

EMPLOYER SPONSORED RETIREMENT PLANS: FRIEND OR FOE?

Most financial planners will agree that taking advantage of employer sponsored retirement plans may provide significant benefits to an employee. However, there are many potential pitfalls that are never discussed. Like a patient being given consent prior to surgery, you need to understand all the risks involved before deciding if the potential reward justifies that risk — no matter how small it might be. A better understanding of how pension plans really work and some of the potential pitfalls associated with them is beneficial to all young dermatologists.

Perhaps the biggest benefits are in those types of retirement plans that are creditor protected (those that qualify under the Employee Retirement Income Security Act of 1974) and where your employer may provide matching contributions as an incentive for you to participate in the plan. Then, at the very least, it would be wise to contribute an amount sufficient to receive the maximum employee match. After all, it is “free money”.

Although this is a compelling rationale to participate there are some equally valid reasons to think carefully. The government, mutual fund companies, and the media heavily promote these plans making participation in them seem almost a “no brainer”. Unfortunately, too often, dermatologists decide to “max out” these plans before putting the rest of their finances in order. This can leave them vulnerable in other areas of their financial lives and provide them with little or no flexibility as their careers progress.

Tax deductions, ordinary income vs. capital gains

Although contributions to employer-sponsored retirement plans are depicted as income tax-deductible, this is not actually the case. Taxes are merely deferred to a later point in time — unlike a deduction for mortgage interest paid which provides immediate income tax savings and does not get taxed at a later date.

If your contributions were made on pre-tax basis, all withdrawals will be taxed as ordinary income (currently the top federal bracket is 35 percent). If you made the same investment outside of your pension plan, and held it for at least 12 months, you would only pay capital gains tax (currently 15 percent).

Additionally, if you are like most investors, recent market volatility may have caused some of your investments to perform better than others. If so, it may make sense to offset gains from some holdings with losses from others. After doing that, if your capital losses exceed your capital gains, you can deduct up to \$3,000 against ordinary income. Any additional capital losses are carried forward to the next year. Unfortunately, this deduction is not available with employer-sponsored retirement plan assets.

Reverse Tax Planning?

Income tax rates can also change. The history of income taxes from 1913 (when taxes began) through 2006, reveals that the average highest marginal individual income tax rate is 60.3 percent.

With the deficit being as large as it is, the “war on terror” continuing for the foreseeable future, and social security’s future in question, isn’t it

possible that income tax rates will increase again in the future? If that is the case, by contributing to a retirement plan, you may actually be doing reverse tax planning — deferring income when your bracket is low, only to take distributions when your bracket is higher!

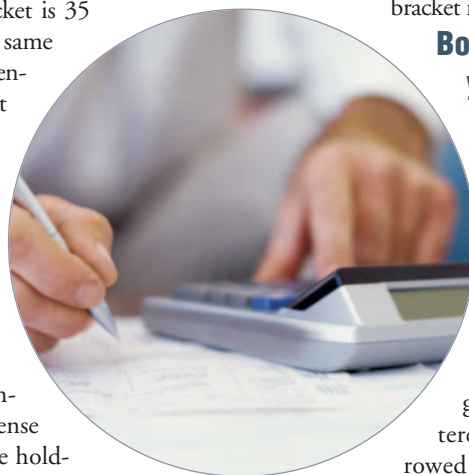
Borrowing from your plan?

Another perceived plus of these types of plans is that, depending upon your specific plan’s document, you might be able to borrow from your account. Although touted as a good idea — as the interest you pay on borrowed funds is generally credited to your own account and you pay interest to yourself — this is one of the last places you should be looking for money. Most dermatologists go into these plans to save on their income taxes — at least initially. Borrowing from your account(s) will only make you pay tax twice on the same money.

The rules state that you can borrow 50 percent of your account balance subject to a maximum of \$50,000.

This loan needs to be paid back within a five-year period with

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interest or when you leave your employer. What you are not often told is that you contribute to the plan on a pre-tax basis. However, when you pay the loan back, it is with post-tax dollars. Then, when you retire and take withdrawals from the plan, the money is taxed again ... and you did not even get the benefit of an income tax deduction for the interest that you paid.

Taking Distributions

Another factor to consider is your tax status at the time of retirement. Although you might believe you will be in a lower tax bracket in the future, this also might not be the case due to the Required Minimum Distribution (RMD) rules. Once you reach age 70 1/2, you must take a distribution by the end of every calendar year until you die or your funds are exhausted. These annual distributions are based on Uniform Lifetime Table. This table sets forth the joint life expectancies at each age for the employee and a survivor who is ten years younger.

The only exception in the use of the Uniform Table will be for an employee whose sole beneficiary is a spouse who is more than ten years younger than the employee. In this case, the distribution period can be the joint life and last survivor life expectancy of the employee and his or her spouse.

Estate implications

Finally, assets included in the taxable estate of a decedent and distributed by the estate receive a "step-up" in basis. The receivers of these bequests receive a basis in those assets equal to the fair market value (FMV) at the date of death or, alternatively, six months after death. Therefore, for estate beneficiaries who sell these newly acquired assets quickly, there should be little or no capital gains or capital gains tax. Again, this is not the case with pension plans.

Retirement plans also constitute what is known as Income in Respect of a Decedent, or income that was entitled to be paid, but was not received by the decedent before his or her death. As a result these retirement benefits are included in the decedent's gross estate, and are subject to income tax when distributed to heirs.

Therefore, if a retired dermatologist has a choice between consuming their retirement plan assets or consuming other assets, it will often be advantageous to take distributions from retirement plans and leave other assets for

inheritances. In this way, the inherited assets avoid the double taxation of estate and income taxes.

Pension Plan Decimated by Taxes

"Dr. Smith" is a Mohs micrographic surgeon living and working in New York State whose non-qualified assets exceed the current exemption amount (\$2,000,000 in 2008). Dr. Smith also has \$1,000,000 in retirement plan assets and dies later that same year (2008). The following analysis details the tax implications of his participation in an employer-sponsored retirement plan.

Pension Plan value: \$1,000,000
Less: Federal Estate Tax at 45 percent: (\$450,000)
Net value after Federal Estate Tax paid: \$550,000

Income in Respect of a Decedent (IRD): \$1,000,000
IRD deduction for Federal Estate Tax Paid: (\$450,000)
Net taxable value: \$550,000
Less: Federal Income Tax at 35 percent (\$192,500)

Total Taxes Paid \$642,500
Amount left for beneficiaries \$357,500
Effective tax rate (estate and income) 64.25 percent

Proceed Wisely

In retirement planning there are three phases: accumulation, distribution and conservation. While employer sponsored retirement plans are very good at helping dermatologists accumulate wealth, they fail miserably in the distribution and conservation phases. Hopefully, the information presented in this article will help you make an informed and educated decision prior to just following the "conventional wisdom" and "maxing-out" your contributions without giving it any thought whatsoever.

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EMPLOYER SPONSORED RETIREMENT PLANS: PROS AND CONS

It's advisable to take a step back and review the rules that generally govern employer sponsored retirement plans and the benefits most often associated with them.

Advantages

- Contributions are made on a pre-tax basis and income tax-deductible.
- Earnings grow on a tax-deferred basis.
- Certain types of accounts are creditor protected.
- You may be entitled to a "match" from your employer.
- You may be able to borrow from your account.
- You may be in a lower income tax bracket when you retire.

Disadvantages

- You can't touch these funds until age 59 1/2 without a 10 percent penalty.
- You must pay ordinary income taxes when funds are withdrawn.
- You must take distributions from these plans when you reach age 70 1/2.
- There are no income tax deductions available for "losses."
- Retirement plans constitute Income in Respect of a Decedent (IRD) property and do not receive a step-up in income tax basis.
- Retirement plan distributions at death to non-charitable beneficiaries are subject to federal income and estate taxes as well as any applicable state income taxes.

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