New Tax Law Can Triple Retirement Plan Contributions

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Defined-benefit pension plans fell rapidly from favor during the 1980s and early 1990s as a result of adverse tax law changes and IRS attacks. A little-noticed 1996 tax law promises to change that, allowing many doctors to double, or even triple, their annual tax-deductible retirement plan contributions through using such plans, beginning next year. Here's what you need to know to take advantage of this tremendous tax-saving opportunity.

Retirement Plan Types

The tax law recognizes two major types of qualified retirement plans. Defined-contribution plans are far and away the most popular and include money purchase pension plans, target benefit pension plans, traditional profit-sharing plans, and related variations, including 401(k), age-weighted, and cross-tested plans. These plans have surged in popularity over the last decade and are now used by approximately 95% of dentists nationwide. As the name implies, defined-contribution plans define the annual tax-deductible contribution made on behalf of each participant (usually as a percentage of salary), and each participant has an individual account balance within the plan. The doctor's future retirement benefits are not determined up front, but are based solely upon the amounts contributed, plan forfeitures, and investment performance.

Under a defined-benefit pension plan, the benefit that the doctor receives at retirement is fixed by the plan formula. Moreover, annual tax-deductible contributions on behalf of the doctor are not limited to $30,000 annually, but are based on the doctor's compensation, age, and certain actuarial assumptions including investment return, retirement age, and employee turnover. Since the annual tax-deductible contributions on behalf of the doctor increase with age, these plans are ideal for older doctors looking to make up for prior retirement funding deficiencies in a short period of time.

Defined-benefit plans offered tremendous tax-saving opportunities in the 1970s and early '80s, and many doctors took advantage of them. However, restrictive tax law changes and IRS attacks prompted many advisers to sound the death knell for these plans in the mid-1980s. Even though the IRS has now thrown in the towel on attacking defined-benefit plans, and recent tax law changes have been favorable, only 5% of doctors are now using these types of retirement plans.

New Tax Law Changes

While doctors looking to maximize tax-deductible retirement plan contributions can now sponsor both a defined-contribution and a defined-benefit plan, the tax law requires the plans to be aggregated, so that the total benefit received by the doctor does not exceed the limitation imposed under Section 415(e). This combined benefit limit has effectively thwarted most doctors' attempts to maximize their retirement plan contributions through using both a defined-benefit and a defined-contribution retirement plan in the past.

Fortunately, Section 1452(a) of the Small Business Tax Act of 1996 repealed this combined limit rule, effective for plan years beginning on or after January 1, 2000. Beginning next year,

TABLE 1
MAXIMUM PENSION PLAN CONTRIBUTIONS

Doctor's Age (Year 2000)	Maximum Defined-Benefit Funding (Doctor Only)	Maximum Defined-Contribution Funding (Doctor Only)	Combined Maximum Tax-Deductible Contribution (Doctor Only)	Potential Federal and State Income Tax Savings (50% Bracket)
45	$31,544	$30,000	$61,544	$30,772
46	$37,014	$30,000	$67,014	$33,507
47	$40,433	$30,000	$70,433	$35,217
48	$44,292	$30,000	$74,292	$37,146
49	$48,674	$30,000	$78,674	$39,337
50	$53,686	$30,000	$83,686	$41,843
51	$59,462	$30,000	$89,462	$44,731
52	$66,179	$30,000	$96,179	$48,090
53	$74,072	$30,000	$104,072	$52,036
54	$83,464	$30,000	$113,464	$56,732
55	$94,804	$30,000	$124,804	$62,402
56	$108,743	$30,000	$138,743	$69,372
57	$113,629	$30,000	$143,629	$71,815
58	$119,097	$30,000	$149,097	$74,549
59	$125,402	$30,000	$155,402	$77,701
60	$133,004	$30,000	$163,004	$81,502
61	$147,923	$30,000	$177,923	$88,962
62	$149,027	$30,000	$179,027	$89,514
63	$169,227	$30,000	$199,227	$99,614
64	$177,956	$30,000	$207,956	$103,978
65	$187,130	$30,000	$217,130	$108,565

doctors can thus fund for the maximum retirement plan benefit allowed under both a defined-contribution and a defined-benefit plan. This creates one of the greatest tax-saving opportunities ever!

Table 1 shows the maximum tax-deductible contribution allowable for doctors through using both defined-benefit and defined-contribution retirement plans, along with the potential tax savings. The chart is based on funding for the maximum possible benefit under a defined-benefit pension plan, using a normal retirement date of the later of age 65 or five years of participation. Please note that the amounts do not include contributions required on behalf of staff employees.

This tax law change creates two exciting tax-saving opportunities. Since most doctors presently sponsor some type of defined-contribution plan, many of them will be able to double, triple, or even quadruple their tax-deductible retirement plan contributions by adding a defined-benefit pension plan as a second retire-

ment plan for their practice. Doctors who currently sponsor a defined-benefit pension plan will similarly be able to add a defined-contribution plan allowing them to contribute and deduct as much as $30,000 more each year on their behalf.

Caveats

This tremendous tax-saving opportunity will help many, but not all, doctors. Doctors under age 45 will generally not benefit from adding a defined-benefit pension plan, because contributions are age-based. Even some doctors age 45 or over will find that this new tax-saving opportunity will not prove cost-effective. The staff contributions required can be substantial when the doctor does not enjoy an age difference of five years or more vs. the average staff employee. Moreover, since the services of an actuary are required, the plan setup and annual administrative expenses can run $1,500-2,000 each, adding further costs that must be taken into account in considering the establishment and maintenance of a second retirement plan.

Probably the biggest impediment to funding a second retirement plan is the doctor's cash flow. Dual plans will prove ideal for older doctors with younger staffs who are netting more than $200,000 and wish to use the second plan to shelter excess profits above that point. Those doctors netting $200,000 or less will probably be required to take a reduced salary in order to fund the additional tax-deductible contributions required under a second plan. While increased retirement plan funding will still prove advantageous, it may require the doctor to live off personal assets to maintain the current personal standard of living.

Still, the possibility of being able to double, triple, or even quadruple the doctor's tax-deductible retirement plan contributions affords a tax-saving opportunity that is simply too good to pass up. Generating federal and state income tax savings of $50,000-100,000 or more each year represents a financial "slam dunk" for most doctors. ❑