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Employee Retirement Plans for Small Businesses

If you're self-employed or a small business owner, you can benefit from employee retirement plans the same as a large corporation. Qualified retirement plans can bring significant tax benefits and help you attract and retain employees.

In this article, we'll break down 6 retirement plan options for small businesses:

- SEP IRAs
- SIMPLE IRAs
- Self-employed 401(k)s
- Traditional 401(k)s
- Roth 401(k); and
- Multiple Employer Plans

We'll look at the tax benefits of each plan, ease of implementation, and recommend which plans work best in different scenarios.

Why Offer a Retirement Plan?

The most obvious advantage to offering a retirement plan is the tax savings. The income generated by the plan is not subject to income tax, because the income is managed within a tax-exempt trust. Employers are entitled to tax deductions for their contributions to the plan and employees only pay taxes when the funds are distributed to them. As an employer, you may also get a tax credit up to $500 for expenses incurred to start the plan (for the first 3 years).

Offering a retirement plan can also help you attract and keep quality employees. Plans may even enhance employee motivation and productivity. If you're a startup with a tight budget, a retirement plan is one way to augment your compensation package.

Because of vesting rules, employees typically have to stay with a company for years to earn the benefits of a retirement plan – so the plans encourage long-term employment. Of course, offering employees a retirement plan also allows you to take advantage of the plan for yourself.

Rules Common to All Qualified Retirement Plans

Employee retirement plans must be a written program that is communicated to all employees. Plans cannot discriminate in favor of employees who are officers, shareholders, or highly compensated.

Vesting refers to an employee's right to the money set aside in a retirement plan, ensuring employees stick around to earn full benefits. There are two vesting methods: cliff vesting and gradual vesting. While you can set more lenient service requirements, you cannot create more restrictive rules.

Assets in a plan grow tax-free until an employee withdrawals funds, then the distribution is subject to income tax. If an employee under age 59 1/2 makes an early withdrawal, they may also be subject to a 10% penalty fee.

Types of Employee Retirement Plans

Different plans have distinctive rules regarding employee coverage, contributions limits, and administrative responsibilities.

Simplified Employee Pension Plan (SEP IRA)

SEP IRAs can be used by the self-employed and small businesses (with any number of employees).

Implementation & Relevant Rules:
These plans are easy to establish and maintain. There are no annual reporting requirements under ERISA. Employees can withdraw assets at any time.

Contributions:
Contributions can only be made by the employer. Employers can contribute up to 25% of an employee's compensation (up to $56,000). The employer must contribute the same percentage to employee accounts in years they contribute to their own account.

Recommended Use:
If you have employees or plan on having employees in the future and want to fund your employees' accounts by yourself this is the best plan for you. If you have a business with a variable income and want more flexibility, you should consider a SEP IRA, because you don't have to contribute to this plan every year.

Savings Incentive Match Plan for Employees (SIMPLE IRA)

SIMPLE IRAs are available for businesses with 100 or less employees.

Implementation & Relevant Rules:
SIMPLE IRAs take slightly more administrative effort than SEP IRAs. There are typically plan fees that add to the cost of offering these plans. You are not required to file Form 5500 under ERISA, but you have to provide annual employee notifications. Assets can be withdrawn at any time. Withdrawals may be subject to a 25% penalty if taken within the first 2 years of beginning participation.

Contributions:
Employers must contribute to this retirement plan every year. You can opt to offer either a 100% match for employee contributions on the first 3% deferred (which can be reduced to 1% in 2 out of 5 years) or a 2% non-elective contribution on behalf of all eligible employees. Employees can contribute up to 100% of their compensation through salary deferral, not to exceed $13,000. Employees can also make catch up contributions up to $3,000 if they are 50 or older.

Recommended Use:
If you have employees or plan on having employees in the future and want to enable your employees to contribute to their own plans, a SIMPLE IRA is for you.

Solo 401(k) Plan

As the name suggests, this is a 401(k) plan for the self-employed, offering the highest contribution limits of any plan. The catch is that this plan is only available for businesses with no employees. In this context, employees are defined as any person working for the business who does not have an ownership interest.

Implementation & Relevant Rules:
This plan requires a little more effort than an IRA. You will have to submit an annual ERISA report (Form 5500) after plan assets exceed $250,000. You cannot take withdrawals until a trigger event occurs (such as termination of employment or the plan).

Contributions:
Solo 401(k)s recognize that the self-employed wear 2 hats - employee and employer. Both the business entity and the individual owner can contribute to the plan, maximizing potential contributions. The business may contribute up to 25% of eligible compensation and employees can defer up to $19,000 in salary (or $24,500 if age 50 or over). Total annual contributions cannot exceed $56,000 (not counting catch-up contributions).

If your business is not incorporated you can generally deduct contributions for yourself from your personal income. If your business is incorporated, the corporation can deduct the contributions as a business expense.

Recommended Use:
Self-employed 401(k)s are best if you have no employees other than yourself and your spouse (or a business partner) and you want the highest possible contribution limits. Avoid this plan if you intend to add employees in the future.

Traditional 401(k)

401(k) plans must be established by an employer. Contributions are held in a single trust, but each employee's account balance is tracked separately.

Implementation & Relevant Rules:
There are more steps (and costs) to implement a 401(k) plan than most of the other plans listed in this article.

401(k)s require tracking of employee and employer contributions, earnings, losses, investments, expenses, and distributions. You will need all of this information in order to prepare and submit the required annual reports. Because establishing and maintaining a 401(k) can be time-consuming, many employers outsource the responsibility to a financial professional.

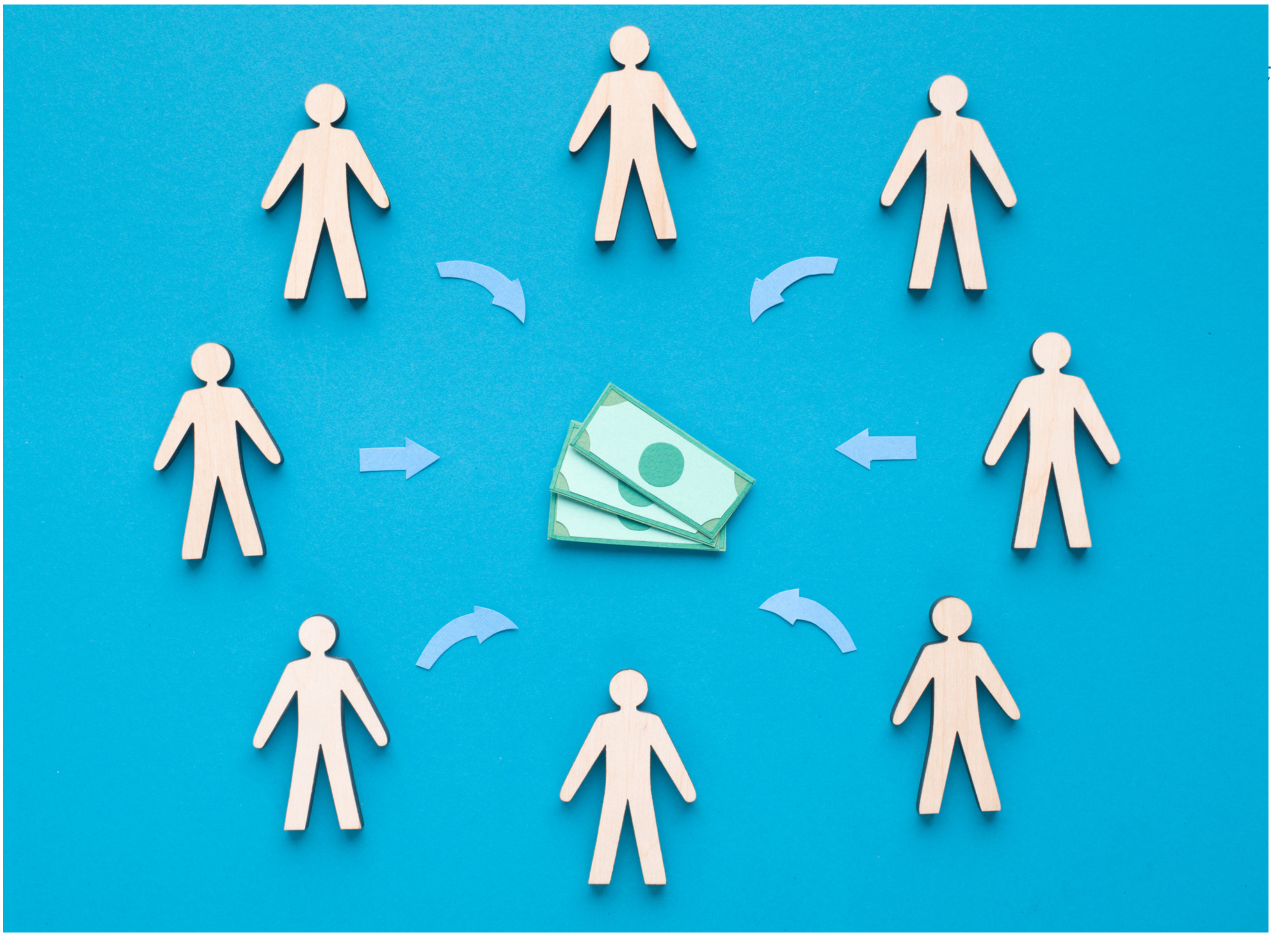
Contributions:
Employees can contribute up to $19,000 (with an extra $6,000 in catch-up contributions over age 50). Employers have the option of making contributions as well - up to 25% of the employee's compensation. Combined contributions are limited to 100% of employee's compensation (up to $56,000).

Employees must reach a trigger event before they can access 401(k) funds (like employment termination, disability, or reaching age 59 ½).

Recommended Use:
Better for larger companies with the financial ability to outsource the management of the plan because of the significant administrative and fiduciary responsibilities

Roth 401(k)

A Roth 401(k) plan is similar to a Traditional 401k plan with one major exception. Contributions by employees are not tax-deferred but are made with after-tax dollars. But, income earned on the account, from interest, dividends, or capital gains, is tax-free. Thus there are no taxes on withdraws from this type of plan.



Multiple Employer Plan (MEP)

MEPs are a way for small, unrelated businesses to pool participants and assets in one large plan, giving employees access to the same cost discounts as large corporations.

Groups can qualify as employers for purposes of sponsoring MEPs as long as the employers are either:

1. In the same trade, industry, line of business or profession, or
2. Have a principal place of business in the same geographic region (either within the same state or metro area).

If you're looking to join an MEP, it may be worth starting with your local chamber of commerce or trade groups which your business is a part of.

Conclusion

The tax aspects of retirement plans and associated rules can be complex and confusing. If you decide that you want to offer employees a retirement plan, you'll want to get professional financial advice. Contact our office to learn more.

About Lewis Hooper Dick, LLC

Lewis, Hooper & Dick, LLC was established in 1955 by Edward Lewis, CPA. Our professionals provide value-added and affordable accounting and advisory services to clients throughout the region. Our dedicated leadership strives to continually grow our practice by instilling our founding principles throughout our organization. The firm's professionals challenge themselves to introduce new and exciting ways to exceed our clients' personal and professional goals. Our experienced and knowledgeable staff continues to be the driving force behind our innovative techniques and ongoing success.

The firm's team of four member/owners and over 20 professionals offers comprehensive accounting, consulting, human resources, financial planning, and tax and computer services. Lewis, Hooper & Dick, LLC specializes in serving feed yards, municipalities, school districts, government entities and construction organizations. We maintain offices in Garden City and Hugoton.

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