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Retirement Plans for Small Businesses

As a business owner, you should carefully consider the advantages of establishing an employer-sponsored retirement plan. Generally, you're allowed a deduction for contributions you make to an employer-sponsored retirement plan. In return, however, you're required to include certain employees in the plan, and to give a portion of the contributions you make to those participating employees. Nevertheless, a retirement plan can provide you with a tax-advantaged method to save funds for your own retirement, while providing your employees with a powerful and appreciated benefit.

TYPES OF PLANS

There are several types of retirement plans to choose from, and each type of plan has advantages and disadvantages. This discussion covers the most popular plans. You should also know that the law may permit you to have more than one retirement plan, and with sophisticated planning, a combination of plans might best suit your business needs.

PROFIT-SHARING PLANS

Profit-sharing plans are among the most popular employer-sponsored retirement plans. These straightforward plans allow you, as an employer, to make a contribution that is spread among the plan participants. You are not required to make an annual contribution in any given year. However, contributions must be made on a regular basis.

With a profit-sharing plan, a separate account is established for each plan participant and contributions are allocated to each participant based on the plan's formula (this formula can be amended from time to time). As with all retirement plans, the contributions must be prudently invested. Each participant's account must also be credited with his or her share of investment income (or loss).

For 2007, no individual is allowed to receive contributions for his or her account that exceed the lesser of 100% of his or her earnings for that year or \$45,000. Your total deductible contributions to a profit-sharing plan may not exceed 25% of the total compensation of all the plan participants in that year. So, if there were four plan participants each earning \$50,000, your total deductible contribution to the plan could not exceed \$50,000 ($\$50,000 \times 4 = \$200,000 \times 25\% = \$50,000$). (When calculating your deductible contribution, you can only count compensation up to \$225,000 (in 2007) for any individual employee).

401(K) PLANS

A type of deferred compensation plan, and now the most popular type of plan by far, the 401(k) plan allows contributions to be funded by the participants themselves, rather than by the employer. Employees elect to forgo a portion of their salary and have it put in the plan instead.

The requirements for 401(k) plans are complicated, and several tests must be met for the plan to remain in force. For example, the higher paid employees' deferral percentage cannot be disproportionate to the rank-and-file's percentage of compensation deferred.

These plans can be extremely expensive to administer, but the employer's contribution cost is generally very small (employers often offer to match employee deferrals as an incentive for employees to participate). Thus, in the long run, 401(k) plans tend to be relatively inexpensive for the employer.

If you don't have any employees (or your spouse is your only employee) a 401(k) plan (an "individual 401(k)" or "solo 401(k)" plan) may be especially attractive. Because you have no employees, you won't need to perform discrimination testing, and your plan will be exempt from the requirements of the Employee Retirement Income Security Act of 1974 (ERISA). You can make a deductible profit-sharing contribution of up to 25% of pay (to \$225,000) on your own behalf in 2007, and in addition you can make deductible pre-tax contributions of up to \$15,500 in 2007 (plus an additional \$5,000 of pre-tax catch-up contributions if you're age 50 or older). However, total annual additions to your account in 2007 can't exceed \$45,000 (plus any age-50 catch-up contributions).

Note: Beginning in 2006, a 401(k) plan can let employees designate all or part of their elective deferrals as Roth 401(k) contributions. Roth 401(k) contributions are made on an after-tax basis, just like Roth IRA contributions. Unlike pre-tax contributions to a 401(k) plan, there's no up-front tax benefit—contributions are deducted from pay and transferred to the plan after taxes are calculated. Because taxes have already been paid on these amounts, a distribution of Roth 401(k) contributions is always free from federal income tax. And all earnings on Roth 401(k) contributions are free from federal income tax if received in a "qualified distribution".

Note: 401(k) plans are generally established as part of a profit-sharing plan.

DEFINED BENEFIT PLANS

By far the most sophisticated type of retirement plan, a defined benefit program sets out a formula that defines how much each participant will receive annually after retirement if he or she works until retirement age. This is generally stated as a percentage of pay, and can be as much as 100% of final average pay at retirement.

An actuary certifies how much will be required each year to fund the projected retirement payments for all employees. The employer then must make the contribution based on the actuarial determination. In 2007, the maximum annual retirement benefit an individual may receive is \$180,000 or 100% of final average pay at retirement.

Unlike defined contribution plans, there is no limit on the contribution. The employer's total contribution is based on the projected benefits. Therefore, defined benefit plans potentially offer the largest contribution deduction and the highest retirement benefits to business owners.

SIMPLE IRA RETIREMENT PLANS

Actually a sophisticated type of individual retirement account (IRA), the SIMPLE (Savings Incentive Match Plan for Employees) IRA plan allows employees to defer up to \$10,500 (for 2007) of annual compensation by contributing it to an IRA. In addition, employees age 50 and over may make an extra "catch up" contribution of \$2,500 for 2007. Employers are required to match deferrals, up to 3% of the contributing employee's wages (or make a fixed contribution of 2% to the accounts of all participating employees whether or not they defer to the SIMPLE plan).

SIMPLE plans work much like 401(k) plans, but do not have all the testing requirements. So, they're cheaper to maintain. There are several drawbacks, however. First, all contributions are immediately vested, meaning any money contributed by the employer immediately belongs to the employee (employer contributions are usually "earned" over a period of years in other retirement plans). Second, the amount of contributions the highly paid employees (usually the owners) can receive is severely limited compared to other plans. Finally, the employer cannot maintain any other retirement plans. SIMPLE plans cannot be utilized by employers with more than 100 employees.

OTHER PLANS

The above sections are not exhaustive, but represent the most popular plans in use today. Recent tax law changes have given retirement plan professionals new and creative ways to write plan formulas and combine different types of plans, in order to maximize contributions and benefits for higher paid employees.

FINDING A PLAN THAT'S RIGHT FOR YOU

If you're considering a retirement plan for your business, ask a plan professional to help you determine what works best for you and your business needs. The rules regarding employer-sponsored retirement plans are very complex and easy to misinterpret. In addition, even after you've decided on a specific type of plan, you will often have a number of options in terms of how the plan is designed and operated. These options can have a significant and direct impact on the number of employees that have to be covered, the amount of contributions that have to be made, and the way those contributions are allocated (for example, the amount that is allocated to you, as an owner).

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