Qualified and Non-Qualified Plans: Why Physicians Should Consider Both to Reach Retirement Goals

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In our work with more than 1,000 physicians across the country, we have observed that the Number 1 financial goal for nearly all physicians is to achieve a financially secure retirement on their terms, including each doctor's unique timeline and lifestyle goals. It is not surprising that data from national physician surveys confirm this as the top financial objective.

What is surprising (to us anyway) is how many physicians attempt to reach this goal using just one of the tools at their disposal – a qualified retirement plan (QRP) – while so many are completely unaware of another tool they could be using– a non-qualified plan (Non-Q Plan). In this article, we will briefly describe these two types of plans that can have a significant impact on retirement.

Qualified Plan Basics

The designation (QRP) means that the plan meets the definition of a retirement plan under U.S. Department of Labor and Internal Revenue Service rules created under the Employee Retirement and Income Security Act (ERISA). A QRP 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 traditional QRP, funds within the QRP grow tax-deferred, and (if non-owner employees participate) the funds within a QRP enjoy superior asset protection. Although traditional QRPs can offer numerous benefits, there are a host of disadvantages that physicians should understand:

- Mandated maximum annual contributions for defined contribution plans
- Mandatory participation by employees
- Potential liability for management of employee funds in the plan
- Controlled group and affiliated service group restrictions
- Penalties for withdrawal prior to age 59½
- Required distributions beginning at age 70½
- 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%)

Despite these numerous disadvantages, nearly all U.S. physicians participate in traditional QRPs. The tax deduction is a strong lure that often cannot be resisted. For many physicians, however, the cost of contributions for employees, potential liability for mismanagement of employee funds, and the ultimate tax costs on distributions may outweigh the current tax savings offered by QRPs. If not giving pause, these drawbacks at least suggest that it would make sense to investigate another type of plan that hedges the QRP as an additional savings vehicle.

This is especially true if you believe that income tax rates, especially the higher marginal rates, will go up over the coming decades. When you use a traditional QRP, you trade today's tax rates on your contribution for the tax rates in the future when you withdraw the money from the plan. If

rates rise in the future, the QRP might prove not to be a good deal at all. While none of us know what the future will bring, we do know that, historically, tax rates were much higher than they are today for most of the second half of the 20th century. Thus, the QRP tax rate bet is one that should be hedged against by using retirement savings alternatives.

One alternative to consider is a Roth QRP. Many medical practices sponsor 401(k) plans which give participants the option of making salary deferrals into either a traditional 401(k) or a Roth 401(k). Although traditional contributions, as mentioned above, are a tax deduction today and will be taxed upon distribution at the tax rates in effect at that time, their Roth counterparts are after-tax contributions today. Thus, the participant pays tax at today's rates, but the funds grow on a tax deferred basis and are tax free upon withdrawal assuming they stay in the Roth account for at least five years after the account is opened. Only the salary deferral portion of a contribution can go into a Roth plan. Any profit sharing or match must go into a traditional account.

SEP-IRAs

Simplified Employee Pension Individual Retirement Accounts (SEP-IRAs) are not officially QRPs. They are custodial accounts that are similar in many ways. Both SEP-IRAs and QRPs 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. One big difference is that a SEP-IRA may not have the same level of asset protection under state law that a QRP enjoys.

Many physicians who use traditional QRPs, Roth QRPs or SEP-IRAs as a substantial part of their retirement planning should understand that such plans alone may not be enough to achieve their retirement goals. Whether because of annual contribution limits or the taxation of distributions as ordinary income, the simple fact is that most doctors need another savings vehicle to reach their retirement goals. This is where Non-Q Plans could play a significant role.

Non-Qualified Plan Basics

Non-Q Plans are not used by physicians nearly as much as by corporate executives. This is unfortunate, as they could be valuable retirement tools for many doctors. Because these plans are not subject to QRP rules, Non-Q Plans do not have to be offered to any employees. Further, even among the physician-owners, there is total flexibility. For example, one doctor can contribute a maximum amount, the next partner could contribute much less, and a third physician could opt out completely.

The main drawback to Non-Q Plans is that contributions are never tax deductible. However, they can be structured for tax-free growth and tax-free access in retirement, like a Roth IRA. Ask yourself: How much would you put in a Roth IRA if there were not funding limitations? If you think you would fund such a vehicle, then a Non-Q Plan could be very attractive to you.

In fact, a Non-Q Plan can be an ideal long-term tax hedge against a QRP. Beyond these general ground rules, there is tremendous flexibility and variation with Non-Q Plan designs. Consider that they have the following attributes:

- No limitations on contributions as with QRPs
- Can be implemented in addition to any QRP, such as a 401k or profit-sharing plan
- Owners/partners can vary in how much or whether they participate
- Employee participation is not required

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- No tax deduction on contributions, but funds can grow tax-free and be accessed tax-free upon withdrawal
- Top asset protection in many states

Conclusion

As noted at the outset, the Number 1 financial goal of nearly every physician is retirement on his or her own terms, and both QRPs and Non-Q Plans can play important roles in achieving this goal. If building your retirement wealth is an important goal for you, we highly recommend you work with an experienced advisor to investigate both types of plans for your practice.

This article provides doctors with a few tax-saving ideas. If you want to save taxes, the most important thing you can do is start looking for members of your advisory team who can help you address these issues in advance. Otherwise, you will be in this same position next April 15th and for years to come.

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