

Retirement Options for Small Business Owners

The following is the Fall client newsletter written by Mary Mellem, EA. This installment of the newsletter is addressed to your clients who own small businesses and wish to know how to administrate an effective retirement plan for themselves and their employees.

For those of you who are small business owners, one trick to making your business successful is keeping good employees. Fringe benefits provide incentive to employees to continue to work for you. Retirement plans are just one of many fringe benefits that can be offered.

There are a variety of retirement plans available. It is important to first determine your goal with regard to retirement plans. Your goal may be to provide yourself with the largest retirement benefit available. On the other hand, your goal might be to offer retirement as an incentive to your employees yet minimizing the cost to you. Each type of retirement plan has special features that may help you decide what fits your needs. One key to remember is that discrimination rules apply to pension plans. For retirement plan purposes, it is helpful to know that a sole proprietor is his or her own employee. Here are highlights of some retirement plans.

SEP

A Simplified Employee Pension Plan (SEP) is a plan that is funded solely by employer contributions. Since the revision of pension law in 2002, the contribution limit to this plan has increased to twenty-five percent of compensation (previously fifteen percent). There is an overall limitation of the lesser of twenty-five percent of compensation or \$46,000. This plan is especially beneficial for those of you who are sole owners—whether incorporated or not—who want to contribute a larger amount for yourself. The minimum coverage rules for 2008 require an owner cover all employees who are twenty-one years of age, have been employed for three years, and have compensation of \$500 or more. The plan may be structured to

be more generous in coverage but not less generous. The disadvantage to the plan is that if the business has employees besides yourself, you must contribute to your employees' accounts at the same rate as your own account. If the business is a sole proprietorship, the contribution percentage for you is determined by a formula and does not appear to be as generous as the rate for the employees.

For example, John is a self-employed dentist. He employs a hygienist and a receptionist. He pays \$35,000 in wages and his profit is \$150,000. John wants to maximize his contribution. Because the maximum rate is twenty-five percent, he must contribute \$8,750 for his employees assuming they meet the age, years of service, and compensation requirements.

Another advantage of the SEP is that administrative costs of the qualified plans, such as the 401(k), are not applicable to the SEP. No Form 5500 (Annual Return/Report of Employee Benefit Plan) is required for this plan. It is a very easy plan to implement. Each employee establishes a SEP IRA. You, as the employer, can choose one financial institution or allow each employee to choose the institution he or she likes. Your employee's contribution is fully vested as soon as it is contributed. If the employee terminates employment, the entire contribution belongs to the employee. This plan is the only type that can be set up and contributed to after the close of the tax year and be deductible for that tax year. The contribution must be made by the due date of the return plus extensions.

SIMPLE

A Savings Incentive Match Plan for Employees (SIMPLE) is the pension plan answer for those of you who

want to offer a plan for your employees but do not want to spend a lot of money. The SIMPLE has two parts—the deferral contribution made by the employee and the matching contribution made by you, the employer. The deferral contribution is made at the election of the employee. The maximum SIMPLE contribution for 2008 is \$10,500 with an additional catch-up contribution of \$2,500 available to employees who have reached at least the age of fifty by the end of the year. The contribution is limited to the lesser of \$10,500 or 100% of compensation. Generally, you are required to match three percent of the compensation up to the amount the employee contributes. If the employee does not participate, you do not make a contribution. This plan is available to small employers with less than 100 employees. The eligible employee must have had at least \$5,000 of compensation in the preceding two years and reasonably expect to make that in the current year.

Like the SEP, the plan is easy to establish. However, unlike the SEP it must be established by October 1 of the tax year. The deferral contribution must be made by the thirtieth day after the end of the month in which the income was deferred. The matching contribution must be made by the due date plus extensions of the tax return for the year.

401(k)

The 401(k) is a qualified plan that offers a larger deferral opportunity for your employee(s). The maximum deferral is \$15,500 with a catch-up contribution of \$5,000 for those age fifty and over. Like the SIMPLE, you and the employee can participate in the deferral opportunity. A self-employed person is deferring a part of net profits from the Schedule C or F since no W-2 is issued to a self-employed person.

This plan cannot discriminate with regard to employees. However, you need not cover those under twenty-one and those who have less than one year of service (1,000 hours). You can always be more generous with coverage as long as all your employees are treated consistently.

The plan must be established before the end of the year. Your employees will be

required to choose their level of participation. Because the plan is more formal, you must file a Form 5500 annually. This is an information return monitoring the plan.

Many 401(k) plans are combined with profit-sharing plans in which the employer makes contributions in addition to the employee's deferral. This matching contribution is usually limited to a certain percentage of compensation.

The deferral contributions must be deposited by the fifteenth day of the month following the deferral. The matching contributions must be made by the due date plus extensions of the tax return for the year.

This plan has become more popular with the self-employed businessperson. So, for those of you who are self-employed, this plan is something to consider. The Solo 401(k) is a modern name for the 401(k) that covers a one-man show. Due to the pension revisions, the sole owner's contributions formula makes the plan more attractive than it previously was.

Profit Sharing Plan

The pure Profit Sharing Plan is a discretionary contribution plan. You can choose to make a contribution for the year (or not) depending on the profitability of your business. Contributions must be made based on a formula that does not discriminate. These plans also require the filing of Form 5500-EZ.

Keogh Plan

Qualified plans set up by self-employed individuals are sometimes called Keogh or H.R. 10 plans. They can be either defined contribution or defined benefit plans. Prior to the 2002 pension reform bill, it was common practice to combine the two plans as one paired plan. The profit sharing plan had a maximum contribution of fifteen percent. However, to increase the contribution percentage, it was combined with a money purchase plan creating an additional ten percent contribution for a total of twenty-five percent. This plan had to be established by the end of the tax year but could be funded by the due date of the return plus extensions. It requires the filing of Form 5500-EZ.

Defined Benefit Plan

The defined benefit plan is a plan suitable for the highly-compensated individual who wants to put away more money than the other plans offer. This plan works backwards to determine the allowable contribution. The theory of the plan is to first establish the amount of retirement dollars that is desired. The contribution is actuarially determined and is based on the amount of money needed to produce the desired dollars at retirement. The benefit to be paid out is limited to 100% of the average compensation for the three consecutive years of highest compensation and is capped at \$185,000 for 2008.

IRA

If you do not want to bother with a formal pension plan, an IRA can be set up as a retirement option. You can make a contribution to your own IRA independently or you can make contributions for your employees. Employer contributions would increase the wage of your employees with the contribution being potentially deductible on the employee's personal return. The maximum IRA contribution is \$5,000 with a \$1,000 catch-up contribution available to those fifty and older.

Conclusion

There are many options available. This article in no way provides all the possibilities. If you are looking for retirement options for your small business, this information should give you a taste for what is available. It is important to determine what you wish to achieve with a retirement plan. Discuss your options as a small business owner/employer with your enrolled agent and a financial advisor to make sure your objectives are met.

If you'd like the text of this newsletter to make it more customizable or as source material for your own client newsletter, please email to mmitchell@naea.org. Alternatively, you can find the text of this article at www.naea.org under "Publications."