FINANCIAL PLANNING'S NEW AGE: BUDGET AND SOUL

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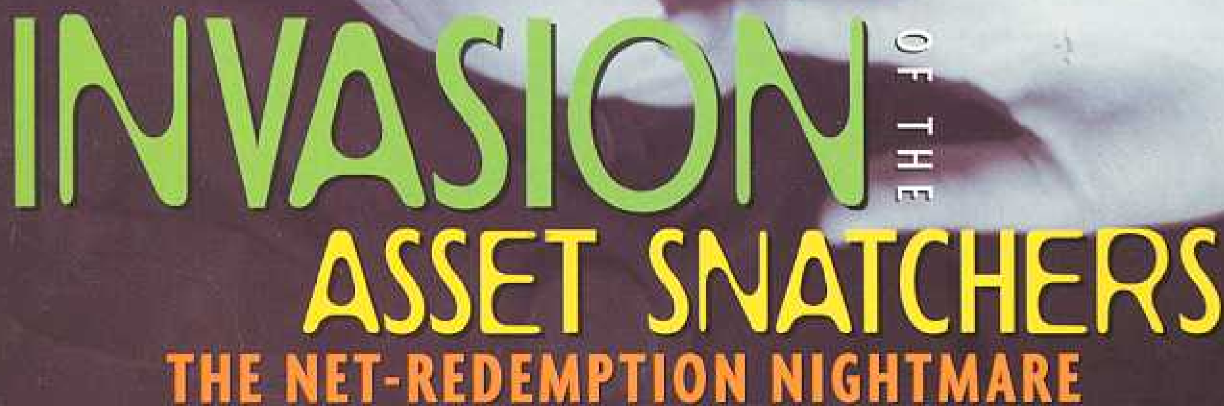
INSIGHT AND INFORMATION FOR THE FINANCIAL ADVISER



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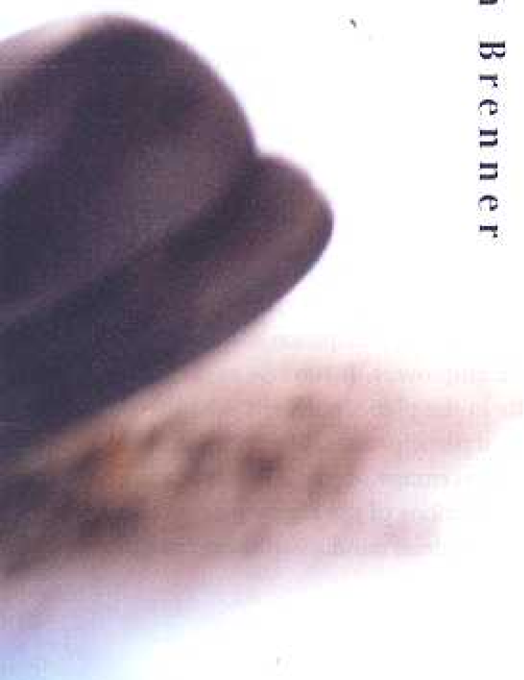
By Lynn Brenner

Many advisers turn up their noses at the idea of developing and managing retirement plans for small businesses, but the work can be surprisingly rewarding

Photographs by Neal Brown



Quick

If you were asked to create a retirement plan for a small business, would you scent a money-making opportunity—or a big potential headache? Bet you're already searching for a couple of aspirin and a polite excuse. After all, everyone knows pension plans with fewer than 25 participants or less than $10 million in assets pay too little and take too much time and expertise to be worth tackling.

Well, guess what. Everybody's wrong.

The truth is that small-company plans are a potentially lucrative market niche. We had to search for financial advisers who are active in this market—but those we found say that small-company retirement plans account for 30 to 40 percent of their business. One of them, Jane King, president of Fairfield Financial Advisors in Wellesley, Mass., notes that many certified financial planners avoid this niche because they're only interested in managing money. "What they don't realize," she says, "is that in this market they can create money to manage."

A major reason it has such potential is that the financial advisers who help design and manage small companies' retirement plans are ideally placed to meet all the owners' financial needs. In particular, says Edward Stuart, a principal with Bugen Stuart Korn & Cordaro in Chatham, N.J., advisers can offer a solution to a problem faced by virtually all successful business owners—namely, how to get money out of their companies without paying an exorbitant amount in taxes. Stuart's own firm manages some $125 million in small retirement plans and IRAs. "If the owner takes his profit out as a bonus on top of compensation, more than 40 percent of it will go to taxes," explains Stuart. "We can design a plan to keep that 40 percent, spreading it between him and his employees."

Still, as Stuart and others are quick to point out, conventional wisdom is half-right: retirement plans do demand expertise. "Whenever you're dealing with ERISA [Employee Retirement Income Security Act] and employee–benefit-plan issues, the liability exposure is incredible," says Virginia Stanley, president of Stanley & Associates in Albuquerque, N.M. Advisers can be held personally liable for negligence if their mistakes cause a retirement plan to be penalized or disallowed by the Internal Revenue Service. (See "Beware the Tangle of Red Tape," on page 34.)

Perhaps the biggest opportunity for financial advisers in this market lies in small-business owners' lack of information about retirement plans; most owners have never been approached by a financial adviser. "They don't have a clue what retirement-plan options are available to them," notes Joel Weiner, an adviser in Palatine, Ill., who also runs Professional Training Service, a continuing-education program for financial-services professionals.

Often an adviser's first step must be to explain to small-business owners that they have other retirement-plan options than the ubiquitous 401(k) plan. In fact, as Russ Alan Prince, a consultant in Shelton, Conn., points out, a 401(k) plan is often the worst choice for a small-business owner. "A 401(k) isn't appropriate for a small, privately held business because it doesn't do enough for the owner," says Prince.

The 401(k)'s chief failing is that the amount of money that highly paid employees—the owners, in other words—can contribute depends on the participation and contribution levels of lower-paid employees. If too few rank-and-file workers participate in the plan, compared with the percentage of higher-paid participants, or if the rank and file's contributions, as a percentage of pay, are too low compared with the contributions of the higher-paid workers, the 401(k) plan flunks federal nondiscrimination tests. To

avoid flunking, most companies simply limit the annual contributions of their top earners.

Small-company 401(k) plans typically are top-heavy, says Prince. In other words, more than 60 percent of their assets belong to the owner and other highly paid staffers. When a 401(k) plan is top-heavy, its sponsor is required to make a 3 percent matching contribution for all employees. A small-business owner's typical reaction to this added expense: "A 401(k) plan costs me a lot every year, and I don't even get to save much money in it myself."

It's little wonder, then, that advisers who think only in terms of 401(k) plans don't see much point in going after small-company business. Enrolling and educating rank-and-file employees takes time, and the rank-and-file contributions are too small to generate meaningful compensation—regardless of whether the adviser uses loaded fees or charges a percentage of assets.

In fact, the advisers who serve small 401(k) plans say they do it primarily to accommodate individual clients or to gain entrée to business owners. "Most of my business is asset management for individuals who are business owners," explains Malcolm Greenhill, principal at Sterling Wood Financial in San Francisco. But as a service to his clients, Greenhill also manages 401(k)-plan investments for five firms, in conjunction with a third-party administrator. "Retirement plans aren't a big part of my practice, but they're a great way to add value for clients," he says.

A lot of the value Greenhill adds is in the form of cost savings. The small-401(k)-plan market, he notes, is dominated by insurance products like group annuities—products whose true cost isn't obvious. "I can show clients that

Contributions: The Lid's About to Blow

When section 415(e) of ERISA expires at the end of the year, the result—little heralded until now—is likely to be a flood of new money into small-company retirement plans, along with a big boost in business for financial advisers.

Currently, the law limits an employee's and employer's joint contribution to a defined-contribution plan to $30,000 a year or 25 percent of compensation, whichever is less. It limits the joint contribution to a defined-benefit plan to no more than what's needed to produce a $130,000 annual retirement benefit. And if a company offers both kinds of plans, the total contribution is limited to the maximum allowable amount for either of the two plans.

In other words, explains Steven Lockwood, a pension attorney, if both plans are offered and contributions to a defined-contribution plan total $15,000 a year, the defined-benefit plan can be funded only for a $65,000 retirement benefit. What's more, use of a defined-contribution plan erodes eligibility for a defined-benefit plan. "Under 415(e), a 40-year-old sole proprietor who has saved the $30,000-a-year maximum in a defined-contribution plan for 15 years is not eligible to save in a defined-benefit plan at all," says Lockwood.

Next year, that sole proprietor still won't be able to use both plans to the maximum, but he will regain eligibility for a defined-benefit plan. "He'll be able to switch from a $30,000 annual contribution to his profit-sharing plan to putting $80,000 a year into a defined-benefit plan," says Lockwood.

Of course, qualified retirement plans must include all eligible employees. So the question the small-business owner faces is: How much will it cost me in additional contributions for my employees to be able to save the maximum for myself?

The answer depends primarily on employee demographics. As the accompanying story explains, defined-benefit plans, by nature, favor older employees over younger ones.

Don't be concerned if you weren't aware of the upcoming change in the law. The history of the repeal of 415(e) is convoluted. In 1996 Congress enacted a three-year suspension of the 15 percent excise tax on large retirement-plan balances. Legislators reasoned that this tax was unnecessary because 415(e) served the same purpose—namely, to discourage excessive retirement savings.

The original idea was to bring back the excise tax in 2000, while simultaneously repealing 415(e). Instead, Congress definitively killed the excise tax in 1997 but left the pending repeal of 415(e) in place. And most pension lawyers don't expect any further legislative action in the months ahead. The current political trend, after all, is to encourage retirement saving. —*LB*

their 401(k) plan is paying an extra 1 percent on top of investment-management fees for the insurance contract," he says. "The greater the assets, the more they're paying."

Greenhill generally recommends that plan assets be placed in no-load funds at Charles Schwab. He also saves his clients money by working for a flat fee instead of on a percentage basis. For companies with fewer than 25 employees, he charges $1,500 to set up a plan and $2,800 a year to run it. This fee covers the development of an investment policy statement, along with model portfolios, an employee-enrollment meeting, and two yearly brown-bag–lunch meetings to explain to employees what's happening in the market, as well as quarterly reports to the plan trustees. "And I'm always available to answer employee questions," he adds. The third-party administrator's fees are separate.

Although Greenhill doesn't lose any money under this arrangement, the real payoff for him has been in the new clients the business has brought in. "People get to know and trust you, and business owners like to deal with one person," he says. "One company owner and three employees in plans I manage decided they wanted me to manage their assets [outside the plan]. That made everything worthwhile."

Randolph Shine, an adviser in Deerfield Beach, Fla., has adopted a different strategy. The way Shine sees it, the real money to be had in small retirement plans is not in 401(k)s. It's in age-weighted profit-sharing plans and defined-benefit plans—especially now that the federal cap on total plan contributions is about to expire. (See "Contributions," on page 30.) A financial adviser can earn fees both for helping to design these plans and for managing the assets. "My annual investment-management fee starts at 1 percent on the first $250,000 and scales to 0.065 percent on $1 million or more," says Shine.

Unlike 401(k) plans, defined-benefit plans and age-weighted or "integrated" profit-sharing plans are fully funded by the business. By law, the business must contribute to these plans on behalf of all eligible employees. But—and here's what makes the plans so appealing to small-business owners—the company can make much larger contributions on behalf of older and typically higher-paid employees than younger and typically lower-paid workers. That's because these age-weighted plans are structured to try to ensure that all participants get the same percentage of their salaries as a monthly retirement benefit at age 65. "Contributing $20,000 a year into the plan for a 60-year-old and $4,000 a year for a 30-year-old may work out to equivalent retirement benefits," explains Steven Lockwood, a pension attorney in New York.

Moreover, in integrated defined-benefit and profit-sharing plans, businesses can make a higher-percentage contribution on behalf of workers who earn more than the Social Security wage base. The reason: Social Security discriminates in favor of lower-paid workers. This year the tax is based only on the first $72,600 in wages. "The government lets the employer even the playing field by making an extra private-plan contribution for the higher-paid worker based on the difference between his salary and the Social Security wage base," explains Stuart.

Financial advisers have a competitive edge when it comes to setting up these custom-designed retirement plans. Big financial-services supermarkets, like Fidelity or Charles Schwab, generally don't take the time to analyze a small company's employee demographics in the same detail as an independent comprehensive financial adviser does, says Steven Kaye, president of the American Economic Planning Group in Watchung, N.J. He cites, by way of example, the knee-jerk analysis the owner of a five-employee firm recently received from a big financial supermarket. According to the supermarket analysis, if the owner set up a profit-sharing plan, he would be able to keep only 60 percent of the money going into it. Subsequently, the owner sought advice from Kaye's firm. "When we looked at his employee turnover, we saw no worker lasted for two years," says Kaye. This meant that if the owner set up a plan with two-year cliff vesting, he could keep more than 90 percent of the contributions. So, says Kaye, "that's what we set up."

Small-business owners naturally want a company plan that will benefit them personally. Take the case of a 56-year-old with four employees who earns about $80,000 a year, says Shine. "[Let's assume] the business generates much more than $80,000 and he has no other major assets. He needs a tax deduction, he wants to retire in five years, and he can't be sure how much he'll get for the business because it may not be worth that much without him." With a defined-benefit plan set up to guarantee him $80,000 a year in retirement, the business can make an annual tax-deductible contribution equal to 140 percent of the owner's income. It must contribute for all employees—but because they're younger and earn less, 80 percent of the money going into the plan is earmarked for the owner.

Financial advisers can also often add value to the work they do for small-business owners by taking over the

Beware the Tangle of Red Tape

It may sound easy, but developing retirement plans for small companies is not a slam-dunk service. It's a technical business, governed by complex laws that Congress changes frequently. "A CFP who wants to work in this market has to make a commitment to learning it or team up with others who understand it," says Steven Kaye, president of the American Economic Planning Group in Watchung, N.J.

Granted, every broker-dealer and mutual fund company offers the independent adviser a measure of pension-plan expertise in the form of prototype plan documents. But these documents are no security blanket. Some 200,000 small-company plans are out of compliance with the law, estimates Seymour Goldberg, a Garden City, N.Y., pension attorney who is often called in as an adviser when pension plans are being audited. Many of the audit candidates, he's discovered, have off-the-shelf plans that financial advisers obtained from brokerages, mutual fund companies, or banks. The most frequent problem: plan documents that were improperly filled in or were never amended as required by law. "Is there bad ERISA advice out there? You bet," says Virginia Stanley, president of Stanley & Associates. "There are financial-services–company people offering standard plans who know just enough to be dangerous."

The Internal Revenue Service can disqualify any plan with improper documentation. When that happens, the business retroactively loses its tax deduction for contributions, and the contributions become taxable income for the plan participants. What's more, if the employees have already worked more than 1,000 hours during the year, the business must continue making nondeductible plan contributions until the year ends.

The best recourse when a plan is disqualified is to terminate it as soon as possible, says Stanley. But unfortunately, she says, instead of recommending termination, business owners are often counseled to set up a new plan and roll the dollars into it—a move that just taints the new plan.

Who's liable when a plan is disqualified? Probably not the institution that supplied the prototype documents, says Goldberg. That institution is merely a custodian, not a fiduciary. The employer, however, is almost certainly liable—as is, probably, the financial adviser who provided investment advice and filled out the documents.

The prospect of taking on this much liability scares some advisers. But others see their willingness to assume liability as a major competitive advantage over big financial-services firms. "The client shifts liability when he hires a professional," says Kaye. "All a brokerage or a mutual fund or insurer supplies is a cookie-cutter document, not advice or consulting. What the client needs is a pension professional to customize the plan and a financial planner to integrate it with his personal estate-planning needs. We're fiduciaries." —*LB*

management of the assets in the plan, says Mark Balasa, president of Balasa & Hoffman in Chicago. Today, says Balasa, most small-company retirement plans are managed by insurance companies and brokerage firms, who often invest them in expensive proprietary products. Balasa's firm, on the other hand, which manages about $55 million in small-company retirement-plan assets, invests the money in no-load mutual funds through Charles Schwab and earns an asset-based fee.

Still, it's not enough to offer prudent investment management. To compete in this market, says Stuart, a financial adviser must be able to deliver the whole package. Stuart, for example, depends on his relationship with other professionals—including a tax accountant, an ERISA attorney, and a third-party administrator. He relies on them for their expertise and as a source of referrals. Balasa agrees: "Small-business owners don't reply to blind ads and mailings. Nine times out of 10, our referrals come from accountants and attorneys."

Unfortunately, financial advisers who are primarily interested in investment management often neglect the technical side of retirement plans. (See "Beware the Tangle of Red Tape," above.) "We see a lot of plans put in by advisers who used a boilerplate document but never read its provisions to find out if it really served the client's purposes," says Helen Michelson, vice president of pension-

plan administration at the American Economic Planning Group.

All plan documents must include a definition of eligibility for participation, for example. Some financial advisers use the simplest definition possible: all workers employed as of a certain date. This simple definition might inadvertently include part-time employees. Then, if the business owner doesn't set aside money for them, the plan can be disqualified.

Another common mistake is to assume that to terminate a plan one needs only to stop contributing to it. Not so, says Michelson: "You need a resolution to terminate; you have to notify the employees; and you have to update the plan documents for all regulatory changes since they were last amended—[including] changes that are in effect even though they may not yet be required for submission to the IRS." What's more, the defined-benefit plan cannot legally terminate before it's determined that it has sufficient assets. The plan administrator may also have to notify the Pension Benefit Guaranty Corp. (For more information on how to get up to speed on retirement plans, see "Find Out More," below.)

Jane King considers it part of her job to make sure that her clients' retirement plans comply with the law. She relies heavily on the expertise of independent actuaries. "I don't care if they ever send me clients," she says. "I run stuff past them; they run stuff past me. We're all in specialized areas and need people who'll be responsive when we call—people we can trust. You've got to protect your clients from other people who don't know what they're doing. The money-management piece is how you get paid—but you need to know the rest, too."

Shine agrees. He works with a third-party administrator that has its own preapproved defined-benefit plan. Nevertheless, he submits all plans he's involved with to the IRS for approval. "You don't want to use boilerplate when you're putting $100,000 a year or more into a plan," he says. "That's serious money. It's worth paying $150 to get IRS approval of the documents."

Even though these plans are small, the IRS isn't going to simply ignore them. And if you're looking to build up your business, maybe you shouldn't ignore them either.

Lynn Brenner, author of Smart Questions to Ask Your Financial Advisers *(Bloomberg Press), a 1998 Small Press Award winner, writes a weekly column for* Newsday.

Find Out More

Financial advisers who want to serve small-business owners need to be familiar with all the retirement-plan options available to them. "Without that understanding, it will be very difficult for you to establish a good working relationship with a quality ERISA attorney, who actually creates the plans," explains Dan Moisand, president of Optimum Financial Group in Melbourne, Fla.

You can contact the following organizations for more information about retirement-plan options:

■ **The CFP Board** (www.cfp-board.org, 800-487-1497) has a full list of course offerings at colleges nationwide. Once you've contacted the board's Web site, click on CFP Certification; then select CFP Education Programs.

■ **The American College** (www.amercoll.edu, 610-526-1000) offers self-study courses on the sale and service of employee benefit plans and retirement-plan design.

■ **The International Foundation of Employee Benefit Plans** (www.ifebp.org, 414-786-6700) offers a 10-course study program through correspondence and at community colleges nationwide.

■ **The American Institute of Certified Public Accountants** (www.aicpa.org, 212-596-6200) provides links to state CPA societies, which in turn sponsor workshops and lectures on tax planning and retirement assets by experts like Seymour Goldberg.

■ **Professional Education Systems** (www.pesi.com, 800-826-7155) also sponsors lectures and workshops on tax issues and pitfalls in retirement plans.

■ **The Bureau of National Affairs** (www.bna.com; 202-452-4200; e-mail, icustrel@bna.com) publishes excellent written materials on the tax rules governing pension plans. BNA recommends the Tax Management Educational Institute's annual compensation-and-benefits conference, scheduled for February 7–8, 2000, in San Diego. Cost is $675.

■ **Commerce Clearing House** (www.toolkit.cch.com, 800-835-5224) is also an excellent source of educational material, particularly its *1999 U.S. Master Pension Guide.* —*LB*