Retirement Plans
For the Sole Practitioner and the Small Law Firm

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This article addresses the question “What retirement program would be a good match for a sole practitioner or small law firm?”

Sole practitioners and small law firms need a good retirement plan, but the decision of which type of plan to adopt can be difficult. There are many IRS-blessed retirement vehicles, each with its own arcane restrictions and obligations, and failure to follow the rules will likely result in severe tax and employee relations issues.

The wrong retirement plan can become an expensive and administratively burdensome program and leave everyone – owners and employees alike - dissatisfied. But the right plan will bring you closer to your retirement goals, it will help the Firm recruit the best associates and employees, it will provide employees with a greater sense of well-being, and it is a great tax shelter.

Roth IRAs, SEPs and SIMPLEs, 401(k) plans, comparability plans, and defined benefit plans are plans that I believe would be appropriate for a sole practitioner or a small firm in particular situations. This article reviews these 6 retirement vehicles and makes suggestions for their use in common situations.

Here are the caveats. First, these suggestions are based on my experience working with retirement plans. But every Firm is different, and the Firm’s tolerance for administrative work, its labor market (do employees expect a 401(k) plan?), and its level of interest in helping employees prepare for retirement must be taken into account. Second, in the interests of brevity, the article summarizes relentlessly - not every important requirement or consideration is described, just the ones that seem most important (to me). Ultimately, a Firm would do well to find and rely upon a knowledgeable retirement plan professional.

Overview - Retirement programs are generally subject to the requirements of the Internal Revenue Code and the Employee Retirement Income Security Act of 1974 (“ERISA”), which are intended to insure that tax-favored programs do not discriminate in favor of owners and the highly compensated, and that employees’ benefits are protected from the fraud and incompetence of the managers of the benefits.

There are more than 4 trillion dollars held by U.S. retirement plans, and hundreds of thousands of individuals make their living working with retirement plans. The assets are under the intense focus of retirement plan advisers, such as stockbrokers, insurance
agents, banks, mutual funds, investment advisers, CPAs, CFPs, consultants, and recordkeepers. It is helpful to have the assistance of a competent adviser, because you want to be practicing law, not administering plans or picking investment funds. But beware! Most stockbrokers and insurance agents have little understanding of the intricacies of retirement plans. Further, retirement plan investment fees must be closely scrutinized. In selecting an adviser, confirm its retirement plan credentials, check references, and get full disclosure of all fees and services.

There are two broad categories of retirement programs:

1. **IRA-based vehicles** are simpler and cheaper to administer, but have lower contribution maximums. These arrangements require employees to establish their own individual retirement account (“IRA”) to which contributions are deposited. Employees control investments and withdrawals. Contributions are 100% vested when deposited with the IRA. These arrangements are mostly exempt from ERISA and place few administrative burdens on Firms.

2. **Qualified plans** include profit sharing and 401(k) plans (as well as other more complex plans). They allow significant deductions (as much as $41,000 (or more) per year per individual), but are subject to the full array of ERISA and IRS rules. Within the category of qualified plans, some are extremely complex, while others may be well within the administrative capabilities of a small, well-run office.

A strategic reason for Firms of a certain size (say 5 to 10 lawyers) to go with a qualified plan is the financial leverage a qualified plan ultimately may provide to the Firm. Once contributions are made to an IRA-based plan, they are dispersed among the various IRAs of employees. If, instead, the contributions are made to a plan sponsored by the Firm, the Firm will eventually control a plan with significant assets, which could be a benefit to the Firm and its employees. Having a $3 million dollar (or more) plan says something about the Firm to employees and the financial institutions it works with. Further, once plan assets reach the $3 million level, small banks, professional recordkeepers, and financial advisors will be very interested in working with the plan; and once assets reach approximately $10 million, fees (as a percentage of assets) are significantly reduced while services, such as customized websites and communications, are significantly improved.

Here are the 6 retirement plans, listed in order of the simplest (the IRA-based plans) to more complex (qualified plans), that sole practitioners and small Firms should consider.

1. **Roth IRA – A Tax Deal for Young Lawyers** – This is not actually an “employer” plan because contributions are made entirely by the individual on an after-tax basis. However, withdrawals for retirement are completely tax-free.
Who Should Consider a Roth IRA:

*The young lawyer, just starting out.* Regular contributions are not obligated, and it is easy and inexpensive to create and maintain. Because contributions are not tax-favored, but payments at retirement are tax-free, this is an excellent choice for someone currently in a low tax bracket. Because the maximum contribution to a Roth IRA is only $3,000 ($3,500 if age 50 or older), and because a Roth IRA is not available at higher income levels, it would not be appropriate as a lawyer's primary retirement vehicle for his or her entire career.

Important Roth IRA Facts:

- **When to Set Up:** As late as April 15 of the following year. For example, April 15, 2005 for the 2004 calendar year.
- **Restrictions:** Available only if income is less than $110,000 (individuals) or $160,000 (joint).
- **Maximum contribution:** $3,000\(^1\) per person (total $6,000 for married filing jointly)
- **Tax Treatment:**
  - Amounts are **NOT** tax deductible when contributed, **but**
  - If the Roth IRA has been established for at least 5 years, withdrawals after age 59 ½, or for first time home purchase, are entirely **excludible** from income tax.
  - 10% tax on earnings withdrawn if not eligible for exclusion (see above), with some exceptions.
- **Who Does Them:** Any financial institution that sponsors IRAs – such as banks, mutual funds, brokerage firms, insurance companies.
- **Administrative Complexity:** None.
- **Other Plans Allowed:** Yes.
- **Bonuses:** (1) Can be first set up after the end of the calendar year, and contributions can be made as late as April 15. (2) The ability to withdraw the account tax free after 5 years to purchase a home makes this a great way to save for a down purchase on a home.

2. **Simplified Employee Pension (“SEP”)** – Maximum Contributions to a Simple Plan – This plan requires employer contributions. The Firm’s SEP agreement (generally using an IRS model) allows the Firm to make contributions at its discretion, which are shared with all eligible employees. *The SEP requires that all employees who have attained age 21 and who have compensation with the Firm in 3 of the preceding 5 years share in the contribution.* The Firm makes the contributions directly to the employees’ IRAs. [Note that the term “employee” as used in this article includes partners and sole proprietors, who are considered “employees” by the IRS for retirement plan purposes.]

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\(^1\) This is the 2004 limit. Many of the dollar limits increase from year-to-year. The dollar limits mentioned in this article are the limits in effect for 2004.
Who Should Consider SEPs:

- **Sole practitioners with a more established practice.** A SEP is an employer plan that requires the adoption of a SEP agreement. The big advantage over IRAs is that it allows discretionary deductible contributions up to the lesser of $41,000, or 25% of pay. However, it has slightly more administrative complexity, and if the sole practitioner ever has employees, it obligates coverage of all employees who meet the service requirements.

- **Small firms.** A SEP is a good compromise between individual, low maintenance IRA’s, and the more complicated 401(k) arrangement (see below). An effective way to use a SEP is to promise a fixed contribution, such as 10% of pay per pay period. Employees would consider this plan a significant benefit, and it could be budgeted and funded each payroll period.

Comments: With the higher contribution limits, and the minimal administrative burdens, these are great plans for small firms. The downsides (not everyone would consider them such) are that the contributions are 100% vested and available for immediate withdrawal by employees, the stringent coverage requirements, and the fact that all covered employees get the same level of contributions (as a percentage of pay).

Important SEP Facts:

- **When to Set Up:** As late as the Firm’s tax return due date (with extensions) for the first year for which contributions will first be made.
- **Contributions:** The Firm contributes all the funds for the SEP. (Certain pre-1997 SEPs, called SARSEPs, may allow employee elective contributions.)
  - Maximum deductible contribution per employee is the lesser of $41,000, or 25% of pay.
  - The employee may also contribute to a traditional or Roth IRA.
- **Tax Treatment:** Payments are included in income unless rolled over to another retirement vehicle. 10% tax on withdrawals before age 59½, with some exceptions.
- **Coverage Requirements:** All employees who have attained age 21 and have service in at least 3 of the 5 preceding years must be covered.
- **Other Qualified Plans Allowed?** Yes, but the contribution limits are coordinated.
- **Who Does Them:** Any financial institution that sponsors IRAs.
- **Administrative Complexity and Costs:** Low.
- **Bonus:** Can be set up as late as the Firm’s tax return due date (with extensions) of the following year, making it a great way to tax shelter a financial windfall received late in the year.

3. **Simple IRA Plan – An Inexpensive 401(k) Look-Alike –** A Simple IRA plan (or "Simple Plan") allows employee contributions - like a 401(K) plan, but the contribution limits are lower than for a SEP (or a 401(k) plan). Contributions are made directly to employees’ IRAs.
Who Should Consider A Simple Plan:

Small law firms that wish to provide an easy, inexpensive retirement plan that looks like a 401(k) plan.

This is the most inexpensive of all employer-sponsored arrangements. The great benefit for the small firm is that a Simple Plan looks like a 401(k) plan to employees, but the maximum employer contribution is only 3% of pay. A Simple Plan is easy to create and administer. The downside is that a Firm can have no other plans, so if the maximum contribution per employee (@$15,000 with the match) is not enough, the owners are out of luck.

Important Simple Plan Facts:

- **When to Set Up**: Because it requires salary reduction contributions, a Simple Plan should be set up at the beginning of the year. IRS rules allow it to be set up as late as September of the year (or later for a new employer).
- **Maximum Salary Deferral Contributions**: $9,000; $10,500 if 50 or older.
- **Required Firm Contribution**: Either 2% of pay, or a dollar-for-dollar match on salary deferrals up to 3% of pay.
- **Other Plans**: No other employer-sponsored plans are allowed, but employees may contribute to a traditional or Roth IRA under the rules above.
- **Tax Treatment**: Just like a SEP.
- **Who Does Them**: Any financial institution that sponsors IRAs.
- **Administrative Complexity and Costs**: Low. Requires payroll deduction contributions.

4. **401(k) Plan – The Plan That Everyone Knows** – Most employees have heard of 401(k) plans, and many employees expect a 401(k) plan as an employee benefit. In certain markets, the absence of one may prevent a Firm from recruiting the best employees.

Salary deferrals, and the ability to direct the investment of those deferrals, are the core attributes of a 401(k) plan. However, other types of contributions may be made. Most 401(k) plans are designed to allow the Firm to make matching contributions (which are generally made in the range of 1% to 6% of pay) and year-end profit sharing contributions.

All qualified plans impose administrative responsibilities on a Firm, but 401(k) plans require more than most, because of payroll and investment obligations, and the special nondiscrimination and payment rules that apply only to 401(k) plans. The Firm will have to hire an investment adviser and a recordkeeper, it will have fiduciary responsibilities, and it will have to be regularly involved in the administration of the plan.
Who Should Consider a 401(k) Plan:

- Any Firm with the resources to handle an administratively demanding plan that wishes to attract employees who expect a 401(k) plan – in other words, most established Firms with employees.
- A sole practitioner with no employees seeking a significant tax shelter. Up to $41,000 a year can be contributed as a discretionary profit sharing contribution.

Important 401(k) Plan Facts:

- **When to Set Up:** The plan has to be in place before the compensation that is deferred is payable, but in any case before the end of the year. For sole proprietors, the plan may be set up as late as December 31 because income is not determined until the end of the year.
- **When to Contribute:** Salary deferral contributions must be made each payroll period.
- **Restrictions:**
  - Must meet coverage tests and be nondiscriminatory. Generally, this means that most employees must be covered, and that contributions (or the opportunity to make salary deferral contributions) be about the same for all employees. Salary deferrals and matching contributions of the nonhighly compensated employees must be within a certain ratio of the salary deferrals and matching contributions of the highly compensated.
  - Safe harbor contributions (around 3% of pay) can be made that result in the automatic satisfaction of the nondiscrimination rules for salary deferrals and matching contributions.
- **Contributions:**
  - Maximum total contribution: The lesser of $41,000 or 100% of pay per year. *Note: compare the 100%-of-pay limit for qualified plans to the 25%-of-pay limit for SEPs.*
  - Maximum salary deferral: $13,000 ($16,000 for employees who have attained age 50).
- **Tax Treatment of Payments:** Payments may be rolled over tax-free to another retirement vehicle. Amounts not rolled over are subject to income tax and an additional 10% tax for withdrawals before age 59 ½, with some exceptions.
- **Estimated Costs:** Moderate to Costly. A 401(k) plan for a sole practitioner with no employees could cost only $250 per year, plus investment fees. A full-blown plan with employees will cost significantly more, depending upon the number of employees and the financial institution. *Note: in most 401(k) plans the bulk of the expenses are paid from plan accounts either as a percentage of assets, or as investment fund fees.*
- **Administrative Complexity:** Medium. Requires a plan document that must be kept up to date. Requires an annual report (Form 5500), unless it is the plan of a sole proprietor with no employees. Requires employee booklets. Requires payroll deduction forms and procedures. Requires investment procedures.
5. **Comparability Plans – More for Older Owners** – This is a 401(k) plan or profit sharing plan with two additional features that make it extremely favorable to lawyers who have been in practice for a number of years:

- First, these plans allocate greater levels of contributions to older employees, even if they are owners or highly compensated. The plan is not discriminatory because contributions are tested on the basis of the value of accounts projected to retirement. Under this method of testing, a contribution of $1,000 made today for a 30-year old that is projected to grow with earnings to $10,000 when the employee is 65 is considered equal to a contribution of $10,000 made today for a 65-year old.

The chart below shows an example of how this works.

<table>
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<th>NAME</th>
<th>AGE</th>
<th>PAY</th>
<th>CONTRIBUTION</th>
<th>% of PAY</th>
<th>PROJECTED BENEFIT (% OF PAY)</th>
</tr>
</thead>
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<tr>
<td>OWNER</td>
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<td>$40,000</td>
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<td>6.25%</td>
<td>20.549%</td>
</tr>
<tr>
<td>NHCE#2</td>
<td>27</td>
<td>$20,000</td>
<td>$1,250</td>
<td>6.25%</td>
<td>17.455%</td>
</tr>
</tbody>
</table>

The highly compensated owner receives a contribution of 40% of pay, while the other employees receive only 6.25% of pay, but the arrangement is nondiscriminatory because the other employees are young, and their projected benefits are greater than the projected benefit of the owner.

- Second, these plans allow different levels of contributions for different groups of employees, so long as each group is nondiscriminatory. For example, the plan might have three groups – associates and counsel, the litigation group, and all other employees - with different levels of contributions for each group.

The IRS has established a safe harbor for comparability plans that requires that all participants covered by a comparability plan receive a minimum contribution of 5% of pay (or the highest percentage received by a highly compensated employee, if less). As many plans were already committed to a 3% contribution (because of top heavy or 401(k) safe harbor commitments), the safe harbor requires an additional commitment of only 2%, and consequently many plans are being designed to meet the safe harbor.

*Comments:* These plans can work well for law firms that have highly compensated employees (such as associates and counsel) who can be excluded or given lower levels of contributions than other groups – meeting the nondiscrimination tests is easier if some highly compensated employees are excluded. These plans are trickier than other qualified plans because they must be actively tested for nondiscrimination, and because they may be difficult to explain to employees.

*Who Should Comparability Plans:* A firm with the resources to handle an administratively demanding plan that wishes to maximize the contributions made to older
owners, and/or that wishes to make different levels of contributions among different groups of the Firm’s employees.

**Important Comparability Plan Facts:**

- **When to Set Up:** If the plan includes salary deferrals, the plan has to be in place before the compensation that is deferred is payable, but in any case before the end of the year.
- **Restrictions:** Same as for 401(k) plan, but in addition special nondiscrimination tests must be run every year.
- **Contributions:**
  - Same as a 401(k) plan: The lesser of $41,000 or 100% of pay per year.
  - Minimum 5% contribution for all covered employees.
- **Tax Treatment of Payments:** Same as for 401(k) plan
- **Who Does Them:** Many financial institutions and recordkeepers – such as banks, mutual funds, brokerage firms, insurance companies. *Note: A local recordkeeper is a good choice because a “hands-on” approach is helpful.*
- **Administrative Complexity and Costs:** High. More costly than a 401(k) plan.

6. **Defined Benefit Plan** – A defined benefit plan (or “pension plan”) promises a lifetime monthly benefit determined by a formula that takes into account employees’ compensation and years of service. An older sole practitioner with no employees (or possibly with a few young employees) might consider a defined benefit plan because the contribution limits are much higher than for 401(k) plans and defined contribution plans. For example, a 55-year old sole practitioner might be able to contribute $100,000 to a defined benefit plan (versus a maximum of $41,000 for a 401(k) plan).

Defined benefit plans pose significant risks for a Firm. An actuary determines the minimum and maximum contributions every year based on employee data and the investment returns of the fund, and the Firm is required to make the minimum contribution, whether or not the Firm is profitable that year. Further, older employees are expensive under defined benefit plans. Finally, it is difficult to extricate a Firm from a defined benefit plan if the plan is underfunded. These risks, plus the fact that defined benefit plans are expensive to administer, make them appropriate in limited situations.

**412(i) Plans:** A simpler approach to the administration of defined benefit plans is a “412(i) plan,” which is available only from insurance companies. The benefits are fully funded each year by purchasing individual level premium annuity contracts. No actuary is required, but contributions are required every year. A *significant concern with 412(i) plans is the high cost of the insurance contracts, which have high sales loads (as much as 4%) and low investment returns (currently as low as 1.5% or 2% per year till retirement).*
Important Defined Benefit Plan Facts:

- **Maximum Contribution**: Depends upon the benefit formula and the contributions determined by an actuary.
- **How to Set Up**: An actuary must determine contributions and administer the Plan. Some insurance companies sponsor “412(i) plans.”
- **Estimated Costs**: $1,000 to $3,000 a year for actuarial and administrative costs, plus investment expenses, with increases as the number of employees covered increases.
- **Administrative Complexity and Costs**: High.
- **Caveat**: These plans are a big commitment. 412(i) plans, though simpler to administer, are very expensive.

Retirement plans are essential for Firms, owners, and employees, but they are a significant cost and administrative commitment. Firms should carefully review the choices for retirement plans and choose the plan that is within their financial and administrative capabilities. The time spent choosing the right adviser and the right plan will be well spent.

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