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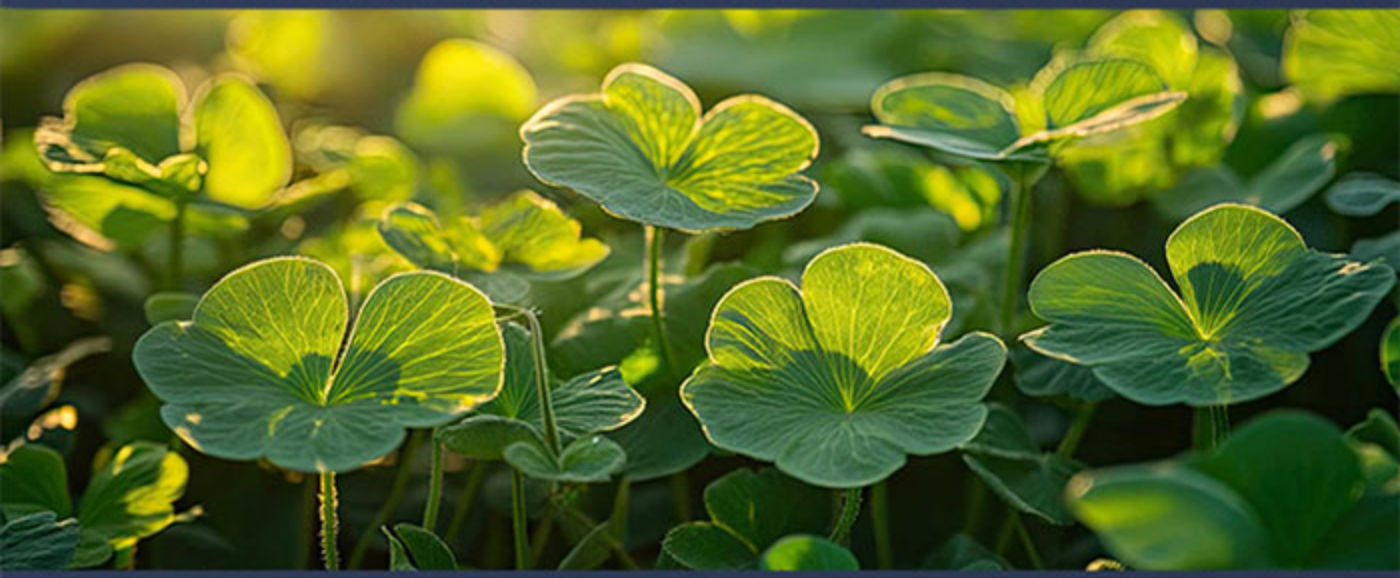

Choosing A Retirement Plan For Your Business

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WHY HAVE A RETIREMENT PLAN?

A retirement plan set up through your business allows you to accumulate and save for your own retirement in a tax-advantaged manner, even if you are self-employed. If you have employees, retirement plans may offer tax savings to your business while helping you attract and retain qualified employees.

In the private-sector, there are essentially three types of retirement vehicles: Individual Retirement Arrangements (IRAs), defined contribution plans, or defined benefit plans—each type has different features and requirements.

IRA BASED PLANS

People tend to think of an IRA as something that individuals establish on their own, but an employer can help its employees set up and fund their IRAs. With an IRA, the amount that an individual receives at retirement depends on the funding of the IRA and the earnings (or losses) on those funds.

A traditional IRA is 100% taxable as income when funds are withdrawn, while a Roth IRA is funded with after-tax dollars so withdrawals are tax-free as long as all IRS rules are followed.

1. Payroll Deduction IRA Plan

Even if a business owner doesn't want to adopt a retirement plan, they can allow employees to contribute to an IRA through payroll deductions, providing a simple and direct way for employees to save. Any employer or sole proprietor can set up a payroll deduction IRA program as a convenience to their employees (and themselves) to help them save for retirement. Allowing payroll deductions throughout the year helps people save continuously, rather than deciding during tax season that they can't afford to contribute a big lump sum to their IRA this year.

Employees decide if, when, and how much to contribute at any time; the contribution limit for 2024 is $7,000, or $8,000 for participants age 50 or over. To participate, employees first establish their own personal IRA or Roth IRA, then as the employer, you simply set things up so that employees can make contributions through payroll deductions; you just transfer their desired amount to their selected financial institution.

There are no IRS forms to complete, but you must allow all employees to participate with no service-length requirements, and everyone is immediately 100% vested. The program can be discontinued at any time without penalty. With a payroll deduction IRA plan, employers have no fiduciary liability because the retirement plan is not employer-sponsored—employees are responsible for meeting all IRS requirements and taking any applicable tax deductions. If your goal is to attract/retain employees, this sort of plan may not be seen as that valuable by some employees.

2. SEP (Simplified Employee Pension) IRA Plan

Sole proprietors, partnerships, and corporations, including S-corporations, can establish a SEP IRA plan. A SEP plan allows business owners to set up and contribute to separate IRAs for themselves and each of their employees. In fact, with a SEP IRA, employers are the only ones who contribute, although they don't have to contribute every year, offering flexibility during low-profit years.

Employers must contribute a uniform percentage of pay for each employee, and employer contributions are limited to the lesser of 25% of pay or $69,000 for 2024. NOTE: If you're self-employed, your contributions are generally limited to 20% of your net income using calculations set by the IRS. Contributions are generally tax deductible as long as all IRS requirements are met, and your business pays no taxes on the investment earnings.

SEPs have low start-up and operating costs and can be established using a two-page form (Form 5305-SEP). There is no annual filing requirement for the employer—the plan is managed and filings are made by a bank or financial institution.

If you choose to set up a SEP IRA plan, it must be offered to all of your employees who are at least 21 years old, in your employ for three of the last five years, with a compensation of $750 or more for 2024. You must base the employee's SEP plan contribution on the employee's entire plan-year compensation. Loans are not allowed, but withdrawals can be made subject to tax laws. In 2024, due to the SECURE Act 2.0, Roth IRA accounts can now be used in SEP IRA plans.

3. SIMPLE (Savings Incentive Match Plan for Employees) IRA Plan

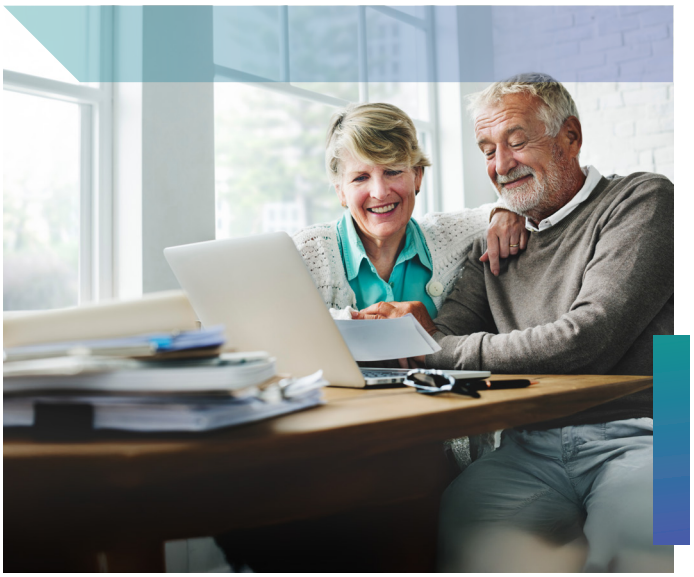
A SIMPLE IRA plan is a retirement plan option for organizations with 100 employees or less. Any employer—including self-employed individuals, tax-exempt organizations and governmental entities—with no more than 100 employees who received $5,000 or more in compensation during the preceding calendar year can establish a SIMPLE IRA plan if they don't currently maintain another retirement plan.

Unlike a 401(k) plan, SIMPLE IRA plans are required by law to match employee contributions. Employees can contribute a percentage of their salary each paycheck and employers must either match employee contributions dollar for dollar up to 3% of an employee's salary–or make a fixed contribution of 2% of compensation for all eligible employees, even if the employees choose not to contribute.

Tax credits may be available for both employees and employers with a SIMPLE IRA. Contributions by employees are optional—they decide the amount and employee contributions up to $16,000 are allowed in 2024, or $19,500 for participants age 50 or over.

SIMPLE IRA plans are easy to set up and administration costs are generally low. An employer may use IRS Form 5304-SIMPLE or 5305-SIMPLE to set up the plan. There is no annual filing requirement for the employer; a bank or financial institution handles most of the paperwork. You can have your employees set up their own SIMPLE IRAs at a financial institution of their choice or have all SIMPLE IRAs maintained at one financial institution you choose.

SIMPLE IRA plans have rules that can be less complicated to administer than a 401(k), because they do not require non-discrimination or top-heavy testing, vesting schedules, or tax reporting at the plan level.



Employees can decide how and where the money will be invested, and keep their SIMPLE IRAs even when they change jobs. Matching employer contributions belong to the employee immediately and can go with them whenever they leave, regardless of tenure. Loans are not allowed.

NOTE: As of January of 2023, SIMPLE IRAs can use Roth accounts but are not required to. This changes things in terms of salary reductions, since Roth account contributions are taxed in the year contributions are made.

DEFINED CONTRIBUTION PLANS

Defined contribution plans are employer-established plans that do not promise a specific benefit at retirement. Instead, employees or their employer (or both) contribute to employees' individual accounts under the plan, sometimes at a set rate (such as 5% of salary annually). At retirement, an employee receives the accumulated contributions plus earnings (or minus losses) on the invested contributions.

1. Profit Sharing Plans

With a profit-sharing plan, any employer with one or more employees can make discretionary annual contributions for employees—up to the lesser of 100% of compensation, or $69,000 for 2024. Depending on the plan terms, there is often no set amount that an employer has to contribute each year. However, if you do make contributions, you will need to have a set formula for determining how the contributions are allocated among plan participants.

Profit sharing plans can vary greatly in their complexity, and have funds which are accounted for separately for each employee. There is no model form to establish a profit-sharing plan, and you may need advice from a financial institution or employee benefit adviser. Employers must file annual Form 5500 with the IRS.

Many financial institutions offer prototype profit sharing plans that can reduce the administrative burden on individual employers. Profit-sharing must be offered to all employees at least 21 years old who worked at least 1,000 hours in a previous year, and the employer can deduct amounts that do not exceed 25% of the aggregate compensation for all participants. A vesting schedule may apply.

Employee withdrawals are permitted after a specified event occurs (retirement, plan termination, etc.), and are subject to federal income taxes. Furthermore, the plan may permit loans and hardship withdrawals; early withdrawals are subject to an additional tax.

2. Safe Harbor 401(k) Plans

Any employer with one or more employees can establish a safe harbor 401(k) plan. This type of plan may be ideal for businesses with highly compensated employees whose contributions would be more limited in a traditional 401(k) plan—it permits high level of salary deferrals by employees without annual nondiscrimination testing.

A safe harbor 401(k) plan allows employees to contribute a percentage of their salary each paycheck and requires employer contributions. In a safe harbor 401(k) plan, the mandatory employer contribution is always 100 percent vested. Employees can decide how much to contribute based on a salary reduction agreement, and the employer must make either specified matching contributions, or a 3% contribution to all participants.

For 2024, an employee can contribute $23,000, or $30,500 for participants age 50 or older. The combined employer/employee contribution to a safe harbor 401(k) plan in 2024 is up to the lesser of 100% of compensation or $69,000.

There is no model form to establish a profit-sharing plan, and you may need advice from a financial institution or employee benefit adviser. Generally, it must be offered to all employees at least 21 years old who worked at least 1,000 hours in a previous year. Employers must file annual Form 5500 with the IRS. The employer can deduct amounts that do not exceed 25% of aggregate compensation for all participants and all salary reduction contributions.

3. 401(k) Plans - Traditional or Automatic Enrollment

Any employer with one or more employees can establish a 401(k) plan; these plans have become a widely accepted type of plan for many businesses. With a 401(k) plan, employees can choose to defer a portion of their salary, so that instead of receiving that amount in their paycheck today, the employees can contribute that money into a 401(k) account sponsored by their employer instead. Employee contributions/deferrals are made on a pretax basis but, if the plan allows, the employee can choose to make them on an after-tax (Roth) basis. Contributions are accounted for separately for each employee.

401(k) plans can vary significantly in their complexity. However, many financial institutions and other organizations offer IRS pre-approved 401(k) plans, which can greatly lessen the administrative burden of establishing and maintaining them. Generally, a 401(k) plan must be offered to all employees at least 21 years old who worked at least 1,000 hours in a previous year.

Many 401(k) plans provide for employer matching or additional employer contributions as well as vesting schedules. Employee salary reduction contributions are immediately 100% vested, but employer contributions may vest over time according to plan terms. 401(k) plans may require annual nondiscrimination testing to ensure that the plan does not discriminate in favor of highly compensated employees, and the employer must file an annual Form 5500.

Beginning January 1, 2025, organizations with 401(k) plans must offer automatic enrollment to eligible employees into their 401(k) plans and deduct contributions from their employees' paychecks, although employees can opt out. The SECURE Act 2.0 made this legislative change because they found that mandates can increase plan participation. Default employee contribution rates may rise incrementally through the years.

For 2024, an employee can contribute up to $23,000 into their 401(k), while those age 50 or over can contribute up to $30,500. Combined employee/employer contributions in 2024 can be up to the lesser of 100% of compensation or $69,000. Withdrawals are permitted after a specified event occurs (retirement, plan termination, etc.) and are subject to federal income taxes. Plans may permit loans and hardship withdrawals; early withdrawals are subject to an additional tax.

The employer can deduct the amounts that they contribute or match on their company tax returns, up to 25% of aggregate compensation for all participants.

DEFINED BENEFIT PLANS

Any employer with one or more employees can establish a defined benefit plan which provides a fixed, pre-established benefit for employees at retirement, for example, $1,000 a month. The amount of the benefit is often based on a set percentage of pay multiplied by the number of years the employee worked for the employer offering the plan. Employer contributions must be sufficient to fund the promised benefits.

Defined benefit plans can offer business advantages for some organizations because businesses can generally contribute (and therefore deduct) more each year than in defined contribution plans. In addition, employees often value the fixed benefit provided by this type of plan and can receive a greater benefit at retirement than under any other type of retirement plan.

However, defined benefit plans are often more complex and often more expensive to establish and maintain than other types of plans. There is no model form to establish this plan, so advice from a financial institution or employee benefit adviser is necessary. The business must file an annual Form 5500, and an actuary must determine annual contributions. Generally, a defined benefit plan must be offered to all employees at least 21 years old who worked at least 1,000 hours in a previous year.

A defined benefit plan is primarily funded by the employer, who is required to make contributions as set by plan terms, in an overall amount determined annually by an actuary. Employees may be vested over time according to plan terms. Payment of benefits to an employee begins after a specified event occurs (retirement, plan termination, etc.). The plan may permit loans; early withdrawals are subject to an additional tax.

To discuss your options when it comes to setting up a retirement plan for your business, please contact us.

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Sources: 1. https://www.dol.gov/sites/dolgov/files/ebsa/about-ebsa/our-activities/resource-center/publications/choosing-a-retirement-solution-for-your-small-business.pdf
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