

# Picking the Right Plan For Your Practice

**B**y sponsoring a retirement plan, your practice and its employees can enjoy tax deductions today, tax-free investment buildup tomorrow and perhaps low-taxed withdrawals far into the future. However, there are many retirement plans from which to choose. Considering how important such a plan may be to you, your loved ones and your employees, it is important to select the right one. Here are some you should consider:

## 401(K)/PROFIT-SHARING COMBINATION

You're probably familiar with 401(k) plans, which allow employees to defer some taxable income. Indeed, offering a 401(k) plan may be necessary in order for you to attract and retain high-quality employees. The workers you'd like to hire may expect a 401(k) plan as a perk.

**The combination plan starts with a standard 401(k), to which employees may elect to contribute some of their compensation. The profit-sharing plan may be "wrapped" around the 401(k), allowing physicians to contribute up to \$42,000 (\$46,000 for those 50 and over) in total in 2005.**

Employers like these 401(k) plans because employees largely fund their own retirement through salary deferral. Medical practices offering such plans don't have to assume the risks of providing pensions. For employees, 401(k)s offer tax deferral of earned as well as investment income. Moreover,

workers retain control over vital investment decisions.

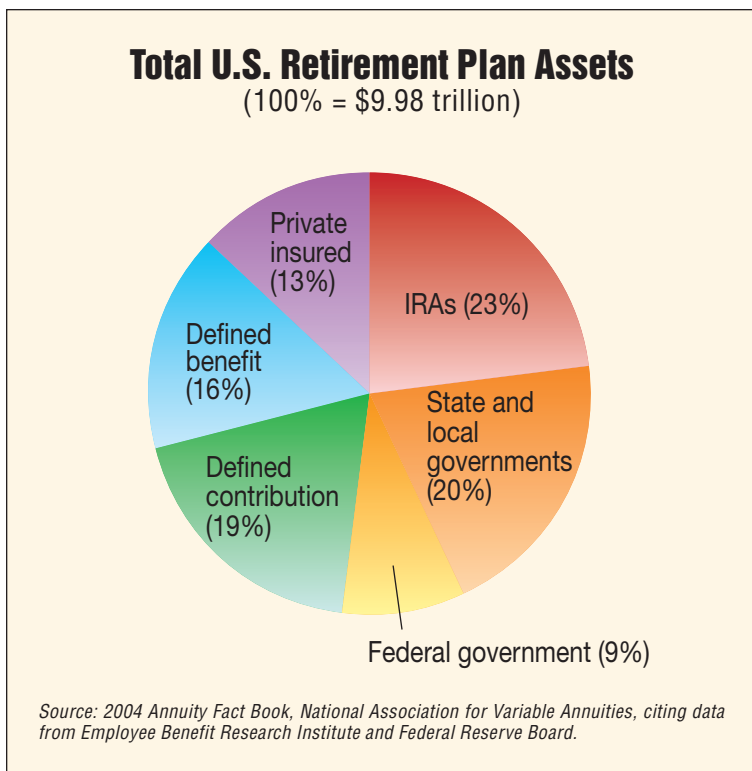
There is a catch, though. "In 2005, employees may contribute up to \$14,000 worth of income to their 401(k) accounts," says Roger Lusby, tax partner in the accounting firm Frazier & Deeter in Atlanta. "Those 50 years of age or over may defer an extra \$4,000." Because you are an employee, you are effectively lim-

ited to a \$14,000 or \$18,000 contribution to your 401(k) account this year. You and your colleagues may well want to make larger contributions to your retirement funds.

“Our accounting firm has adopted a 401(k)/profit-sharing plan,” says Mr. Lusby. “This type of plan may appeal to many types of professional firms, including medical groups.”

The combination plan starts with a standard 401(k), to which employees may elect to contribute some of their compensation. Your practice can offer an employer match to encourage lower-paid workers to participate. “If participation among the rank-and-file is low,” says Mr. Lusby, “the physicians in the group may find their contributions are limited.”

The profit-sharing plan may be “wrapped” around the 401(k). Profit-sharing plans are flexible, allowing your practice to make



a contribution for its employees if it has the required cash, or to refrain from contributing in lean years. With a profit-sharing plan in the mix, you and other physicians may receive contributions that total \$42,000 (\$46,000, for those 50 and over) in 2005.

Chad Parks, president and CEO of Decimal, Inc. in San Francisco, a provider of retirement plan services, says that 401(k)/profit-sharing plans have become a popular choice among medical groups. “Often physicians choose a safe harbor feature for such plans,” he says.

The safe harbor feature addresses one of the reasons that some medical practices have been reluctant to offer 401(k)s: these plans must meet nondiscrimination standards. That is, low-paid workers have to contribute certain amounts. If not, highly paid employees (including physicians) can’t maximize contributions. In some cases, the rules keep highly compensated physicians from any 401(k) contribution.

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However, there is one way for physicians to get full 401(k) benefits, even if nondiscrimination tests can’t be met. You can offer a so-called “safe-harbor” 401(k) plan. A notice from the IRS in 2000 clarified how such a plan can work. In essence, three conditions must be met for a 401(k) to enjoy this safe harbor:

1. The employer must make minimum contributions.
2. Contributions must immediately be 100-percent vested.
3. Employees must be notified of the plan rules.

In terms of minimum contributions, either of two options can meet the requirement:

**Option one.** Your practice must at least match 100 percent of the first 3 percent of a low-paid worker’s contribution, plus a 50 percent match on the next 2 percent. Suppose you employ a clerical worker who earns \$30,000 per year and contributes \$1,500—5 percent—to his 401(k). Under option one, your practice must match at least \$900 (3 percent of pay) plus \$300 (50 percent of 2 percent of pay), for a total match of \$1,200. With this safe har-

bor, your practice can match \$8,400 per year for its highly paid physicians in 2005. That is 4 percent of \$210,000, which is now the most compensation that can be considered when figuring a retirement plan contribution.

**Option two.** Alternatively, your practice can contribute 3 percent of compensation for all eligible workers. Say your receptionist earns \$35,000 per year and elects not to make a 401(k) contribution. Under this option, your practice would contribute \$1,050 (3 percent of her pay) to a 401(k) account in her name. If

**According to a survey** by the Employee Benefit Research Institute, 72 percent said an employer-matching contribution of up to 5 percent of their salaries would make them more likely to participate in a savings plan at work. Such a tactic may be expensive, though, because more money will be required for employer-matching contributions.

this is done, highly paid physicians can receive a non-elective contribution up to \$6,300 this year: 3 percent of \$210,000. That is in addition to the \$14,000 each can shelter in a 401(k) plan this year, or \$18,000 if he or she is at least 50 years old.

With either option, all contributions (including employer matches and investment earnings) belong to the employees. They can take their money if they leave the company. In addition, eligible em-

ployees must receive a written notice each year. Their rights and employer obligations have to be explained at least 30 days prior to the beginning of the plan year.

If your practice meets these requirements, you may find that safe-harbor 401(k)s have other benefits. Plan administration costs may be reduced if expensive nondiscrimination tests aren't necessary, for example. The safe-harbor rules eliminate the need to return excess contributions, for example, if a physician contributes \$14,000 and later discovers he can't put in more than \$8,000 because of nondiscrimination tests.

If you're interested, your practice can use the safe-harbor rules one year and not the next, as long as the proper paperwork is in place. Nevertheless, there are disadvantages to the safe-harbor rules. One is that you can't limit participation to employees who are on the payroll at year-end. Thus, departed workers may have to be covered.

There won't be any forfeitures, either. In a traditional 401(k) plan, departing employees may forfeit some of the money in their accounts. These forfeitures help to reduce future company contributions, but that won't happen in a safe-harbor 401(k), with full vesting.

Weighing the tradeoffs, safe-harbor 401(k)s may appeal to medical practices that have been deterred by nondiscrimination rules. This approach allows highly paid doctors to save more for retirement on a tax-deferred basis while morale among all employees may be improved. Such benefits may be worth the cost of making required employer contributions. With a safe-harbor 401(k), highly paid physicians can maximize their tax deferral, regardless of decisions made by other employees.

### **Boosting Participation Rates**

At many medical practices, demand from employees has led to the creation of 401(k) plans. This demand, though, may not be shared by all workers. On average, slightly fewer than 50 percent of workers choose to participate in these 401(k) plans; moreover, some participants make minimal contributions.

Such low participation is likely to have a very tangible cost. Under the tax code, 401(k) plans are subject to nondiscrimination tests; the less that low-paid workers contribute, the less that highly paid employees can defer of their own salaries. Instead of making a \$14,000 or \$18,000 contribution—the maximum amounts allowed in 2005—physicians may be limited to, say, an \$8,000 contribution. Indeed, a physician may defer \$14,000 and eventually get back a \$6,000 “excess contribution,” which will lead to unhappiness all around.

What can your medical practice do to solve this problem? In addition to the safe-harbor strategy described above, you should consider offering a matching contribution. According to a recent survey by the Employee Benefit Research Institute (EBRI), 72 percent said an employer-matching contribution of up to 5 percent of their salaries would make them more likely to participate in a savings plan at work. Such a tactic may be expensive, though, because more money will be required for matching contributions.

Another technique for raising employee participation in 401(k)s is automatic enrollment. With this approach, all eligible

workers are included in the 401(k), with a given level of salary deferral (perhaps 3 percent of pay) and an employer match (often 25 to 50 cents on the dollar). Automatic enrollment plans permit potential participants to make a “negative election”—within a certain time period, they may sign a form to opt out of the plan. Otherwise, they’re in, with a given level of contributions. (They can contribute more, in many plans.)

Experience has shown that fewer than 20 percent of eligible participants remove themselves from automatic enrollment plans. Thus, overall participation rates are likely to be 75 percent to 80

**Automatic enrollment** does have disadvantages. For one, increased participation will create the need for more employer matches, so costs will rise. What’s more, if automatic enrollment is offered to new employees, your practice won’t be able to exclude newcomers from plan participation—and such exclusions are a cost-cutting measure in many 401(k) plans.

percent, rather than 50 percent, and highly compensated physicians are more likely to be able to maximize their own contributions.

If your practice decides to implement an automatic enrollment plan, there are several ways to put it into practice:

■ **New hires.** New employees generally spend a good deal of time filling out benefit enrollment forms and getting oriented. Thus, this may be the ideal time to provide an explanation of the 401(k) plan’s advantages and a negative

election form, on the off-chance that someone might not like to enroll. New employees usually are told about benefits such as health insurance and life insurance, so information about the retirement plan would seem to be a natural fit.

■ **Existing employees.** A focus on new hires may not impact low participation rates among existing workers. If this is a concern, a companion campaign may be aimed at current personnel. Indeed, the Internal Revenue Service has approved plans to target both sets of workers. At many organizations there is a year-end review of employee benefits. During this period, automatic enrollment in the 401(k) plan may be introduced, effective the next January 1.

■ **On-line participation.** Some vendors offer so-called “e-401(k)s,” where employees can check their account balances and

redirect investments over the Internet. These programs are especially effective when an organization’s work force is made up largely of young people who are used to handling matters on-line.

### Turning Nonparticipants into Participants

Change in the likelihood of participating in a retirement savings plan if the following features were offered, among workers offered an employer-sponsored plan but not participating:

	<b>Much more likely</b>	<b>Somewhat more likely</b>	<b>No more likely</b>	<b>Already offered</b>
A matching contribution of up to 5% of your salary	31%	41%	14%	13%
A fund option that is designed for people of your age and income level and automatically becomes more conservative as your retirement date nears	21	44	29	5
An option that automatically raises your contribution by a certain percentage or amount whenever you receive a pay raise	19	37	37	7
A matching contribution of up to 3% of your salary	16	35	35	14
An option where a professional financial manager makes investment decisions for you based on your responses to a questionnaire	15	20	49	14
A fund option that maintains a pre-set level of risk and generally has a mix of conservative, moderate and aggressive investments	13	36	32	19

*Source: Employee Benefit Research Institute and Mathew Greenwald & Associates, Inc., 2005 Retirement Confidence Survey.*

In most cases, e-401(k) plans use automatic enrollment; few workers opt out when they have the ability to see the growth of their retirement funds on the Internet.

Young, lower-paid staffers generally are the least likely to save regularly and the least likely to truly understand the benefits of a 401(k) plan. Moreover, the high turnover rates among these workers make it doubtful that they'll qualify for pensions. Participating in a 401(k) can provide the discipline needed to help these workers invest for the future. They'll benefit from employer matches, too.

With all of these advantages, what are the disadvantages of automatic enrollment? For one, increased participation will create the need for more employer matches, so costs will rise. What's more, if automatic enrollment is offered to new employees, your practice won't be able to exclude newcomers from plan participation—and such exclusions are a cost-cutting measure in many 401(k) plans.

Maintaining an automatic enrollment plan may increase an employer's record-keeping burden, too. Someone in your office will have to keep track of when employees are put on notice about automatic enrollment, how long they have to opt out and which ones have chosen to do so.

Nevertheless, the increasing popularity of automatic enrollment indicates that the pros far exceed the cons. Negative-election 401(k)s can be a positive strategy for all concerned.

### **AGE-WEIGHTED PROFIT-SHARING PLANS**

Whether or not they include a 401(k) plan, standard profit-sharing plans can be expensive. If your company makes a contribution of, say, 15 percent of pay to your own account, it will have to contribute 15 percent of pay for all eligible employees.

Many physicians don't see the need to make a 15-percent contribution for a 24-year-old employee with one year of service, which may be required with a standard profit-sharing plan. With an age-weighted plan, such contributions can be minimized. However, age-weighted plans won't help if the principal doctors are younger than their employees.

“If you and other physicians are older than most of your employees,” says Mr. Lusby, “you might adopt an age-weighted

profit-sharing plan. Older employees have fewer years to build up a retirement fund, so larger contributions to their accounts may be justified. You might be able to reduce the amounts you have to contribute to younger employees.”

For example, suppose you’re in your 50s while most of your employees are in their 20s and 30s. You may get a \$46,000 contribution to your profit-sharing account this year, while your young employees get only 5 percent of pay: \$2,000 on a \$40,000 salary, for example.

“Some very sophisticated plan designs may enable your company to skew most of its profit-sharing contributions to you and other older physicians,” says Mr. Lusby. “Such plans can be expensive to create and administer, but the savings in employee contributions may be worthwhile. Vesting schedules also can apply, making such plans more cost effective.” That is, your practice may be allowed to skip contributions for workers who don’t stay very long or who are not employed at the plan’s year-end.

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Moreover, age-weighted plans may be effective in providing incentives to employees, even if they’re skewed to favor physicians. Today, with so many self-funded plans, such as 401(k)s, employees tend to appreciate any profit-sharing plan because the employer makes contributions. As profits go up, contributions generally increase. In addition, with an age-weighted plan, an employee’s contribution may increase each year as that employee grows older, which can help with employee retention.

Nevertheless, there may be problems with a straightforward age-weighted plan. In a medical group, the senior physicians

will get much larger benefits than the younger ones. In some cases, an older but low-paid staff member may be entitled to a large contribution.

If such large outlays are not desirable, a “new comparability” or “cross-tested” plan may be used instead. New comparability plans are age-weighted by groups of employees, not by individuals. In general, as long as the average age of the physicians’ group is at least five years greater than the average age of the other groups, sharply higher payments can be made on behalf of the physicians.

**There may be problems with a straightforward age-weighted plan. For example, in a medical group, the senior physicians will get much larger benefits than the younger ones, or an older but low-paid staff member may be entitled to a large contribution. In such cases, a “new comparability” plan may be used instead.**

What’s the catch? New comparability plans may be very expensive to create and to administer. Each year, an actuary must be brought in to perform certain tests in order to show that the plan doesn’t discriminate in favor of any group of employees.

You have to decide that the added benefit is worth the added cost, compared with a straightforward age-weighted plan. Typi-

cally, new comparability plans may cost a small practice several thousand dollars to set up and a similar amount each year to maintain, but the payoff can be worth it in increased tax-sheltered contributions to the physicians’ personal accounts.

Not only may new comparability plans deliver more benefits to owner-employees, they retain the flexibility of profit-sharing plans. Sponsoring medical practices can reduce or eliminate contributions in a bad year. They can re-set the groups each year, to account for new employees or changes in employee status.

However, other issues may need to be considered. New comparability plans may be worthwhile if a practice’s employment picture is fairly stable, with low turnover. Ongoing administrative expenses may not be great. But if a practice’s structure changes dramatically, there may be more actuarial work involved to keep the plan in compliance with regulations. In addition, new comparability plans may be difficult to communicate to employees.

## DEFINED BENEFIT PLANS

Even larger contributions can be made to your retirement account with a defined benefit (DB) plan. Doctors often have relatively high incomes, much higher than those of their employees. Often, physicians are older than their employees. In those circumstances, a DB plan may be a good choice. A DB plan is expensive to set up and administer, but large amounts can be set aside very quickly.

DB plans are traditional pension plans. They are meant to deliver a certain amount of retirement income; actuaries determine the required contribution. If your retirement benefit goal is

### Reasons for Not Offering a Retirement Plan

Despite all the advantages of qualified retirement plans, many small employers choose not to offer them. While 64 percent of full-time employees at companies with more than 100 workers were covered by one or more employment-based retirement plans in 1999, just 34 percent of full-time workers in small private establishments (99 or fewer workers) were covered by a retirement plan, according to the Employee Benefit Research Institute. The reasons cited for not offering a retirement plan include the following:

Revenue is too uncertain/too low	27%
Costs too much to set up and administer	16
Employees not interested	12
Too much goes to short-term employees	12
Business is too new	7
Business is too small	7
Required company contributions are too expensive	6
Not interested/no need	4
Administration is too burdensome	3
Employees prefer wages	3
Employees have benefit through spouse's work	2

*Source: Employee Benefit Research Institute, American Savings Education Council and Mathew Greenwald & Associates, 2003 Small Employer Retirement Survey.*

\$160,000 per year, for example, you may have to accumulate over \$2 million by the time you retire.

“The less time you have until retirement, the more you will have to contribute each year to a DB plan,” says Richard Newman, a CPA who is a director at Newman + Cohen Financial Management in Boca Raton, Fla. According to Mr. Newman, a 52-year-old physician who wants to retire at age 62 may be able to contribute (and deduct) over \$160,000 per year with a DB plan, in order to get to the \$2-million level mentioned above.

Along with generous tax shelter, DB plans have drawbacks. Not only are they expensive and complex, they also require substantial contributions year after year. “It’s possible to cut back in a bad year,” says Mr. Newman, “but such a reversal may involve substantial hassle and expense. These plans are best suited for small groups that consistently enjoy plentiful cash flow.”

Among DB plans, moreover, 412(i) plans—named after a section of the tax code—may permit the largest initial deductible contributions. Funded by guaranteed life insurance products, 412(i) plans offer safety as well as the chance to make contributions that may run well over \$100,000 per year.

Often the money that you contribute to a 412(i) plan will be used to purchase annuities. Frequently, some of the contribution also will be used to buy life insurance.

This technique allows you to buy life insurance with pre-tax rather than with after-tax dollars. With life insurance in the plan, it is “self-completing,” meaning that your heirs will receive a pension in case of your premature death.

With a 412(i) plan, you are allowed to use the insurance company’s guaranteed rates as the projected investment return. Such guarantees probably will be low, perhaps 3 percent a year. As mentioned, the lower the projected investment result, the greater the required contribution needed to fund the future pension.

With a 412(i) plan, the 52-year-old physician described above may be able to make a deductible contribution over \$190,000 to a guaranteed annuity at 3 percent, rather than over \$160,000.

What happens if the plan uses a 3 percent projected return but the actual returns turn out to be higher? The interest earned in excess of the guaranteed rates will reduce next year’s contribution. As a result, a 412(i) plan typically front-loads deductions.

This may be a desirable outcome if it permits you to make larger contributions during peak earning years and then taper off as you near retirement.

If you want greater deductions in later years, the 412(i) plan can be converted to a “regular” DB plan by investing in assets other than insurance company products. You may prefer to stay with a 412(i) plan, though. Because 412(i) plans are backed by insurance products, your retirement income is secured. You won’t have to rely upon future results in the financial markets.

Interested physicians should look for a 412(i) plan administered by a financially strong insurer that will be able to deliver on its long-term promises. Moreover, a DB plan such as a 412(i) rewards long-tenured, higher-income employees—the ones that you want to motivate in order to help your practice grow.

In addition, having a 412(i) plan in place means that you’ll be able to rely on a sizable income stream in retirement. Other investment assets can be invested aggressively in stocks, which are risky but which may deliver outstanding long-term returns.

Defined benefit plans, including 412(i) plans, are not for everyone. These plans will work best if you’re in your late 40s or older. The closer you are to retirement, the more that can be contributed on your behalf.

These plans generally gain appeal if you have relatively few employees, and those employees tend to be much younger than you are. In such situations, your practice will have to make only modest contributions for employees other than yourself.

If a practice has two or more principals, each of whom is middle-aged, all of these physicians can benefit from a 412(i) plan. Nevertheless, the disadvantages should be considered:

■ **Costs.** DB plans can be relatively expensive to create and maintain. Ongoing actuarial services will be needed, for example. In addition, the insurance products you buy for a 412(i) plan (an-

**Defined benefit plans** are not for everyone. These plans will work best if you’re in your late 40s or older; you have relatively few employees, and those employees tend to be much younger than you are. In such situations, your practice will have to make only modest contributions for employees other than yourself.

nities, life insurance) come with their own costs, which may be significant. You should work with reputable professionals to get a plan that delivers good value for the money you'll spend.

■ **Staff contributions.** If you have employees who are eligible, the contributions on their behalf can be substantial. You should work with a firm that is familiar with “carve-out” designs. While many 412(i) plans use insurance company prototypes, a more sophisticated approach and review are needed when there are five or more employees.

■ **Commitment.** Your practice must make substantial contributions year after year. It is possible to cut back in a bad year, but such a reversal may involve substantial hassle and expense. You might have to make a longer commitment with a 412(i) plan than with other types of defined benefit plans. Therefore, 412(i) plans are best suited for medical practices that consistently enjoy plentiful cash flow.

■ **Declining tax shelter.** As mentioned, deductions often are front loaded in a 412(i) plan. If that's not attractive to you, a traditional DB plan may be a better choice.

In recent years, the federal government has repealed various rules that reduced the allure of DB plans. Moreover, the upper limits for DB funding have been increased. As DB plans have regained appeal, some promoters have stretched the design and funding limits to create plan designs that the IRS calls abusive.

Thus, you should be wary of 412(i) plans that are funded 100 percent by life insurance. Also, be skeptical of plans that require you to exchange your policy for a better one in the future.

## SIMPLIFIED EMPLOYEE PENSION PLANS

As the name indicates, simplified employee pension (SEP) plans demand little in the way of paperwork. You merely have to fill out a one-page form when you set up the plan. There are no further reports and no annual tax filings. The maximum you can contribute to a SEP plan in 2005 is \$42,000.

SEP plans are as flexible as profit-sharing plans, and they offer “look-back” deductions. “Contributions to a SEP plan can be made any time until the due date of your tax return, including extensions,” says Mr. Lusby. “You can make a contribution to a new or existing SEP plan by the due date of your 2005 tax return in

2006, and take a full deduction from your 2005 taxable income. If you want to make a tax-deductible contribution for the prior year and you have not already established a retirement plan, a SEP plan is your only choice.”

As stated, the contribution deadline for practice-sponsored SEP plans is the due date of the employer’s tax return, including extensions. Thus, the timing depends on the filing of your medical practice’s return. If your practice has already filed a corporate return for 2004, it is too late to make contributions for last year, unless you wish to file an amended return.

Moreover, if you made a contribution to your own SEP account for 2004, you also must make proportionate contributions to your employees’ accounts. If you have not done so, you must file an amended return and make the appropriate contributions.

With a practice-sponsored SEP, you can open up a SEP account for each employee at a bank or any other financial institution. Then you’d make the contributions into each employee’s account. If the employee wishes, he or she can invest SEP funds elsewhere, tax-free, until the money is pulled out of the SEP.

Like profit-sharing plans, SEP plans allow contributions anywhere from zero up to the maximum each year. This can be especially appealing if your practice is cyclical and you’re reluctant to make commitments to a retirement plan each year. By contrast, some other types of retirement plans (defined benefit, target benefit and money purchase plans) require a certain level of funding each year.

How much can you contribute to a SEP plan? The answer can be tricky. Generally, contributions can be up to 25 percent of a participating employee’s compensation. For self-employed individuals, though, the calculation is more complicated, and the result is about 20 percent of gross compensation.

In order to make the maximum \$42,000 contribution to your

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own SEP account this year, you must earn at least \$210,000 as a self-employed individual. If you're a corporate employee, your salary must be \$168,000 or more in order to qualify for a \$42,000 contribution.

Employers also like SEP plans because their fiduciary responsibility may be reduced. If you sponsor a SEP plan, bring in

**The bottom line** is that SEPs generally work best for employers with few, relatively low-paid employees. Contributions to their accounts may be modest. The larger your medical group, the more you have to decide whether the simplicity of a SEP plan and the employee motivation are worth the added outlays for your workers.

an investment adviser to help coordinate the program. This adviser can develop a list of investment options, then meet with participating employees to help them make their choices. The more independent the financial professional, the greater the professional's expertise and the greater the number of investment choices, the less fiduciary responsibility you are likely to have.

Because each employee makes his or her own investment decisions, SEP plans generally appeal to workers, too. All SEP contributions are fully vested and portable. The money belongs to the employees, the same as with an IRA. Thus, SEP plans give you an opportunity to provide your employees with a low-cost, highly motivational retirement plan.

With all of these advantages to SEP plans, what are the disadvantages? They can be costly for employers. If your practice contributes 25 percent of pay to your own account, it has to contribute 25 percent of pay for your eligible employees, too.

You may have to contribute on behalf of workers you'd like to omit, including part-timers and employees who have left the company. SEP-plan sponsors must contribute to the account of each employee who meets the following criteria:

- He or she is at least 21 years old.
- The employee has worked for the employer at any time during at least three of the preceding five years.
- He or she has earned at least \$450 during the year for which contributions are being made.

Thus, if an employee worked from December 2003 through

January 2005, you must make a 2005 SEP contribution for that employee, assuming his 2005 earnings were at least \$450. (By contrast, qualified plans generally permit employees who work less than 1,000 hours per year to be excluded. Qualified-plan contributions for employees who have left the company also may not be required.)

Some exclusions are possible from SEP plans, such as union members and certain leased employees. If you wish, you may cover workers who do not meet the three-year, age-21 requirements, but your plan must have formal policies regarding inclusion of employees. If you try to exclude some workers because of the three-year rule mentioned above, all workers who fail this test must be excluded. This may negatively affect morale.

The bottom line is that SEPs generally work best for employers with few, relatively low-paid employees. Contributions to their accounts may be modest. The larger your medical group, the more you have to decide whether the simplicity of a SEP plan and the employee motivation are worth the added outlays for your workers. On the other hand, SEP plans may be particularly appealing to self-employed physicians as well as to those with a few employees.

## **SOLO 401(K) PLANS**

These plans may make sense if you are the only full-time employee of your medical practice. Your spouse can be on the payroll, too. Similarly, if you have some self-employment income aside from your day job, your best choice may be a one-person 401(k) plan.

Participants in solo 401(k) plans merely have to file Form 5500-EZ, and then only after assets in the plan top \$100,000. Some custodians of one-person 401(k) plans will offer to file Form 5500-EZ for you, at a modest fee, or give you thorough filing instructions at no charge. Thus, administrative costs tend to be modest.

In addition, you can borrow from a solo 401(k) without paying tax or an early-withdrawal penalty. As long as your plan has the required language, you can borrow half the balance in your account, up to \$50,000.

Such loans can be obtained without hassle. When you pay back

principal and interest, they go into your retirement account, not into the pockets of a third-party lender. Other retirement plans for the self-employed, such as SEP plans and SIMPLE IRAs, don't permit borrowing.

## Glossary of Retirement Plan Terms

- **401(k) plan:** A defined contribution plan that permits employees to deduct a portion of their salary from their paycheck and contribute to an account before taxation. Employers may also make contributions to a participant's account, called a company match. Federal (and sometimes state) taxes on contributions and investment earnings are deferred until the participant takes money out of the plan.
- **Beneficiary:** A person, persons or trust designated to receive the plan benefits of a participant in the event of the participant's death.
- **Defined Benefit Plan:** A retirement plan in which the sponsoring company provides a certain guaranteed benefit to participants based on a pre-determined formula.
- **Defined Contribution Plan:** An employer-sponsored plan in which contributions are made to individual participant accounts, and the final benefit consists solely of assets (including investment returns) that have accumulated in these individual accounts. Depending on the type of defined contribution plan, contributions may be made either by the company, the participant or both.
- **Distribution:** Any payout made from a retirement plan.
- **Early Withdrawal Penalty:** There is a 10-percent early-withdrawal federal penalty for withdrawal of assets from a qualified retirement plan prior to age 59½, in addition to regular federal and state tax.
- **Eligible Employees:** Employees who meet the eligibility criteria, such as age or length of service requirements, for participation in an employer-sponsored plan.
- **ERISA:** Plan sponsors are required by law to design and administer their plans in accordance with the Employee Retirement Income Security Act of 1974 (ERISA). Among its statutes, ERISA calls for proper plan reporting and disclosure to participants.
- **Fiduciary:** A person with the authority to make decisions regarding a plan's assets or important administrative matters. Fiduciaries are required under ERISA to make decisions based solely on the best interests of plan participants.
- **Lump-Sum Distribution:** The distribution at retirement of a partici-

Moreover, in many situations, solo 401(k) plans permit larger deductible contributions than other retirement plans suitable for one person or one couple. That is because you make contributions as an employer as well as deferring income as an employ-

ment's entire account balance within one calendar year due to retirement, death or disability.

■ **Money-Purchase Plan:** A type of defined contribution plan in which the employer's contributions are determined by a specific formula, usually as a percentage of pay. Contributions are not dependent on company profits.

■ **Nondiscrimination Rules:** IRS rules that prohibit the plan or plan sponsor from giving disproportionately larger benefits to highly compensated employees.

■ **Plan Administrator:** The individual, group or corporation named in the plan document as responsible for day-to-day operations. The plan sponsor is generally the plan administrator if no other entity is named.

■ **Plan Document:** The parameters under which a retirement plan will be operated must be outlined in the plan document. This document must be given to employees upon request.

■ **Plan Sponsor:** The entity responsible for establishing and maintaining the plan.

■ **Portability:** This occurs when, upon termination of employment, an employee transfers pension funds from one employer's plan to another without penalty.

■ **Prohibited Transaction:** Activities regarding treatment of plan assets by fiduciaries that are prohibited by ERISA. This includes transactions with a party-in-interest, including sale, exchange, lease or loan of plan securities or other properties.

■ **Profit-Sharing Plan:** Company-sponsored plan funded only by company contributions. Company contributions may be determined by a fixed formula related to the employer's profits.

■ **Rollover:** The action of moving plan assets from one qualified plan to another or to an IRA within 60 days of distributions, while retaining the tax benefits of a qualified plan.

■ **Safe-Harbor Rules:** Provisions that exempt certain individuals or kinds of companies from one or more regulations

■ **Vesting:** The employees' ownership right to company contributions.

Source: *The Profit Sharing/401k Council of America (www.psc.org).*

ee, as well as a “catch-up” contribution once you reach age 50.

■ As an employer, you can make deductible contributions up to 25 percent of compensation. With \$50,000 of covered income, for example, your contribution may be as much as \$12,500. (If your self-employment income comes from an unincorporated business, the maximum employer contribution will be approximately 20 percent.)

■ As an employee, you can defer compensation up to \$14,000 in 2005. In addition, if you’re at least 50 years old, you can contribute another \$4,000 in 2005.

In 2005, each participant’s account may be able to receive as much as \$42,000, or \$46,000 with a catch-up contribution.

Suppose, for example, you’re 50 years old, with \$50,000 of covered income from a corporation, your contribution may be up to \$12,500 (as explained above), plus \$14,000 and \$4,000, for a total of \$30,500.

If your \$50,000 comes from an unincorporated business, the maximum would be \$10,000 (20 percent of \$50,000) plus \$14,000 plus \$4,000, for a total of \$28,000.

Thus, if you have \$50,000 of income from a practice with no employees, you can contribute up to \$30,500 (incorporated business) or \$28,000 (unincorporated) to a one-person 401(k) in 2005. At that level of income, you could contribute no more than \$13,500 to a SEP, SIMPLE IRA or profit-sharing plan in 2005. In some situations, the maximum would be only \$10,000.

Suppose, on the other hand, you have \$150,000 in income from an owner-only business during 2005. You can contribute (and deduct) as much as \$46,000 to a one-person 401(k) plan, regardless of whether your practice is incorporated or unincorporated. With that income, you could contribute no more than \$37,500 to a SEP or a profit-sharing plan in 2005; with a SIMPLE IRA, the maximum contribution for 2005 would be only \$16,500.

Thus, for many owner-only medical practices, you can maximize retirement plan contributions with a one-person 401(k) plan. While you may contribute the maximum to a solo 401(k), you can contribute less or nothing at all from year to year. You’re not locked into any level of contribution.

As indicated, a solo 401(k) plan can cover you if you have

no employees. The same is true if your only employee is your spouse.

Moreover, these plans can include multiple physicians who own interests in the practice, as long as there are no employees beyond physician-principals and their spouses. In these situations, each physician and spouse must receive the same percentage-of-pay contribution.

If you give yourself a 25-percent-of-pay employer contribution, your spouse also must get a 25-percent contribution. The same 25-percent requirement applies to your colleagues and spouses. Note, however, that this rule does not apply to salary-deferral contributions. You might elect to defer \$18,000 worth of your pay in 2005 while your spouse defers only \$5,000 of pay.

What if you pay a neighbor's teenager to do some filing occasionally? That's no problem because you can exclude any employees who work fewer than 1,000 hours per year.

However, for your spouse to participate in a solo 401(k), he or she must be on the payroll. Then the government will collect payroll (Social Security and Medicare) taxes. Thus, you must decide whether putting your spouse on the payroll of the medical practice will be worthwhile. The greater your spouse's compensation, the larger the benefit to your family.

You can have a one-person 401(k) plan if you have self-employment income from a sideline practice. However, if you participate in a 401(k) from another job, your total salary deferral can't exceed the \$14,000 ceiling in 2005 (\$18,000 once you reach age 50).

As an example, say that Dr. Alan Jones has a full-time job with no 401(k) plan. Seeing patients at home, apart from that job, he earns \$25,000 this year.

With a solo 401(k), Alan can make a \$5,000 employer contribution (20 percent of \$25,000 from this unincorporated practice)

**Unlike other retirement plans** for the self-employed, solo 401(k) plans permit you to borrow money—half the balance, up to \$50,000—without paying tax or an early-withdrawal penalty. When you pay back principal and interest, they go into your retirement account, not into the pockets of a third-party lender.

plus a \$14,000 salary-deferral contribution, thus sheltering most of his sideline income from tax.

Alan's neighbor, Dr. Linda Walker, also has a full-time job and \$25,000 in income from an unincorporated sideline practice. However, she has elected to defer \$10,000 worth of salary at her full-time job.

Therefore, with a one-person 401(k), Linda can defer only \$4,000 this year, bringing her total deferral to \$14,000. She also can make a \$5,000 employer contribution from her sideline practice, bringing her total 2005 contribution to her one-person 401(k) to \$9,000.

**A new type of retirement account** may be offered by employers beginning next year: the Roth 401(k). Contributions to a Roth 401(k) will be made with after-tax dollars, so they won't provide upfront tax deductions. However, the money will grow tax free, and withdrawals after five years and age 59½ will be tax free.

### ROTH 401(K) PLANS

A new type of retirement account may be offered by employers beginning next year: the Roth 401(k). These accounts will combine features of Roth IRAs and 401(k) plans so that your practice can offer the new accounts as an option in a regular 401(k) or a

solo 401(k). Education and nonprofit employers that offer 403(b) plans will also be able to add Roth accounts, but the Roth option will not be permitted in 457 plans that are offered by government employers.

How will the new accounts work? Contributions to a Roth 401(k) will be made with after-tax dollars, so they won't provide upfront tax deductions. However, the money will grow tax free, and withdrawals after five years and age 59½ will be tax free. Those features are similar to those found in Roth IRAs. (As mentioned, in a regular 401(k) plan, contributions provide tax deductions. However, every dollar taken out is taxed as ordinary income.)

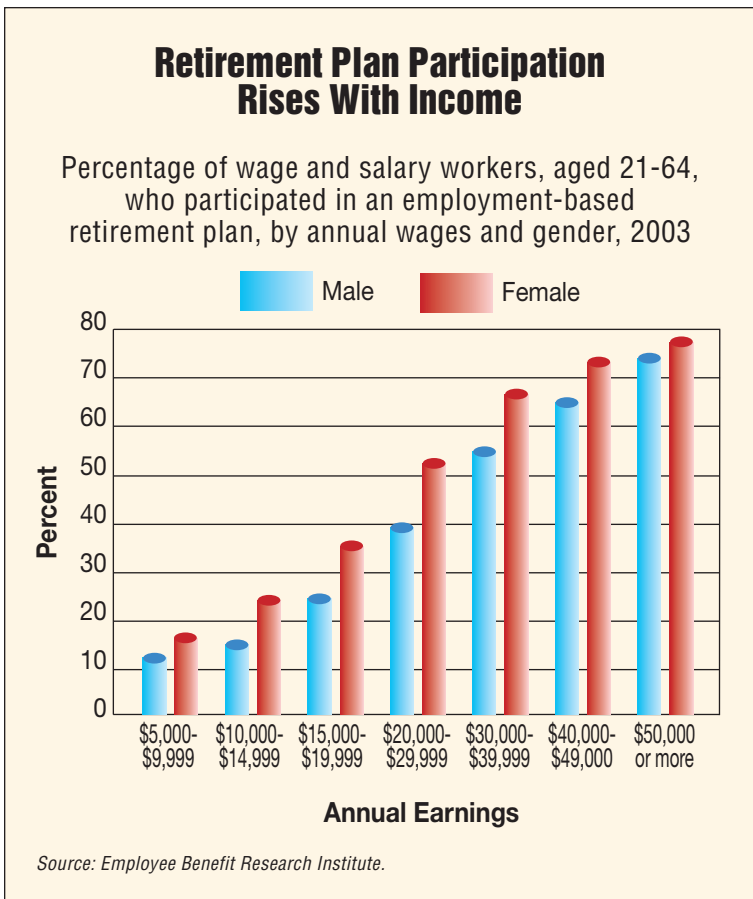
The bottom line, then, is that a Roth 401(k) will generate tax breaks on the back end while regular 401(k) accounts deliver tax shelter upfront. The better choice will depend on how long the money stays in the account, how much it earns, and what your tax rates are when you put the money in or take it out.

Generally, physicians who are in a low tax bracket but expect

to be taxed at a higher rate in retirement will be better off in a Roth 401(k)—that probably includes younger doctors. Roth 401(k)s won't work well for physicians who are close to retirement and expect to tap their accounts before the five-year holding period.

Employees will be able to contribute to one or both accounts, but they cannot switch money from one plan to the other. The 401(k) contribution limits will apply to either account or both combined.

The most that one individual can put into a Roth IRA in 2006



will be \$4,000 (or \$5,000, if you are 50 or older). However, the most you can put into a Roth 401(k) next year will be \$15,000—the same contribution limit that will apply to regular 401(k) plans in 2006. If you put money into a Roth 401(k) and a regular 401(k), your total allowed contribution to both accounts will be capped at \$15,000 next year. (Contributions may be limited by other factors such as the “top-heavy” rules that affect highly compensated employees.)

People 50 and older can contribute an extra \$5,000 to their 401(k) plan next year. IRS proposed regulations do not say whether this catch-up contribution will also be allowed in Roth 401(k) accounts, although some press reports indicate that these contributions will be permitted. If not, that \$5,000 can go into a regular 401(k) account.

**The best news** may be that Roth 401(k) plans will have no income limitations. For Roth IRAs, married couples who have more than \$160,000 in adjusted gross income (AGI) and singles with AGI over \$110,000 may not contribute at all. Thus, physicians who can't contribute to a Roth IRA might be able to invest in a Roth 401(k) next year, through their practice.

For physicians, the best news may be that Roth 401(k) plans will have no income limitations. For Roth IRAs, married couples who have more than \$160,000 in adjusted gross income (AGI) and sin-

gles with AGI over \$110,000 may not contribute at all. Thus, physicians disappointed that they can't contribute to a Roth IRA because their income is too high may be able to invest in a tax-free account next year through their practice.

On the other hand, one of the big attractions of Roth IRAs is the absence of required distributions after age 70½. Under the proposed regulations, people would have to start taking money out of their Roth 401(k) plans at age 70½. However, the proposed regulations also say that money in a Roth 401(k) plan could be rolled over into a Roth IRA. Eventually, the IRS will have to determine whether to allow such rollovers to skirt the rules on required distributions.

In addition, the proposed regulations do not allow conversions from regular 401(k) accounts into Roth 401(k) accounts. You can, though, have both a Roth 401(k) at work and a Roth IRA as well,

assuming you don't earn too much to have a Roth IRA.

If your practice provides a matching contribution, the match must be put into a regular 401(k) account, subject to the regular 401(k) rules, even if the employee is directing all of his or her contributions into a Roth 401(k). Employee deferrals are subject to payroll tax regardless of whether they are contributed to a traditional or a Roth 401(k) plan, so the Roth 401(k) will be no worse for an employer than the traditional 401(k) plan.

Like most provisions of the 2001 tax act, Roth 401(k) accounts are scheduled to expire after 2010. Unless Congress extends them, the money already in Roth 401(k) plans could stay there after 2010, but no new money could go in.

## **SIMPLE IRAs**

Savings Incentive Match Plans for Employees (SIMPLE) retirement plans come in two varieties: SIMPLE IRAs and SIMPLE 401(k)s. SIMPLE 401(k)s are not particularly simple, so most employers who use such plans prefer SIMPLE IRAs, where participants direct their own investments.

Again, these plans require very little administration. The main appeal is that you can contribute 100 percent of your income, up to \$10,000 in 2005. With a 3-percent-of-compensation employer match, the maximum amount that can go into your account this year is \$20,000. Participants 50 and older can defer an additional \$2,000 worth of income in 2005.

Because you can contribute 100 percent of pay, SIMPLE IRAs may be ideal if your income is relatively low, yet you want to make a sizable retirement plan contribution. They might also help you shelter income from a part-time job or sideline practice, a consulting business, etc., depending on your other retirement plan arrangements.

If that seems appealing, you should know that SIMPLE IRAs must be offered to all employees, but there are no anti-discrimination tests. You and any employed relatives can push the upper limits of SIMPLE IRAs even if none of your other employees contributes, in which case no further employer match is required.

Keep in mind that a SIMPLE plan must be in place before October 1 if you want to make contributions for 2005. Most banks,

brokerage firms, insurers and mutual fund companies will help you handle the paperwork.

Self-employed individuals can have SIMPLE plans. They are also available to employers with no more than 100 employees who have earned \$5,000 or more during the preceding calendar year. Neither employers nor the self-employed can maintain a SIMPLE plan if they have another employer-sponsored retirement plan.

To qualify for participation in a SIMPLE plan, an employee must have earned at least \$5,000 during any two preceding years and be expected (by you, the employer) to earn at least \$5,000 during the current year. Thus, you can cut costs by excluding some part-time workers.

**SIMPLE IRAs** must be offered to all employees, but there are no anti-discrimination tests. You and any employed relatives can push the upper limits of SIMPLE IRAs even if none of your other employees contributes, in which case no further employer match is required.

As mentioned, SIMPLE plans come in two varieties: SIMPLE IRAs and SIMPLE 401(k)s. However, SIMPLE 401(k)s must set up a trust with a financial institution, and these plans may be subject to discrimination testing to prevent highly paid employees from taking advantage of the rank-and-file.

Certain compensation limits apply to SIMPLE 401(k)s, and required employer contributions may be significantly higher than for SIMPLE IRAs.

Therefore, most employers prefer SIMPLE IRAs, which truly live up to their name, requiring very little administration. Moreover, with a SIMPLE IRA you won't have fiduciary responsibility or liability for employees' investments. (Employers have an obligation to invest prudently with other types of plans, such as profit-sharing plans; if you invest employees' money, as with a profit-sharing plan, you may have liability for poor results.)

With a SIMPLE IRA, each employee self-directs his or her account, with many investment alternatives. You'll have more freedom investing your own funds, too, compared with the limited menu of a SIMPLE 401(k).

While considering the above advantages, you should be aware of the disadvantages of SIMPLE IRAS, too:

■ Other types of retirement plans, such as profit-sharing and defined benefit plans, may permit you to contribute (and deduct) \$46,000 or even more to your own account this year, as compared with the \$22,000 limit for SIMPLE plans.

■ SIMPLE plans can be expensive because of mandatory contributions on behalf of those employees who choose to defer some taxable income. Employers must comply with mandatory contribution rules in either of two ways:

1. Employers may contribute a flat 2 percent of compensation to the account of each eligible employee. With this option you must contribute for all employees, including those workers who choose not to contribute on their own behalf.

2. Alternatively, employers may provide a dollar-for-dollar match of the amount each eligible employee contributes, up to 3

### When Do SIMPLE IRAs Make Sense?

Give the pros and cons of SIMPLE IRAs, they make the most sense in the following circumstances:

■ **Low income.** Because you can contribute 100 percent of pay, SIMPLE IRAs may be ideal if your income is relatively low, yet you want to make a sizable retirement plan contribution. A SIMPLE IRA might help you shelter income from a part-time or sideline practice while you make other retirement plan arrangements for your full-time practice.

However, if you have a SIMPLE plan for a sideline business while you're in a 401(k) or 403(b) plan at a full-time job, the total amount that you can put into both plans can't exceed \$14,000 in 2005, or \$18,000 if you're age 50 or over. (This amount doesn't include any employer matches).

Say you're 44 years old and you put \$5,000 into your 401(k) or 403(b) account this year. Your SIMPLE contribution will then be capped at \$9,000.

■ **Few, mainly low-paid employees.** SIMPLE plans may be a good choice if you're an employer with a small work force and most of your workers don't earn much. Low-income employees aren't likely to contribute heavily to the plan. The smaller the amount of employee deferrals, the smaller your practice's match will have to be.

■ **Limited means.** If a \$10,000 or \$20,500 contribution this year is all you need or can afford, because of other commitments, there's no reason to adopt another type of retirement plan.

percent of that employee's salary.

Suppose your receptionist, who earns \$35,000 per year, decides to participate in your SIMPLE plan and contributes \$2,000. Your company must kick in a matching \$1,050—3 percent of \$35,000.

Which is the better choice? Many employers prefer No. 2, the 3-percent match, because it will result in (a) a larger contribution for them and (b) a smaller match for other employees, if only a few participate. If most of your employees participate to the maximum allowed, No. 1 (2 percent match) may be less expensive than No. 2 (3-percent match).

**Considering all the possible choices, which retirement plan is most suitable for your practice? To some extent, that depends on your personal goals. "Some types of retirement plans may allow you to skew contributions to your own account," says Ed Slott, a CPA in Rockville Centre, N.Y.**

■ With either matching formula, all contributions are fully vested, so employees who leave will take your SIMPLE matches with them.

There also are some specific drawbacks to SIMPLE IRAs, as compared with SIMPLE 401(k)s.

In the first two years you participate, a 25-percent penalty applies for withdrawals before age 59½. After that, the regular 10-percent early-withdrawal penalty takes effect. Similarly, rollovers from a SIMPLE IRA to a regular IRA are not allowed in the first two years. Moreover, loans aren't permitted from any IRA, including a SIMPLE IRA. Therefore, if you think you may want to borrow from your retirement account, or do a rollover within two years, a SIMPLE 401(k) may be a better choice.

## Comparing Plans

Considering all the possible choices, which retirement plan is most suitable for your practice? To some extent, that depends on your personal goals. "Some types of retirement plans may allow you to skew contributions to your own account," says Ed Slott, a CPA in Rockville Centre, N.Y., who publishes Ed Slott's IRA Advisor newsletter.

Assuming that you are older than your employees, an age-weighted profit-sharing plan may be appropriate. If you have one

older employee who might benefit enormously from an age-weighted plan, a “new comparability” plan (also known as a “cross-tested” plan) may be suitable. If you are older than 50, with young employees, a defined benefit plan may enable you to make even larger deductible contributions, if you can make a commitment to sizable annual contributions.

“Some other types of plans are funded largely by elective deferrals of income by individual employees,” says Mr. Slott. “These include 401(k)s and SIMPLE plans. These plans require your practice to make certain matching contributions, but the employer match may not be large if your employees defer only a modest amount of their incomes.”

Such plans may be more expensive to administer than a basic profit-sharing plan. You should meet with an employee benefits professional to get an idea of how these various alternatives compare. For more information, see IRS Publication, Retirement Plans for Small Business. On the Internet, go to [www.irs.gov/pub/irs-pdf/p560.pdf](http://www.irs.gov/pub/irs-pdf/p560.pdf).

If you haven't sponsored a retirement plan before, you should be aware that eligible employers can receive a general business tax credit for some of the costs of establishing new plans, under a law that took effect in 2002. The credit equals 50 percent of the costs incurred to create or maintain the plan, up to \$500 per year.

This credit may be claimed for qualified costs incurred in each of the first three years, including the tax year in which the plan becomes effective. To qualify for this credit, your practice must not have employed more than 100 employees who received at least \$5,000 of compensation from the company during the preceding year.