Taking Cash Out: Retirement Plans

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Helping Small Business Owners Make the Right Choice

Surveys show that small business owners are woefully uninformed about retirement plan options. For example, according to the Employee Benefits Research Institute, 54% of small employers without a retirement plan have never even heard of simplified employee pension (SEP) plans.

Small business owners are better able to make the right retirement plan choice when they understand the unique features of each type of plan.

For small business owners, the most important considerations for selecting a retirement plan are costs, simplicity, and the owner's personal financial benefit. In other words, an ideal plan would allow owners to salt away a maximum amount for themselves with a minimum of costs and red tape. With that in mind, let's look at the options.

Payroll Deduction IRA

This is probably the simplest retirement arrangement that a business can set up. No plan documents are required and no forms need be filed.

Under a payroll deduction IRA, an employee establishes an IRA (either a Traditional IRA or a Roth IRA) with a financial institution. The employee then authorizes a payroll deduction for the IRA. The employer's responsibility is simply to transmit the employee's authorized deduction to the financial institution [IRS Pub. 3998 (2002)].

The plan is funded entirely by employees. Each employee, including the owner, can contribute up to $4,000 (for 2005-2007) [IRC Sec. 219(b)(5)(A)]. Additional “catch-up” contributions of $500 ($1,000 in 2006) per year are permitted for employees age 50 and over [IRC Sec. 219(b)(5)(B)].

As with all IRAs, participant loans are not allowed. In-service withdrawals are allowed, but may be subject to income taxes and a 10% penalty tax under the normal IRA rules.

Simplified Employee Pension

Under a SEP, the employer makes contributions to traditional IRAs set up for each eligible employee. SEP-IRAs are funded solely by employer contributions. Each SEP-IRA is owned and controlled by the employee. The employer sends the SEP contributions to the financial institution where the SEP-IRAs are maintained.

Available to employers of any size or type of organization, a SEP can be set up by adopting IRS Form 5305-SEP or an individually designed plan document. An employer can not maintain any other retirement plan (except another SEP) if Form 5305-SEP is used.

An employer generally has no filing requirements with regard to a SEP. The annual reporting required for qualified plans (Form 5500 series) is normally not required for SEPs.

An individual is an eligible employee if he or she (1) has attained the age of 21, (2) has worked for the employer in at least 3 of the last 5 years, and (3) has received at least $450 (subject to annual cost-of-living adjustments) in compensation from the employer in 2005 [IRC Sec. 408(k)(2)].

SEPs generally require that allocations to all employees' SEP-IRAs be proportional to their salaries or wages. In the case of the self-employed, the contribution is based on net profit minus one-half the self-employment tax minus the contribution for the self-employed individual [IRC Sec. 408(k)(5)].

Total contributions to each SEP-IRA cannot exceed the lesser of $42,000 for 2005 (subject to cost-of-living adjustments for later years) or 25% of compensation (limited to $210,000 per participant for 2005) [IRC Sec. 402(h)(2)].

An employer cannot make “catch-up” contributions for SEP participants age 50 and over. However, an eligible participant can make an up-to-$500 catch-up contribution in 2005 to the IRA that holds the SEP contributions if the SEP-IRA documents allow it.

Participant loans are not permitted and the usual IRA rules apply to distributions.

SIMPLE Plan

A Savings Incentive Match Plan for Employees, known as a SIMPLE Plan, is usually an IRA-based arrangement that allows employees to elect to defer a part of their salaries into the plan for retirement. (SIMPLE-401(k) arrangements are also available, but are rare). Under a SIMPLE IRA, employees and employers make contributions to IRAs set up for employees, subject to certain percentage-of-compensation and dollar limits [IRC Sec. 408(p)].

SIMPLE IRAs can be set up by employers with 100 or fewer employees. However, there is a 2-year grace period during which growing employers are still eligible even if they go over the 100-employee limit. Employers with a SIMPLE IRA plan cannot maintain another retirement plan.

Employees can contribute up to $10,000 in 2005 to a SIMPLE IRA [IRC Sec. 408(p)(2)(E)(i)]. If the employee is age 50 or over, a catch-up contribution is also allowed up to $2,000.

Employers make either (1) a contribution matching employees' contributions dollar-for-dollar up to 3% of compensation or (2) a 2% non-elective contribution for each eligible employee (even if the employee doesn't make his or her own contributions to the SIMPLE IRA) An employer may reduce the 3% matching contribution to a lower percentage, but not lower than 1%. The employer may not lower the 3% for more than 2 calendar years out of the 5-year period ending with the calendar year the reduction is effective

A SIMPLE IRA can be established by using an IRS model form available from sponsoring financial institutions. If employees are allowed to select the financial institutions that will receive their SIMPLE IRA plan contributions, the employer completes Form 5304-SIMPLE. If the employer requires that all contributions under the SIMPLE IRA plan be initially deposited with a designated financial institution, Form 5305-SIMPLE is completed.

An employer can choose to cover all employees without restriction. Alternatively, an employer can limit the employees covered by the SIMPLE IRA to those who received at least $5,000 in compensation during any 2 years prior to the current calendar year and who are reasonably expected to receive at least $5,000 during the current calendar year IRA [IRC Sec. 408(p)(2)(C)(i)].

Participant loans are not allowed. SIMPLE IRA distributions are generally subject to the usual IRA rules. However, if a withdrawal occurs within the first 2 years of an employee's participation, the normal 10% penalty for early IRA withdrawals is increased to 25% [IRC Sec. 72(t)(6)].

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Safe Harbor 401(k) Plans

Many small businesses shy away from 401(k) plans. They believe there are too many hassles and expenses. However, these problems can be reduced to some extent through the use of a “safe harbor” 401(k) plan.

The Internal Revenue Code generally requires that 401(k) plans provide substantive benefits for rank-and-file employees, as well as business owners. These requirements are referred to as non-discrimination rules and require a certain level of plan benefits for rank-and-file employees when compared to owners and other “highly compensated employees”. As a result, traditional 401(k) plans are subject to annual testing to assure that the amount of contributions made on behalf of rank-and-file employees is proportional to contributions made on behalf of owners and managers [IRC Sec. 401(k)(3)]. This, in turn, drives up the administrative burdens and the cost.

Safe harbor 401(k) plans are exempt from annual non-discrimination testing [IRC Sec. 401(k)(12)]. They are considered non-discriminatory by design, so no testing is needed. Under a safe harbor plan, an employer matches each eligible employee's contribution dollar for dollar up to 3 percent of the employee's compensation, and 50 cents on the dollar for the employee's contribution between 3 percent and 5 percent of compensation.

Alternatively, an employer can make non-elective contributions equal to 3 percent of an employee's compensation to each eligible employee's account. Each year the employer must make either the matching contributions or the non-elective contributions.

All employee contributions and required employer contributions are immediately 100% vested.

Some employees may be excluded from a safe harbor 401(k) plan. These include (1) employees who have not attained age 21, (2) have not completed a year of service, or (3) are covered by a collective bargaining agreement that does not provide for participation in the plan.

The amount employees can contribute to their accounts before taxes under a safe harbor 401(k) plan is limited to $14,000 in 2005 (increasing to $15,000 in 2006.) [IRC Sec. 402(g)(1)(A)]. Safe harbor 401(k) plans can allow for additional catch -up contributions for employees aged 50 and over: The maximum “catch-up” contribution is $4,000 for 2005 ($5,000 for 2006).

The annual amount that can be added to a participant's account from all sources for 2005 is limited to the lesser of (1) 100% of compensation or (2) $42,000 for 2005 (adjusted annually for inflation). The maximum an employer can contribute is 25% of the business's payroll (with only the first $210,000 of each participant's compensation taken into account for 2005). For this purpose, an employee's elective contributions are not counted as an employer's contributions.

As with traditional 401(k) plans, safe harbor plans are usually required to file an annual Form 5500.

Participant loans are permitted, up to a maximum of $50,000. Distributions generally cannot be made from a 401(k) plan, including a safe harbor plan, until an employee retires, dies, becomes disabled, terminates employment, reaches age 59-1/2 or suffers a financial hardship.

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Solo 401(k) Plans

A solo 401(k) plan is a relatively new concept, designed for business owners (whether the self-employed, partners, or corporation owners) with no employees other than their spouses. In this situation, the owners can contribute the maximum possible amounts for themselves without having to make comparable contributions for rank-and-file employees. And, since the plan covers only owners (and their spouses), it's not subject to the administrative rules and non-discrimination testing that are generally required for regular 401(k) plans.

With a solo 401(k) plan, the business owner can elect to defer up to $14,000 of his or her compensation to the plan for 2005 ($18,000 if the owner is age 50 or older). In addition, the business can make a maximum contribution to the plan of up to 25 percent of the owner's compensation (or a little less if the owner is self-employed). Total contributions cannot exceed the lesser of $42,000 for 2005 or 100 percent of compensation [IRC Sec. 415(c)(1)].

Example: Mary is the sole owner and employee of an incorporated business. Her compensation in 2005 is $110,000. Mary sets up a solo 401(k) plan for her retirement. Her corporation can contribute 25% of $110,000, or $27,500. In addition, Mary can make an elective 401(k) contribution of $14,000. As a result, total plan contributions on Mary's behalf equal $41,500, which falls just below the required limit on total contributions.

Solo 401(k) plans are not required to file Form 5500 if plan assets are less than $100,000. But, even if filing is required, a simplified Form 5500EZ may be available. In other respects, solo 401(k) plans are like traditional 401(k) plans (e.g., plan loans are allowed within limits).

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