

Investing For Yourself —And Your Employees

As explained in the previous chapter, there are many types of retirement plans that your practice can sponsor. These plans have different rules and different limits on the amounts that can be contributed. There are, though, some similarities among these plans. In each case, money is invested by the plan rather than being paid out as compensation to participating employees. Eventually that money will be distributed to the participants. In the interim, the money in the plan has to be invested.

“Many plan sponsors believe that letting employees make retirement plan investment decisions absolves them of fiduciary responsibilities,” says Craig Carnick, a financial planner in Colorado Springs. **“That’s not true, though. If you channel your workers to high-cost, low-quality investments, you could wind up facing lawsuits when their accounts have disappointing results.”**

How should that money be invested? To address that question, you need to differentiate among the various types of plans.

In essence, there are two modes of retirement plan investing:

■ **Pooled funds.** Traditional vehicles such as profit-sharing plans call for the sponsoring employer to

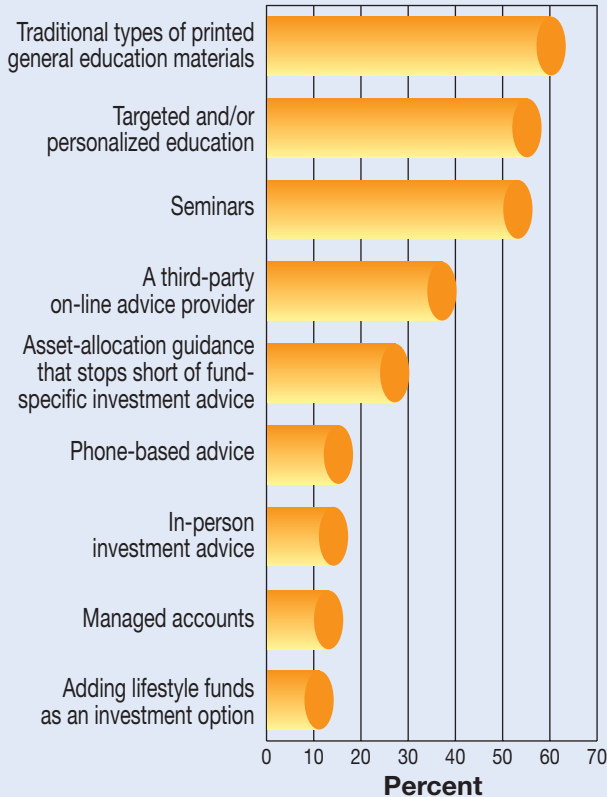
contribute most if not all of the money in the plan. The employer’s contributions go into one fund, which is managed for the benefit of all employees.

■ **Self-managed funds.** In recent years, salary deferral plans such as 401(k) plans have become very common. Participating employees choose to defer some current pay (and some current tax); the deferred amounts go into individual accounts, and each participant makes his or her own investment selections, usually from a pre-set menu.

Although those are the general rules, the lines between the two

Employers Plan Additional Investment Support: Poll

A survey of employers conducted by Hewitt Associates reveals that 70 percent say they are likely to offer employees additional investment support to help them better manage the diversification within their defined-contribution plans. Respondents named the following methods as among the top three ways employers plan to offer this additional support:



Source: *Hot Topics in Retirement 2005*, Hewitt Associates.

types of plans aren't always hard and fast. As noted, many medical practices sponsor a 401(k)/profit-sharing combination plan. In these cases, the 401(k) accounts are self-managed while the profit-sharing plan contributions are invested for all participants.

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"As a retirement-plan sponsor, you are by definition a fiduciary, even if you hire someone else to administer the plan," says Michael Hatlee, director of retirement services at Chemung Canal Trust Company in Elmira, N.Y. **"And you'll always be a fiduciary. This means you have an obligation to act solely on behalf of plan participants."**

Thus, if your practice sponsors any kind of a retirement plan, it bears a fiduciary responsibility to all the participants. "As a retirement-plan sponsor, you are by definition a fiduciary, even if you hire someone else to administer the plan," says Michael Hatlee, director of retirement services at Chemung Canal Trust Company in Elmira, N.Y. "And you'll always be a fiduciary. This means you have an obligation to act solely on behalf of plan participants. You

must track and control the plan's expenses, for example."

On the investment side, a fiduciary is expected to act "prudently," Mr. Hatlee says. "That means diversifying assets in order to minimize risks while allowing the opportunity for substantial returns. If employees are expected to make their own investment decisions, it's expected that the sponsor will provide some education as to how they can choose among the different investment options."

As a plan sponsor, you probably have greater liability exposure with a plan where assets are invested for all employees within one fund, as there is with a profit-sharing plan. "There might be a conflict of interest between the doctor's investment goals and those of the other participating employees," Mr. Hatlee says. These conflicts will be more apparent if the sponsoring physician is making investment decisions, managing the money as if

it were his or her own account.

“If the doctor is actually managing the practice’s retirement fund, the doctor’s investment choices will be open to scrutiny,” Mr. Hatlee says. “There’s a danger an action might be brought against the doctor, who then would have to prove that his or her investment decisions were made in the best interests of the plan participants. If mutual funds are used, for example, the doctor will have to show that he or she looked at fund managers and looked at fund performance, on a regular basis, and made investment decisions accordingly.”

Formal Policy Advised

Hiring a financial professional to make investment decisions will help deal with the issue of fiduciary responsibility, but physicians can take other steps as well. “It’s especially important that the plan have a formal investment policy,” says Mr. Hatlee. “It should be created by the doctor and the plan’s investment manager. This investment policy should spell out an asset allocation, with ranges for various asset classes.”

The manager may be given broad latitude, Mr. Hatlee notes. “For example, the investment policy statement might say that at least 40 percent of the fund but no more than 80 percent will be invested in equities,” he says. “For bonds, the allocation might be from 20 percent to 60 percent.”

For plans such as 401(k)s, where the participants direct their own investments, several ingredients should be in place, according to Mr. Hatlee. “First, enough choices should be offered so that participants are able to diversify their investments,” he says. “If the menu consists of three funds, all of which invest in small-cap value stocks, that’s not a diverse selection.”

Generally, the menu should include attractive equity and fixed-income funds. “At a minimum, plan sponsors should see that participants have an adequate number of investment choices, so they can construct diversified portfolios,” says Scott Revare, CEO of Smart401k in Overland Park, Kan., which provides investment recommendations for plan participants. “There’s a school of thought that says plan sponsors should do more than the minimum—they should be active in helping employees make their choices. That could mean providing advice or providing tools that

the employees can use in their investment process.”

Moreover, there should be some effort to see that high-quality funds are offered to plan participants. “In the investment policy statement, there should be some mention of who will select the funds, who will track them, how often they’ll be reviewed and what circumstances might lead to a fund’s being replaced,” Mr. Hatlee says. “Those could be a manager change, investment style drift or poor long-term performance, for example.”

Mr. Carnick suggests that plan sponsors work with a respected investment adviser, who will meet regularly with each participant. Brokerage firms, financial planners and money managers may be willing to work with medical practices. Mr. Revare says that plan sponsors likely will have more investment options if the chosen adviser is independent and not, say, from one mutual fund company.

Checklist for ERISA Compliance

Reish Luftman Reicher & Cohen, a law firm in Los Angeles, offers the following checklist to ensure that retirement plans comply with section 404c of the Employee Retirement Income Security Act (ERISA):

- The participant has an opportunity to obtain written confirmation of his instructions.
- The person to whom the instructions are given is an identified plan fiduciary who is obligated to comply with the instructions.
- The participant is provided by an identified plan fiduciary with the following:
 - (1) An explanation that the plan is intended to be a 404(c) plan;
 - (2) An explanation that the fiduciaries of the plan may be relieved of liability for losses;
 - (3) A description of the investment alternatives available under the plan;
 - (4) A general description of the investment objectives and risk and return characteristics of each designated alternative;
 - (5) Identification of any designated investment managers;
 - (6) An explanation about giving investment instructions;
 - (7) A description of any transaction fees and expenses which affect the participant’s account balance;
 - (8) The name, address and phone number of the plan fiduciary responsible for providing information;

“Have the adviser distribute investment literature,” says Mr. Carnick. “Participants should be shown how stocks have outperformed bonds long term, for example. Keep records of all your efforts to educate participants—and keep them forever. You can’t force employees to make good decisions, but you can show that you made good investment choices available.”

Another option, says Mr. Revare, is to make arrangements for on-line advice. “Employees can go on-line, enter their personal information and receive portfolio suggestions,” he says. Mr. Revare’s firm, for example, will have them answer such questions as: “How would you feel if a fund you hold dropped 10 percent in a week? Would you take your money out or put more money in?” Based on the answers, he asserts, Smart401k can make appropriate asset allocation recommendations, according to a plan participant’s risk tolerance, age and other characteristics.

- (9) Specified information regarding employer securities;
- (10) A copy of the most recent prospectus provided to the plan for investment alternatives subject to the Securities Act of 1933;
- (11) Any materials provided to the plan relating to the exercise of voting, tender or similar rights.
- The participant is able to obtain upon request:
 - (1) A description of the annual operating expenses of each designated investment alternative;
 - (2) Copies of any prospectuses, financial statements and reports provided to the plan;
 - (3) A list of the assets comprising the portfolio of each designated investment alternative;
 - (4) Information concerning the value of shares or units in designated investment alternatives;
 - (5) Information concerning the value of shares or units in designated investment alternatives held in the account of the participant.
- Plan permits participants to give investment instructions with a frequency that is appropriate in light of market volatility.
- The core investment alternatives, constituting a broad range, permit instructions at least once within any three-month period.

A more complete look at the requirements of ERISA’s Section 404c can be found at the firm’s Website, www.reish.com/pa/benefits/404c.cfm.

The rules concerning a plan sponsor's fiduciary responsibility are set out in the Employee Retirement Income Security Act (ERISA), the federal law covering retirement plans. "Section 404c of ERISA has a checklist of requirements," says Mr. Hatlee. "If a doctor follows them, he or she can be insulated against suits resulting from financial performance."

Balancing Assets

Once all the ERISA formalities have been followed, investment decisions must be made. You may want to hire a skilled professional to manage money held in the plan for all participants. For your own account, though, you may prefer to have more input regarding the selection of investments.

Some financial advisers aim for a balance between taxable and tax-deferred accounts, with similar allocations on each side. With this approach, an investor has several asset classes in the taxable account, so it is possible to take losses on the taxable side when a given asset class falls.

If you do all of your investing inside of a tax-deferred retirement plan, you won't have to worry about "asset location." You can simply decide how much to invest in stocks, how much in bonds, etc., then buy the appropriate securities within your plan.

Problems arise, though, if you invest through a taxable account as well. What goes in the plan and what goes out? The recent bear market, low interest rates and new tax legislation make it more challenging than ever to develop an effective holding pattern.

Some financial advisers aim for a balance between taxable and tax-deferred accounts, with similar allocations on each side. With this approach, an investor has several asset classes in the taxable account, so it is possible to take losses on the taxable side when a given asset class falls. You can re-balance by taking gains inside the tax-deferred account, to avoid paying some tax.

Such an asset-location strategy can offer intangible benefits to investors. If you put different asset classes in different accounts, you may be unhappy about one or the other. You might want to know why your taxable account did very well but you earned only a little bit in your retirement plan. If you don't want one account doing much better than another, you can build diversification into

each account, which might include both retirement accounts for a working couple.

Indeed, asset location may be even more complex for a working couple, both of whom have retirement plans. “We try to look at all their accounts to get the best possible asset allocation and choice of investments,” says Chris Cordaro, a financial planner and chief investment officer at RegentAtlantic Capital in Chatham, N.J.

Mr. Cordaro explains that the “pecking order” his firm has created is aimed at producing the best results for a client’s overall holdings (*see box below*). “High-growth, tax-inefficient asset classes go inside a retirement plan,” he says, “while tax-efficient assets belong in a taxable account.”

Real estate investment trusts (REITs), for example, go inside

Where to Hold Assets

According to RegentAtlantic Capital in Chatham, N.J., tax efficiency is improved by allocating higher-growth, tax-inefficient asset classes to retirement accounts first. The following list shows those asset classes that the firm allocates to retirement accounts in descending order.

Asset Class	Income	Gain Realization	Potential Return
REITs	High	Low	Medium
Hedge Funds	High	Low	Medium
U.S. Small-Cap Stocks	Low	High	High
Emerging Markets	Low	High	High
High-Yield Bonds	High	Medium	Medium
Treasury Inflation Bonds	Medium	Low	Low
International Bonds*	Medium	Low	Low
Short-Term U.S. Bonds	Medium	Low	Low
International Large-Cap Stocks	Medium	Low	High
U.S. Large-Cap Stocks	Medium	Low	High

*Note: If international bonds are not to be allocated to retirement accounts, they are eliminated from RegentAtlantic’s clients’ allocations.

retirement plans, according to Mr. Cordaro. Some of the dividends paid by REITs are not taxable, but most of the yield to investors is taxable, so they belong inside a plan.

Those dividends may be significant: In 2005, Morningstar put the yield from real estate mutual funds at 3.9 percent. Utility funds (2.2 percent) are the only other type of stock fund yielding more than 1.5 percent. (Most REIT dividends do not qualify for the favorable 15-percent tax rate, so those payouts would be

Taxable bonds also may fit well inside a retirement plan because the tax on the interest can be deferred. Indeed, you may prefer a conservative approach in your retirement plan so you're less likely to lose principal there. Holding bonds inside the plan reduces the risk of such losses.

taxed as much as 35 percent outside of a retirement plan.) Therefore, considerable shelter is possible if you hold REITs and REIT funds in a tax-deferred plan.

Next on Mr. Cordaro's "inside" list are hedge funds, which may do well for investors but can generate short-term gains. "Small-cap stocks also go inside tax-deferred accounts," he says, "because they have the potential for high returns,

and there may be substantial turnover among small-cap funds, leading to capital gains." Inside of a taxable account, the tax on such gains will be deferred.

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Indeed, you may prefer a conservative approach in your retirement plan so you're less likely to lose principal there. Holding bonds inside the plan reduces the risk of such losses while investors don't have to worry about the income taxes on bond interest.

If those are the ideal asset classes for keeping inside a retirement plan, what belongs on the outside? "Large-cap domestic equities," says Mr. Cordaro. "Especially if you invest through index funds, they can be very tax-efficient. We also hold bond allocations on the outside, in many cases, because our clients tend to be high-income taxpayers who are better off in municipal bonds."

As mentioned, the tax rate on corporate dividends is now 15

percent (5 percent for low-bracket taxpayers), so stocks that pay substantial dividends probably should be held outside of a retirement plan. If such stocks are held inside a plan, the dividend income eventually will be fully taxed on withdrawal, and the tax break will be wasted.

The 2000-2002 bear market also has had an effect on asset-location decisions. Many stock funds now have capital loss carry-overs, which are wasted inside a tax-deferred account. If you invest through mutual funds, you may want to put those funds in your taxable account, especially the large-cap growth funds that have been hit the hardest.

Mutual funds may have two kinds of net losses: realized and unrealized. "Some funds have realized more losses than gains on their trades," says Sue Stevens, a financial planner in Deerfield, Ill. "Funds also may be holding onto stocks that have fallen in value since their purchase by the fund. Such holdings may be converted into realized losses at any time."

Funds can't pass realized losses through to shareholders, but those realized losses can be "banked" by funds and carried forward for up to eight years. During this time, realized gains may be sheltered from tax.

Suppose, for example, ABC Mutual Fund had realized losses in previous years that totaled \$5 per share at the start of 2005. This year, suppose that ABC realizes \$3 per share in gains. The fund will not have to make any capital gains distributions. Its carried-forward loss will offset the \$3-per-share realized gains, and the fund will still have \$2 per share in banked losses to offset future realized gains.

Even if your shares of ABC appreciate in 2005 through profitable trades, you'll owe no tax on the gains. "To enjoy the tax benefit of untaxed internal gains, you must hold a fund in a taxable account," says Ms. Stevens. "Funds held in a tax-deferred retirement plan will generate fully taxed income as money is withdrawn from the plan."

What about international stocks? They tend to break down by market capitalization, according to Mr. Cordaro. "International large-caps tend to be tax-efficient, so they should be held in taxable accounts while international small-caps can go on the inside," he says.

International stocks pose another tax-planning issue. Investors who pay foreign taxes can get a tax credit, but that tax credit is lost if the foreign equities are held in a tax-deferred account. That may not be a huge amount, but it can help cut your taxes if international stocks are held in a taxable account.

Your age and retirement schedule also can affect asset location. Younger physicians should hold the assets with the highest expected return inside of a plan. Hopefully, the tax-deferred growth over a long time period will make up for the loss of tax benefits. Any gains will wind up being taxed as ordinary income, not long-term capital gains, when withdrawn from the plan.

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At some point, “crossover” occurs, when it makes more sense to hold fixed-income assets inside of a plan because the expected holding period is shorter. You may reach that point when you near retirement or when you begin to take distributions from a tax-deferred plan.

Besides age, liquidity concerns may influence asset location. If you will need access to funds, it makes sense to have some fixed-income assets outside of a retirement plan. You’ll know that you can get your hands on those bonds, without paying tax, when you need to tap your portfolio.

On the other hand, liquidity from fixed-income assets may be needed inside of a tax-deferred account. When you are taking required distributions, you should make sure you have ample liquidity inside your IRA. You shouldn’t have to sell stocks at the wrong time—those stocks might thrive with a longer holding period.

Commissions and Fees

Choosing the investments you place in a plan also may affect the costs you’ll pay. “If you work with an adviser, you’ll pay some type of a fee,” says Chad Parks, president and CEO of Decimal, Inc. in San Francisco. “Generally, you’ll pay either an asset-based fee or commissions.”

That is, some advisers will charge a fee that's based on the size of your retirement fund. An adviser managing a \$500,000 fund, for example, might charge you a 2 percent fee, or \$10,000 per year.

"Other advisers work on a commission basis," says Mr. Parks. "If you work with that type of adviser, and you use mutual funds in your retirement plan, the commissions will depend on whether you're buying A, B or C shares."

With A shares, for example, you pay an upfront load. For every \$10,000 invested, the adviser might collect \$575, leaving you with \$9,425 in mutual fund shares, to begin with.

B shares impose the load at the back end, when you sell the shares. They generally have higher annual expenses than A shares; there's also a charge if you leave the fund within a pre-determined time period. If you invest in C shares, you pay neither an upfront nor a back-end load, but you will have higher annual costs year after year.

"There may be other costs that are not well-disclosed," says Mr. Parks. "In small-group plans, such as those sponsored by medical practices, variable annuities are often found. Variable annuities may have an additional asset-based fee, anywhere from 50 to 150 basis points [0.5 percent to 1.5 percent] per year, and a declining surrender charge." The latter term refers to a fee that is imposed if you terminate the annuity within, say, seven years after a purchase.

Whether or not you hire an investment adviser, you probably will have to hire a firm to administer your retirement plan. "Such companies usually provide tax filing and record keeping," says Mr. Parks. "They also may provide access to investments, without having to pay an adviser, and educational materials for participants, which might be on a Website."

The amount you'll pay for such services will vary by type of plan and by the number of participants. "Among the medical groups we serve," says Mr. Parks, "a 401(k)/profit-sharing combination is the most common. We charge \$155 per month if they have 10 or fewer participants and \$185 per month if there are 11 to 25 participants." A "new comparability" plan that allows contributions to be skewed towards physicians' accounts has a higher monthly cost.

Self-employed physicians who have an owner-only (or owner-

and-spouse-only) 401(k) plan will pay a small annual fee, according to Mr. Parks. On the other hand, adopting a defined-benefit plan, which permits extremely high contributions but involves complex calculations, may add thousands of dollars per year to your administrative costs.

Going for Guarantees

As mentioned, variable annuities are frequently held in small-company retirement plans. Variable annuities (VAs) fall into the category of deferred annuities, meaning that you can invest now but avoid tax on investment income until you pull

Skeptics often question the appeal of variable annuities. To the doubters, VAs suffer from high fees, surrender penalties, limited fund choices and misleading guarantees. What's more, any long-term capital gains taken inside of a variable annuity will be taxed as ordinary income upon withdrawal, forfeiting the benefit of favorable tax rates.

out some cash. In the interim, you can choose among several investment accounts inside the annuity, and the contract's value will depend on the performance of the chosen "subaccounts." Thus, VAs offer a way to invest in mutual fund look-alikes without having to pay tax each year.

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antees. What's more, any long-term capital gains taken inside of a variable annuity will be taxed as ordinary income upon withdrawal, forfeiting the benefit of favorable tax rates.

If variable annuities receive little respect from some observers, those held within retirement plans may inspire true disdain. According to the critics, investors pay higher fees to hold a tax-deferred investment inside an already tax-deferred account.

Nevertheless, VAs continue to be sold, and most of them are sold for tax-deferred accounts. According to the National Association for Variable Annuities (NAVA) in Reston, Va., about 60 percent of all the money going into VAs winds up in retirement programs funded with pre-tax dollars.

The bottom line is that billions of dollars are being invested each year in variable annuities that will be held inside retirement

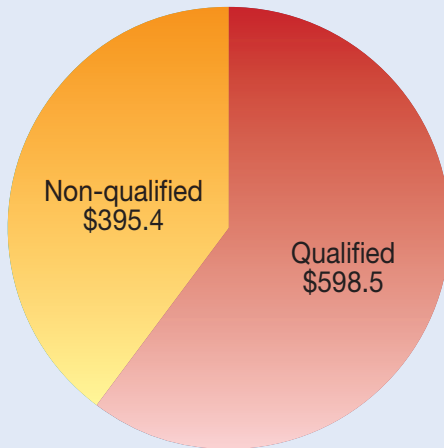
plans. Are those billions being sold to bilked investors? Many advisers concede that variable annuities may not mix with retirement plans in every instance but insist that this combination does work well in some cases.

If no additional tax deferral will be obtained by holding a VA inside your retirement plan, why consider such a tactic? The guarantees of variable annuities (pledges not available from mutual funds) are frequently cited as the reason for holding VAs inside retirement plans.

Traditionally, VAs offered a return-of-principal death benefit: beneficiaries would receive whichever was greater, the amount invested (minus any withdrawals) or the contract value. In recent years, enhanced death benefits were introduced, ratcheting up the guaranteed amount for investors willing to pay an additional annual fee.

During the 1980s and 1990s, when stocks and annuity contract

Net Assets Held in Variable Annuities, 2003 (dollars in billions)



Source: 2004 Annuity Fact Book, National Association for Variable Annuities.

values generally moved upwards, this guarantee was often disregarded, but the recent bear market changed perceptions. From 2001 to 2003, NAVA reports, variable annuity beneficiaries received \$2.8 billion more than the value of the annuities, making up for market losses.

This provision was comforting to Jane Davis, as we'll call her. Dr. Davis is a widow who has enough assets for herself, besides her retirement plan, and she wants to leave the money in her plan to her children. She has invested her retirement plan money in a VA. Within the VA, Dr. Davis can invest aggressively in equity

Guaranteed death benefits have been joined by so-called "living benefits" in recent years. "Among new sales of VAs, most of the contracts contain at least one living benefit," says Rick Carey, managing director of research at Fine-tre Corporation in Roswell, Ga. In essence, living benefits provide a guarantee to a VA's owner rather than to a beneficiary.

subaccounts, which should pay off over the long term. However, even if the equity accounts lose value, her children will get at least a return of her original investment at her death. The guaranteed death benefit will help her deal with any bear market that may occur during her retirement.

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Among living benefits, the "guaranteed-minimum withdrawal benefit" may be the most popular. This is a fairly straightforward benefit, allowing investors to get their money back through a series of contract withdrawals, so it's easy to understand.

Guarantees that provide a positive return, rather than a return of principal, also appeal to some investors. As another example, take the hypothetical case of Dr. Sam Long, who wanted to have a slice of his assets in something with a guaranteed return. He looked around and decided that a VA offering a 5-percent guaranteed return was more attractive than anything else with a guarantee these days. With a VA, you have the chance to beat the guaranteed return if your chosen investments do well.

The next step was determining where to hold his VA. Dr. Long decided that investing in a VA outside of a retirement plan, where any long-term gains eventually will be taxed as ordinary income, would be more harmful than holding a VA inside a retirement plan, where tax deferral is redundant.

Thus, Dr. Long invested some of his retirement plan money in a VA with a 5-percent guaranteed annual return. That is, if he annuitizes this VA (converts the contract value to an income stream) with the same issuer after 10 years, he can do no worse than a 5-percent annual return.

Living-benefits guarantees can be misleading, though. In some VAs, the guaranteed return not only is costly, it is available only if you decided to annuitize the contract within a 30-day window after 10 years. If you don't exercise within that 30-day window, you lose the right to do so.

Therefore, if you are interested in a VA that has a 30-day window at the end of a 10-year period in which to exercise an income guarantee, read the fine print. Look for a VA where you have that window each subsequent year. With such a provision, the guarantee won't be lost if you don't exercise the option within that initial 30-day window.

Living benefits make VAs more attractive, but you must decide if the guarantees are worth the cost. Generally, the closer you are to retirement, the more interest you might have in such guaran-

Fees and Expenses: Variable Annuities vs Mutual Funds

Fund expenses	2003 Average Expenses	
	Mutual Funds	Variable Annuities
Fund expenses	1.452%	0.974%
Mortality and expense charges	—	1.014
Administrative	—	.148
Distribution	—	.179
Total	1.452%	2.315%

DIFFERENCE

0.863%

Source: 2004 Annuity Fact Book, National Association for Variable Annuities, citing data from Morningstar, Inc.

tees. Younger doctors probably will be less willing to pay the extra costs over long time periods.

What are those costs? VAs often have M&E (mortality and expense charges, to pay for insurance and administration) of 1.3 percent to 1.5 percent per year, and there may be an added 0.5 percent a year to pay for the minimum-income guarantee. Altogether, the total cost might be one percentage point more per year than you'd pay for mutual fund "C" shares. Besides the difference in cost, you need to deal with the lack of liquidity and the limited investment options that are inherent with VAs.

Ever since the bear market of 2000-2002, some investors do not want the risks of stocks or stock funds. Nevertheless, exposure to equities is likely to be necessary for long-term investment success. Emotionally and psychologically, the guarantees of VAs may help reassure you sufficiently so that you'll put some of your retirement plan money into equities.

VAs have another advantage, though: they offer peace of mind if you're investing in stocks. Ever since the bear market of 2000-2002, some investors do not want the risks of stocks or stock funds. Nevertheless, exposure to equities is likely to be necessary for long-term investment success. Emo-

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For a retirement plan with a large asset base, you might use several different VAs with different guarantees. Using multiple VAs provides exposure to different insurance companies and more investment options. Diversification among annuities provides even more reassurance to wary investors.

VAs held inside retirement plans may work well for small groups, such as medical practices. Often they provide a wider range of investment options than are found in a 401(k) plan. The cost of using a VA for a small group's SIMPLE plan, for example, may be no greater, or even less, than other alternatives.

While the guaranteed death benefit of a VA often appeals to the principals of small groups when they choose a retirement plan, you may not want to pay extra for living benefits. Doctors should ask about the added cost and then decide. Also, you should

ask about the surrender charges. In most VAs, taking money out of the contract within a pre-set number of years not only will void living-benefits guarantees, it also will trigger extra fees.

If a VA is held inside a retirement plan when minimum required distributions begin, will surrender charges be a problem? Not really—most companies include liquidity features in their VAs that are sufficient to cover the required distribution. Some companies will waive a surrender charge if a withdrawal is necessary to satisfy the minimum distribution rules.

Wrap Programs

Instead of VAs, small retirement plans may invest through “wrap” programs, which have recently become popular. In a wrap program, a financial adviser helps a client acquire a mix of investments. These investments may be mutual funds, individual securities selected by money managers or some combination. The adviser provides assistance in creating a portfolio designed to meet the investor’s specific objectives and monitoring progress towards meeting those goals.

Although this approach sounds straightforward, the distinctive feature of a wrap account is the way the adviser is compensated. “No commissions are paid when securities are bought or sold,” says Ed Slott, a CPA in Rockville Centre, N.Y., who publishes Ed Slott’s IRA Advisor newsletter. “Instead, the adviser receives a percentage—generally, 1 percent to 3 percent per year—of the assets being managed.”

Thanks to advances in technology, wrap programs now are offered to investors with modest portfolios. A retirement plan with \$250,000, \$100,000 or even smaller amounts to invest can find a wrap program today.

Suppose, for example, Dr. Janice King uses a wrap account for her practice’s \$500,000 retirement fund with a 2-percent annual fee. Her practice will pay the adviser \$10,000 per year, whether the plan’s investment portfolio is traded actively or if there are no trades at all.

This compensation arrangement offers two advantages. First, there is no risk that the adviser will recommend trades in order to generate trading commissions. The practice of “churning,” which enriches brokers at the expense of investors, is eliminated.

Second, the adviser now has an incentive to perform well. If the assets in the plan grow to \$700,000, thanks to good advice, the adviser will earn \$14,000 a year, at 2 percent, instead of \$10,000. However, if the plan's assets fall to \$300,000, the adviser will collect only \$6,000.

Assuming that this approach appeals to you, how should the wrap fee be paid? "A recent IRS private letter ruling (PLR), while

A wrap program's compensation arrangement offers two advantages. First, there is no risk that the adviser will recommend trades in order to generate trading commissions. The practice of "churning," which enriches brokers at the expense of investors, is eliminated. Second, the adviser has an incentive to perform well; his or her fee will rise along with your assets.

not serving as absolute authority, indicates that wrap fee payments to employer-sponsored retirement plans with outside funds are not deemed contributions, even though a portion of the wrap fee represents the cost of trading securities," says Marty James, who heads an accounting firm in Mooresville, Ind. "That's good for plan sponsors because it's usually advantageous to pay wrap fees with outside money." Over the long term, the payoff for staying on the outside track can be enormous.

In PLR 200507021, the IRS made these points:

- Brokerage commissions must be paid with money inside the retirement account. If outside funds are used, they will be considered plan contributions and may put the plan over permissible contribution limits.
- Annual maintenance fees, on the other hand, may be paid with plan funds or with outside funds.
- Wrap fees are hybrids of commissions and maintenance expenses. In many cases, it is acceptable to pay wrap fees with outside funds.

"This PLR related to IRAs, not employer-sponsored plans, but the rationale behind this ruling supports paying the wrap fees in qualified plans from outside funds, assuming that substantial trading costs would not be a problem," says Mr. James. "That's especially true when you consider that this strategy can improve the investment results for rank-and-file employees, in addition to returns for key employees."

In this PLR, two factors seemed to make a difference:

1. The financial firm seeking the PLR estimated that only 15 percent of the wrap fees went to brokerage commissions. Thus, these fees were largely imposed for advisory services.

2. The wrap fee here did not depend on the extent of sales commissions. No matter how many or how few trades were made, the owner of the retirement account would owe the same percentage of assets to the financial institution.

“Thus, if you are in a true wrap program, you have justification for paying the wrap fee with outside funds,” says Mr. James. “You won’t be charged with making an illegal plan contribution.”

Should you use funds from outside of a plan to pay a wrap fee? Generally, yes, because such a fee would appear to be a tax-deductible business expense. “In fact, if you have an IRA, you might want to roll that IRA into your practice’s employer-sponsored

Be Cautious Before ‘Zeroing Out’ at Year End

Besides the ability to deduct wrap fees, other tax strategies should be weighed in relation to the retirement plan your practice sponsors. For example, if your practice is structured as a professional corporation, you might be in the habit of “zeroing out” corporate income by paying year-end bonuses to yourself and to the other doctors.

However, if you pay out all the practice’s income in a year-end bonus, there may not be enough money left to fund a tax-deferred retirement plan. Even if your practice has cash to fund a retirement plan, you’re wasting a tax-deductible expense if you have already zeroed out corporate income.

Similarly, zeroing out corporate income might waste an “expensing” opportunity. In 2005, up to \$105,000 worth of outlays for business equipment can be written off right away, rather than depreciated over many years.

This expensing deduction, though, can’t exceed the company’s taxable income. If your professional corporation zeroes out its income by paying everything in salaries and bonuses, there won’t be enough income to cover the expensing election.

Therefore, you should proceed carefully before paying year-end bonuses. Make sure your practice has enough pre-bonus income to get deductions for retirement plan contributions and equipment expensing, two valuable tax breaks.

plan in order to deduct the wrap fees,” Mr. James says.

Besides, by paying wrap fees with outside funds, you’re increasing the buildup inside your employer-sponsored retirement plan. Long-term, adding an extra 1 percent or so each year can dramatically increase returns.

“If your plan is a long-term holding, one that eventually will be rolled into an IRA, you should pay the wrap fee with outside funds,” says Mr. Slott. “That will mean more money working for you inside the plan, where those funds can enjoy the benefit of compound tax-deferred growth, long-term.”

Although this tactic seems like a win-win situation, another factor may affect your decision on wrap fees: the cooperation of the plan custodian.

In most wrap programs, money is deducted automatically to pay advisory fees. Typically, this is done every quarter. If the annual wrap fee is 1 percent, for example, every three months 0.25 percent of the total assets in the plan is moved from the investor’s account to the adviser. The custodian handles the transaction (and takes its own fee). For advisers and institutions, operating in this manner is easier and more efficient than having to bill clients for fees each quarter and trying to collect.

“Some plan custodians will be willing to take on the administrative burden of giving investors the choice of paying wrap fees from outside funds,” says Mr. James. “As another approach, your practice might be given the opportunity to reimburse the plan for wrap fees already paid.”

Other plan custodians, though, may not be ready to go along. If you’re considering the creation of a retirement plan at your practice, the ability to pay fees with outside funds is a factor to keep in mind when choosing a custodian.

Retirement Plan Pitfalls

As you can see, in order to derive maximum benefit from your retirement plan, you must take care to comply with a host of laws and regulations. An error can result in costly fines or, in a worst case, disqualification of your plan, which would trigger all the deferred taxes. Here are some traps you need to avoid:

■ **Excluding eligible employees.** “Some employers make the mistake of contributing to their own account, within a retirement

plan, but not for their employees,” says Sandy Soltis, partner in the tax department of Blackman Kallick Bartelstein, an accounting and consulting firm in Chicago. “You are required to make contributions for all eligible employees each year.”

Nevertheless, different types of plans permit you to exclude employees based on age or length of service. “With a 401(k) plan, for example, employees over age 21 who have worked for your company at least one year must be included,” says Ms. Soltis. “With profit-sharing plans, you may make employees wait for two years, if the plan provides for immediate 100 percent vesting.”

■ **Cashing out not-so-small accounts.** If an employee leaves your practice with, say, a \$3,200 balance in his retirement plan account, what should you do? What if the employee does not tell you what to do with that money? For many employers, the answer has been to simplify matters by paying out the \$3,200 and closing out the departing worker’s account.

However, new federal regulations went into effect in March 2005, reining in that practice. Employers whose retirement plan mandates cashing out small accounts when the company doesn’t receive instructions from the departing employee must automatically roll the balance directly into an IRA on behalf of the employee if the account is worth \$1,000 to \$5,000. “This provision is meant to help younger workers, who switch jobs more often, have smaller sums in their retirement plans and are unlikely to roll over the funds on their own if the plan simply cashed them out,” says Mr. Hatlee.

Involuntary cash-outs of more than \$1,000 (but less than \$5,000) are required to be automatically rolled over to an IRA unless the participant elects otherwise. “It used to be okay to send a check,” says Mr. Hatlee, “withholding 20 percent for federal income tax.” That’s no longer true for amounts in the \$1,000 to \$5,000 range.

Under new federal regulations that went into effect in March 2005, employers whose retirement plan mandates cashing out small accounts when the company doesn’t receive instructions from the departing employee must automatically roll the balance directly into an IRA on behalf of the employee if the account is worth \$1,000 to \$5,000.

“Now,” says Mr. Hatlee, “if you want to make distributions and cash out these departing employees, you have to open an IRA in their name. Generally, that means you’ll have to have a written agreement with a financial institution to open these IRAs. For plan sponsors such as medical practices, that’s something else to think about.” To comply with this rule, your plan can reduce the mandatory cash-out amount to \$1,000, or it might completely eliminate mandatory distribution provisions.

When stock prices rise sharply, as they did in 2003-2004, the result is that some defined-benefit plans become overfunded. However, some sponsors continue to make contributions although they’re not permitted. Therefore, you should monitor any defined-benefit plan carefully. If yours is overfunded, check with a professional about starting a new plan, qualified or nonqualified.

There is some good news, according to Mr. Hatlee. “If you keep these accounts in your plan, the Department of Labor has ruled you can charge fees to departed employees, if fees are fairly allocated to all participants on a reasonable basis,” he says.

■ **Failing to update your plan.** If you sponsor a qualified retirement plan, you probably have a prototype plan offered by a bank, brokerage firm, mutual fund company, insurer or some other financial institution. If so, new tax laws usu-

ally require technical amendments.

You have until the last day of the plan year beginning in 2005 to completely amend your plan to comply with the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA). Your custodian should have sent the documents for you to complete. If not, find out where they are, and have your tax adviser begin working on them.

“In addition, your plan may not have been amended to comply with prior tax laws,” Ms. Soltis says. “If your plan isn’t up-to-date, your tax adviser may be able to negotiate a modest fine with the IRS, which would be better than paying a larger penalty if your noncompliance is detected during an audit.”

■ **Overfunding your pension.** As explained in the preceding chapter, defined-benefit plans are designed to build up a certain amount in order to pay participants a pension in retirement. Excess accumulations are not permitted.

For example, a plan may be designed to pay out \$150,000 per year, which might require \$1.8 million in capital. If such a plan has \$2.2 million, it is overfunded by \$400,000—no further contributions are permitted.

When stock prices rise sharply, as they did in 2003-2004, the result is that some defined benefit plans become overfunded. However, some sponsors continue to make contributions although they're not permitted. Therefore, you should monitor any defined benefit plan carefully. If yours is overfunded, check with a professional about starting a new plan, qualified or nonqualified.

■ **Taking impermissible withdrawals.** The 10-percent tax penalty for early withdrawals does not apply to distributions after age 59½. Therefore, you might assume that you can withdraw money from your plan once you reach that age.

Unfortunately, that may not be the case. Such withdrawals may be illegal unless they're permitted by the plan's language. Some plans, for example, restrict distributions until retirement.

If desired, you may be able to amend your plan to permit in-service distributions after age 59½. This might allow you to take penalty-free withdrawals if you need to, yet still benefit from further contributions.

■ **Undervaluing life insurance held inside a plan.** The IRS recently published a series of rules describing transactions that are considered abusive. Suppose, for example, you are a sole practitioner who has built up a large amount inside your retirement plan. Say you then buy a \$1 million policy on your own life through your retirement plan. The practice pays \$100,000 in premiums each year for five years.

After five years, the policy has a cash value of \$450,000 but an enormous surrender charge is in place, reducing the supposed "surrender value" to \$100,000. Thus, when an irrevocable trust you have created buys the policy, only \$100,000 is paid to the retirement plan.

In this situation, the IRS likely will contend that the trust has paid \$100,000 to buy a policy worth \$450,000. The extra \$350,000 will be considered a distribution from your retirement plan. Not only would that \$350,000 be taxable income to you, the transaction might lead to plan disqualification if such distri-

butions are not permitted by the plan.

In April 2005, the IRS further clarified the issue by spelling out rules for valuing life insurance policies held within qualified retirement plans. This guidance provides a formula for determining the fair market value of life insurance policies held within qualified plans.

“Transactions between retirement plans and ‘disqualified persons’ are prohibited,” says Seymour Goldberg of the law firm Goldberg & Goldberg P.C., in Melville, N.Y. **“If you sponsor a qualified plan, you probably are a disqualified person.”** Therefore, you should not permit your plan to enter into transactions with yourself, your family or your company.

The formula, as outlined in the new guidance, consists of premiums paid plus interest, dividends or other credits, minus “reasonable mortality and other reasonable charges actually charged.”

For variable life insurance policies, the guidance establishes fair market value as cash value without reduction for surrender charges. The cash value must be at least equal to the total premiums paid plus all adjustments made to those premiums reflecting investment

return and the value of segregated asset accounts, minus reasonable mortality and other charges.

To obtain more information on these rules, go to www.irs.gov/pub/irs-drop/rp-05-25.pdf.

■ **Shifting money from one pocket to another.** “Transactions between retirement plans and ‘disqualified persons’ are prohibited,” says Seymour Goldberg of the law firm Goldberg & Goldberg P.C., in Melville, N.Y. “If you sponsor a qualified plan, you probably are a disqualified person.”

Therefore, you should not permit your plan to enter into transactions with yourself, your family or your company. “Even if you sell property to your plan at a bargain price and the plan makes money, that would be a prohibited transaction,” Mr. Goldberg says.

■ **Neglecting spousal consent.** For married participants in defined benefit plans, distributions generally need to have the spouse’s written consent. This may apply to some other types of plans, too, depending on the plan language. Often a spouse has the right to be named as account beneficiary.

If you sponsor a plan where such rules apply and you don't enforce them, you may be vulnerable to a lawsuit from the employee's spouse as well as IRS penalties.

■ **Relying on a prenuptial agreement.** When you marry or re-marry, you may enter into a prenuptial agreement with your spouse. Chances are that part of that prenuptial agreement will cover your retirement plan if that is a valuable asset for you.

“However, before the marriage, your future spouse can't sign away any rights to your retirement plan,” says Mr. Goldberg. Only a spouse can legally do that.

How can you resolve this dilemma? “One approach,” says Mr. Goldberg, “is to have your spouse-to-be promise to sign a post-nuptial agreement, in which rights to your retirement plan will be waived.”

A better solution may be to terminate your retirement plan before the marriage and roll your balance into an IRA, where spousal rights don't apply.

“You can start a new plan after the marriage, at which time your spouse can waive his or her rights, if that's desirable,” says Mr. Goldberg. “Make sure such a waiver is included in the plan administration documents.”

■ **Missing deadlines.** Different types of plans are on different schedules. For example, a SIMPLE plan must be created by Oct. 1 in order to permit deductible contributions for that year. If you are late by even a day or two, you may lose a full year of tax-deferred retirement investing.