. Jim had a "free" prototype profit-sharing plan with a well-known brokerage. He has been putting 15% of his \$230,000 income into the plan each year (\$35,000), and thus he must also contribute 15% of all employee compensation (employee compensation totaled \$100,000) to the plan as the employee cost.

Jim pays his wife \$60,000 a year in order to get a \$9,000 annual contribution for her, but at an additional cost of \$9,000 in Social Security taxes. His plan is invested in a variety of mutual funds and stocks that carry high transaction costs and/or "loads," and he was not sure how it was doing in terms of performance.

**Change:** The plan was changed to a customized 401(k)/profit-sharing plan using a third-party administrator at a cost of \$2,500. Jim's wife lowered her salary to \$20,000, which saved more than \$5,000 annually in Social Security taxes. Yet Jim and his wife were now able to contribute more than \$65,000 in pre-tax money, rather than \$44,000 as in prior years. His employee cost for the plan dropped from 15% of the \$100,000 payroll to 6%, for an additional annual savings of \$9,000.

2. Statewide Healthcare medical group had an insurance-based retirement plan. All of the investments allowed were wrapped in variable annuity/insurance wrappers with an annual expense ratio

**"MAXIMUM CONTRIBUTIONS TO A DEFINED BENEFIT PLAN PRECLUDE CONTRIBUTIONS FOR THE SAME BUSINESS TO A PROFIT-SHARING PLAN."**

### POWER POINTS

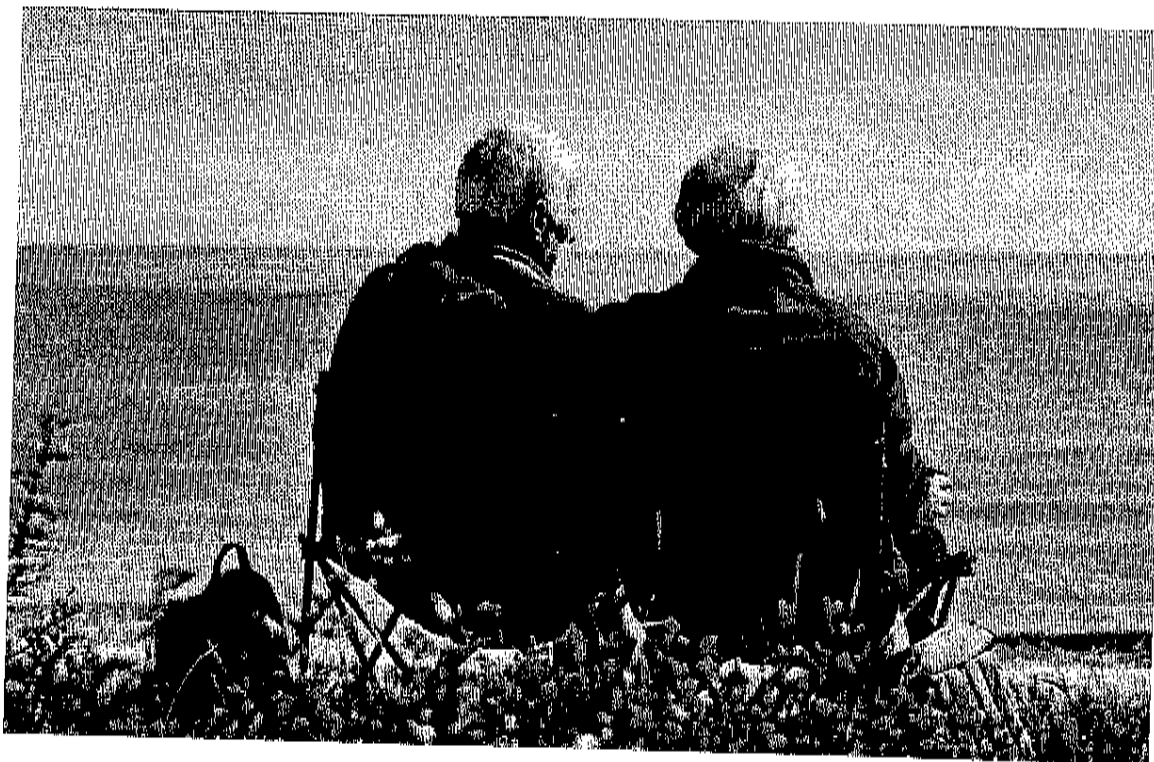
Many physicians count on retirement plans for financial security, but few understand how they work.

Retirement plans vary in their complexity.

401(k)/profit-sharing plans are the most common type of qualified plans.

Make sure to customize your retirement plan to your practice's needs.

## RETIREMENT OPTIONS



of between 2% and 4% annually. The plan was free to the group but did not allow any differentiation in benefits or contributions between the physicians and their employees.

**Change:** The practice changed to an unbundled 401(k)/profit-sharing plan that allowed physicians to contribute the maximum in salary deferral and profit-sharing contributions. Using an age-weighted contribution formula, the physicians were able to save 14% of their salary in the profit-sharing plan as compared with a 5% contribution for employees. The new investment portfolios carried an annual cost well below 1% annually and were actively monitored by a fee-only fiduciary advisor, mostly relieving the group from the fiduciary responsibility for the fund investments.

3. Kirk L, an internist, employed his wife and 5 employees in a busy practice. He is 55 years old and looking toward retirement in 10 years. He had a reasonably well-designed 401(k)/profit-sharing plan which let him and his wife put away from \$70,000 to \$75,000 a year with an employee cost of about \$15,000. He was beginning to worry he would not have enough savings to make his retirement goal.

**Change:** Kirk and 2 of his younger employees switched to a new defined benefit plan, but also continued in the 401(k) salary deferral plan. Kirk's wife and the other employees stayed in the old plan, and his wife's salary was reduced to lower Social Security

costs. With the new plan, Kirk and his wife are now putting away about \$200,000 in pre-tax contributions annually at a marginally higher cost for the employees brought into the defined benefit plan.

### CUSTOMIZATION IS KEY

Whichever form of retirement plan you choose, it is crucial to make sure that the plan is customized to meet your or your practice's specific needs. Customization by a financial planning expert or third-party administrator will enable you, your partners, and your employees to enjoy the maximum benefits of a plan at the lowest cost and provide greater peace of mind as you look toward retirement. ■



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