



MEDICINE & BUSINESS:

MANAGING THE HEALTH OF YOUR RETIREMENT

By William L. MacDonald

Physicians of non-profit hospitals are at a disadvantage over their for-profit colleagues when it comes to retirement planning (Part 1 of 2)

Tax-exempt organizations are subject to more stringent IRS rules than their for-profit counterparts in terms of how they can provide nonqualified deferred compensation plans for highly paid employees. Nonprofit organizations should analyze their deferred compensation arrangements to ensure that such arrangements comply with the restrictive tax requirements of Code Section 457.

Code Section 457(f) generally provides that in order to defer an employee's compensation to a future calendar year, the payment of that compensation must be contingent on the employee performing substantial services through a date in a future calendar year. When such a contingency is no longer present, the compensation will be taxed in the first calendar year. For example, if an organization establishes a deferred compensation arrangement that provides an employee an opportunity to defer compensation, the employee must make an election to receive the dollars deferred at some future date (i.e. 2 years) to avoid current taxation. However, under a typical nonqualified plan in this tax exempt environment, the employee generally will be taxed on the \$50,000 in the calendar year that the arrangement is established if the payment of that \$50,000 is not contingent on the employee performing substantial services for the organization in the two future calendar years.

So why would an employee defer current income with the possibility of losing it? Certain arrangements are exempt from the substantial services requirement in Code Section 457, including eligible deferred compensation plans under Code Section 457(b), tax-sheltered annuity plans under Code Section 403(b), and qualified retirement plans under Code Section 401(a). However, there are limits on the amounts that can be deferred under these plans. Nonqualified arrangements without limits fall under Code Section 457(f); however, they cause this substantial service requirement discussed above.

DEFERRED COMPENSATION ALTERNATIVES

Fortunately, alternatives are available for tax-exempt organizations that seek to set up such plans for their highly compensated employees, including their employed and contracted physicians. By subjecting employer-paid, tax-deferred compensation to "risk of forfeiture" (discussed later) or by paying the required taxes, tax-exempt organizations can develop workable alternatives for funding nonqualified deferred compensation plans.

Nonqualified deferred compensation plans in tax-exempt organizations, unlike those in for-profit organizations, are subject to Code Section 457. Two types of deferred compensation plans exist under Code Section 457: eligible and ineligible. Under this code, contributions to an eligible plan (403(b)) are limited to the lesser of \$16,500 (as of 2009) or 100 percent of an employee's annual compensation. In general, it is financially advantageous to highly compensated employees to maximize contributions to 403(b) and 401(k) plans. However, maximizing these contributions can be accomplished only at the expense of the Code Section 457 plan.

NON-PROFIT ORGANIZATIONS HAVE FEW OPTIONS FOR DEFERRED COMPENSATION

Considering there are few options, employees who choose to maximize contributions to Code Section 403(b), 457(b), and 401(k) plans can participate only in an ineligible Code Section 457(f) plan. Many organizations are taking advantage of the ability to maximize their contributions in both the 401(k) or 403(b) and a 457 plan. This coordination allows a person whose employer has a 401(k) or 403(b) plan and a 457 plan to defer the maximum contribution into two plans instead of being subject to a single limit amount. Thus, a participant can contribute the maximum \$16,500 for 2009 into their 401(k) and also the maximum \$16,500 into their 457(b). If that person is over age 50, they can also contribute the additional catch-up amount into each plan—meaning an additional

\$5,000 into the 401(k) and another \$5,000 into their 457(b). With an ineligible plan, deferred compensation contributions have no limits. However, they are taxed in the current year unless the plan is subject to a substantial risk of forfeiture.

It is important to understand why tax-exempt organizations are subject to Code Section 457 for



both non-elective (employer-paid) and voluntary (employee-paid) deferred compensation plans. For-profit organizations pay taxes on the deferred compensation until it is paid to employees: tax-exempt organizations, by definition, are not subject to this taxation. In addition, the growth of assets held by tax-exempt organizations to fund nonqualified plans is non-taxable because the organization itself is exempt from taxes. By subjecting nonqualified deferred compensation plans to strict forfeiture requirements, the IRS intends to discourage the provision of tax-sheltered deferred compensation to highly paid employees at the expense of all other employees in the tax-exempt organization.

MAXIMIZING RETIREMENT SAVINGS

Consider the limits discussed above, and let's take a look at an example. Let's assume that a 60 year old physician employed by a non-profit hospital is earning \$300,000 annually and wants to significantly increase his deferrals during the next five years in anticipation of retiring upon reaching age 65. The physician participates in a Section 403(b) plan therefore he can contribute \$16,500 each year. Since he is over age 50, he can also make an additional contribution of \$5,000

each year. If his hospital offers a 457(b) plan, he can make an additional \$16,500 and the extra \$5,000 make up. He may want to think twice about contributions to the 457(b) plan, as those assets are subject to the hospital's creditors and could be lost if the hospital becomes insolvent.

Under the applicable rules, the physician can be fully vested in the additional deferral in the 457(b) plan, but the deferred amount (plus earnings on the deferred amounts) must remain unfunded or, alternatively, can be funded by the hospital in a "rabbi trust," the assets of which remain subject to claims of the hospital's general creditors.

In addition, the physician may defer an unlimited amount of additional compensation pursuant to an "ineligible" Section 457(f) plan. If the physician elected to defer, for example, an additional \$50,000 in 2009, such amount would be deducted from the physician's 2009 income and invested in the plan (typically mutual funds) as the physician and his employing entity determine.

The \$50,000 deferral (plus earnings on the deferral) would be subject to forfeiture if the physician voluntarily elects to terminate his employment prior to reaching age 65 (the targeted retirement date previously selected by the physician), the deferred amount and its earnings would not be subject to income tax until it is actually paid to the physician following the physician's retirement, in accordance with the payment arrangements the physician had previously elected. The problem, as we mentioned above, is that the physician has risk of losing these dollars if he leaves the hospital before a stated date, or the hospital becomes insolvent, therefore, we are not seeing them used as much today.

Part 2 of this article will appear in the November issue of Physicians News Digest and on PhysiciansNews.com. William L. MacDonald is Chairman, President & CEO of Retirement Capital Group, Inc. (www.retirementcapital.com).