Fringe Benefit Plans: Valuable Planning Tools You Haven't Heard Of

Fringe benefit plans lack many of the restrictions of qualified plans, and, therefore, are relatively inexpensive to implement.

BY DAVID B. MANDELL, JD, MBA AND CAROLE C. FOOS, CPA

As authors of a number of books on financial planning specifically for physicians, we have had the opportunity to speak with many neurologists and neurosurgeons of various ages over the past decade. What we have seen is that two such physicians with similar incomes can have very different income levels in retirement. Why? Three reasons physicians may have very different qualities of life in retirement are:

1. Devastating incident (lost lawsuit or divorce)
2. Poor investments
3. Lack of attention to taxes

Fortunately, both qualified retirement plans and fringe benefit plans can help you address the three challenges above in significant ways. Unfortunately, most physicians only utilize traditional qualified plans—such as pensions and 401(k)s—which are restrictive and burdensome, while completely ignoring the more flexible fringe benefit plans. In fact, only a handful of the thousands of the doctors we have spoken with over the years employ fringe benefit plans in a significant way. This is unfortunate.

In this article, we will discuss the basics of qualified and fringe benefit plans.

QUALIFIED PLAN BASICS

The term "qualified plan" ("QP") means that the plan meets the definition of a retirement plan under Department of Labor and Internal Revenue Service rules created under the Employee Retirement and Income Security Act (ERISA). These plans may be in the form of a defined benefit plan, profit sharing plan, money purchase plan, 401(k), or 403(b). Properly structured plans offer a variety of benefits: you can fully deduct contributions to a QP, funds within the QP grow tax-deferred, and (if non-owner employees participate) the funds within a QP enjoy superior asset protection. Despite the benefits QPs can offer, there are a host of disadvantages that physicians must understand:

> "[W]hen you use a QP, you trade today's tax rates on your contribution for the tax rates in the future when you pull the money out of the plan."

- Mandated maximum annual contributions for defined contribution plans ($51,000 for pensions, profit-sharing plans, $17,500 employee deferral for 401(k) plans in 2013)
- Mandatory participation by employees
- Potential liability for management of employee funds in plan
- Controlled group and affiliated service group restrictions
- Penalties for withdrawal prior to age 59.
- Required distributions beginning at age 70.
- Full ordinary income taxation of distributions from the plan
- Full ordinary income taxation and estate taxation of plan balances upon death (combined tax rates on these balances can be over 70 percent)

Despite these numerous disadvantages, nearly all neurologists and neurosurgeons in the United States participate in QPs. The tax deduction is such a strong lure, it often cannot be resisted. For some doctors, this makes sense. But for many, the cost of contributions for employees, potential liability for mismanagement of employee funds, and the ultimate tax costs on distributions to you and your family may outweigh the current tax savings offered by QPs.

This is especially true if you believe that income tax rates, especially the higher marginal rates, will go up over the coming decades. That is because, when you use a QP, you trade today's tax rates on your contribution for the tax rates in the future when you pull the money out of the plan. If rates rise in the future, the QP might prove not to be a good deal at all. While none of us know what the future will bring, we do know that the highest marginal federal tax rates in the United States were well above 50 percent for most of the 20th century and that the highest rates today, even with the fiscal cliff deal raises, are near the lowest they have ever been in the nearly 100-year history of the federal income tax. Thus, the QP tax rate bet is one that, at minimum, should be hedged against—which can be done with certain fringe benefit plans (see below).

SEP-IRAS

SEP-IRAs are not officially QPs—they are custodial accounts, yet, in many ways, they are similar. You have the same tax restrictions on annual contribution amounts, penalties for early withdrawals, mandatory withdrawal rules, and taxation on distributions and plan balances at death as you have with a QP. One big difference is that a SEP-IRA may not enjoy the same level of asset protection that a QP does under state law. For these reasons, a SEP-IRA is typically no better financially than a QP.

FRINGE BENEFIT PLAN BASICS

Fringe benefit plans are, astonishingly, relatively unknown to physicians. This is true, despite the fact that most Fortune 1000 companies make fringe benefit plans available to their executives. While many of these plans in public companies cannot be used in a private medical practice (think stock options) many use structures that a physician certainly could easily employ in a practice.

Although fringe benefit plans are not subject to the qualified plan rules listed above, they are based on many of the same tenets. Some are explicitly compensation plans that provide some long-term retirement benefits and present tax reduction benefits to the key employee(s). Other plans are aimed primarily at a goal other than compensation, such as asset protection or employee retention.

EXAMPLE: FRINGE BENEFIT PLAN

Let's examine one such fringe benefit plan that could be utilized by nearly all neurology practices. It has been in the tax code for decades and the IRS issued 'safe harbor' rules related to the plan within the last decade. This makes the plan straightforward to implement properly from a tax point of view—just follow the rules already established.

Other benefits of the plan include:

- Utilization of the plan in addition to a qualified plan like pension, profit-sharing plan/401(k) or SEP-IRA;
- Contributions qualify for current tax deductions;
- The plan assets grow tax-deferred and can be accessed tax-free;
- The plan acts as an ideal tax hedge technique against future income and capital gains tax increases, thus it can be used to hedge against the tax rate risk inherent in QPs described above;
- Maximum contribution levels are $100,000 per doctor in practices with 10 employees or less. In larger practices, these levels can be even higher;
- In a group practice, not every doctor need contribute the same amounts. This is extremely beneficial for group practices who have doctors who want to "put away" differing amounts;
- Employee participation requires a minimal funding outlay;
- There are no minimum age requirements for withdrawing income (no early withdrawal penalties);
- The transfer of assets at the doctors death is income tax-free to heirs.

While these benefits are powerful, this plan is not for everyone. Like most plans, this benefit plan is only appropriate for physicians who are looking to build long term wealth. It is not one that is designed for contributions, growth and access in a short time frame.

CONCLUSION

Every successful physician should at least consider a fringe benefit plan. Qualified Plans are burdened with a host of restrictions, costs and tax limitations. This often makes them extremely expensive for the physicians and does not allow for significant retirement wealth accumulation. Fringe benefit plans do not have these restrictions and, therefore, are relatively inexpensive to implement. If building your retirement wealth is an important goal for your financial plan, we highly recommend you investigate fringe benefit plans in your practice. ■

For a free hardcopy of For Doctors Only: A Guide to Working Less & Building More, please call (877) 656-4362. If you would like a free, shorter eBook version of For Doctors

Only, please download our "highlights" edition at www.fordoctorsonlyhighlights.com.

© Guardian Publishing

David B. Mandell, JD, MBA, is an attorney and author of five national books for doctors, including FOR DOCTORS Only: A Guide to Working Less & Building More, as well a number of state books. He is a principal of the financial consulting firm OJM Group (www.ojmgroup.com), where Carole C. Foos, CPA works as a tax consultant. They can be reached at 877-656-4362 or mandell@ojmgroup.com.

Disclosure:

OJM Group, LLC. ("OJM") is an SEC registered investment adviser with its principal place of business in the State of Ohio. OJM and its representatives are in compliance with the current notice filing and registration requirements imposed upon registered investment advisers by those states in which OJM maintains clients. OJM may only transact business in those states in which it is registered, or qualifies for an exemption or exclusion from registration requirements. For information pertaining to the registration status of OJM, please contact OJM or refer to the Investment Adviser Public Disclosure web site (www.adviserinfo.sec.gov).

For additional information about OJM, including fees and services, send for our disclosure brochure as set forth on Form ADV using the contact information herein. Please read the disclosure statement carefully before you invest or send money.

This article contains general information that is not suitable for everyone. The information contained herein should not be construed as personalized legal or tax advice. There is no guarantee that the views and opinions expressed in this article will be appropriate for your particular circumstances. Tax law changes frequently, accordingly information presented herein is subject to change without notice. You should seek professional tax and legal advice before implementing any strategy discussed herein.

SHARE YOUR FEEDBACK

Would you like to comment on an author's article?
Do you have an article topic to suggest?
Do you wish to tell us how valuable
Practical Neurology is to your practice?
We would love to hear from you. Please e-mail us at editor@bmctoday.com with any thoughts, feelings, or questions you have regarding this publication.