A Quick Guide to Retirement Plans for Small Business Owners

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As a business owner, you may be surprised to find that offering the right retirement plan to your employees may significantly benefit both you and your employees. Here's an overview of all the major features of each kind of retirement plan, including SIMPLE, SEP, 401(k), defined-benefit, and profit-sharing plans.

Small employers cite the following as their major reasons for offering retirement plans, according to the Small Employer Retirement Survey (SERS):

Reasons Small Employers Establish Retirement Plans	
Positive effect on employee attitude and performance	61%
Competitive advantage in employee recruitment and retention	47%
Employers have an obligation to provide a retirement plan for employees	35%
Tax advantage for employees	34%
So the owner can save for retirement on a tax-deferred basis	34%
Tax advantage for key executives	25%
Employees demand or expect it	24%
Availability of an employer tax deduction	22%
Other	5%

Source: "2003 Small Employers Retirement Survey," Employee Benefit Research Institute

The top two business reasons for offering retirement plans—employee attitude and performance and competitive advantage in employee recruitment and retention—show demonstrable evidence that offering a retirement plan will actually bolster your bottom line. This is especially true for businesses dependent on skilled, loyal employees for continued growth.

With the right kind of plan and some assistance with education and administrative issues, you could help "uncovered" Americans gain some retirement benefits—and build a profitable business at the same time.

Overview of small business retirement plans

In choosing the right plan, it pays to have a working familiarity with the different kinds of retirement options. Below, we've compiled the major features of each type of plan, along with an overview of benefits.

Another good source of information on retirement plans can be found at the Department of Labor's website. And, of course, the plan providers you work with should be able to provide you with educational materials.

Simplified Employee Pension (SEP)

A SEP will allow you to set up a type of IRA for yourself and each of your employees. You must contribute a uniform percentage of pay for each employee, although you won't have to make contributions every year. SEPs have low start-up and operating costs and can be established using a two-page form. As a small employer, you can also decide how much to put into an SEP each year, offering flexibility when business conditions vary.

Simplified Employee Pensions (SEP)	
Key advantage	Easy to set up and maintain
Employer eligibility	Any employer with one or more employees
Employer's role	Set up plan by completing IRS Form 5305-SEP. No annual filing requirements for employer
Contributors to the plan	Employer contributions only; 100% tax-deductible
Date to set up new plan	By due date of tax return (including extensions)
Date contributions are due	Due date of tax return (including extensions)
Maximum annual contribution (per participant)	Up to 25% of W-2 wages or 20% of net adjusted self-employment income for a maximum of $50,000 in 2012.
Contributor's options	Employer can decide whether to make contributions year-to-year
Minimum employee coverage requirements	Must be offered to all employees who are at least 21 years of age, were employed by the employer for 3 of the last 5 years and had earned income of $550
Vesting	Contributions are immediately 100% vested
Participant loans	Not allowed
Withdrawals	Withdrawals permitted anytime subject to federal income taxes; early withdrawals subject to tax penalty

Source: Based on the booklet "SEP Retirement Plans for Small Businesses," Department of Labor 2012, and "Retirement Plans for Small Business," IRS, Pub 560

SIMPLE

SIMPLE plans are usually set up as IRAs. They are easy to establish and inexpensive to administer. Your contributions as an employer are flexible: you can either match employee contributions dollar for dollar—up to 3% of an employee's compensation—or make a fixed contribution of 2% of compensation for all eligible employees.

SIMPLE Plans	
Key advantage	Salary reduction plan with little administrative paperwork
Employer eligibility	Any employer with 100 or fewer employees that does not currently maintain another retirement plan
Employer's role	Set up plan by completing IRS Form 5304-SIMPLE or IRS Form 5305-SIMPLE. No annual filing requirements for employer. Bank or financial institution processes most of the paperwork
Contributors to the plan	Employee salary reduction contributions and employer contributions
Date to set up new plan	Generally by 10/1 of the year before the start of the plan
Date contributions are due	Due date of tax return, including extensions; elective deferrals by participants due 30 days after the last day of the month for which contributions are made
Maximum annual contribution (per participant)	Employee: Up to $11,500 in 2012 ($14,000 if age 50+). Employer: Either match employee contributions 100% of first 3% of compensation (can be reduced to as low as 1% in any 2 out of 5 years); or contribute 2% of each eligible employee's compensation (up to $250,000 of compensation in 2012)
Contributor's options	Employee can decide how much to contribute. Employer must make matching contributions or contribute 2% of each employee's compensation (up to $250,000 of compensation in 2012).
Minimum employee coverage requirements	Must be offered to all employees who have earned income of at least $5,000 in any prior 2 years and are reasonably expected to earn at least $5,000 in the current year
Vesting	Employer and employee contributions are immediately vested 100%
Participant loans	None allowed
Withdrawals	Can occur any time after contribution is made, but 25% penalty if withdrawal occurs during 2-year period beginning on the first day of participation

Source: Based on the booklet "SIMPLE Plans for Small Businesses," Department of Labor 2012, and "Retirement Plans for Small Business," IRS, Pub 560.

401(k)

401(k) plans have become a widely accepted retirement savings vehicle for small businesses. They can vary significantly in their complexity. However, many financial institutions and other providers offer prototype 401(k) plans, which can greatly lessen the administrative burden on individual employers.

401(k) Plans	
Key advantage	Permits higher level of salary deferrals by employees
Employer eligibility	Any employer with one or more employees
Employer's role	No model form available. Advice from financial institution or employee benefit advisor may be necessary. Annual filing of Form 5500 is required. Also may require annual nondiscrimination testing to ensure plan does not discriminate in favor of highly compensated employees
Contributors to the plan	Employee salary reduction contributions and/or employer contributions
Maximum annual contribution (per participant)	Employee: $17,000 ($22,500 for participants 50+) in 2012 Employer/employee combined: The lesser of 100% of compensation or $50,000 in 2012
Contributor's options	Employee can elect how much to contribute pursuant to a salary reduction agreement. The employee can make additional contributions, including possible matching contributions, as set by plan terms
Minimum employee coverage requirements	Generally, must be offered to all employees at least 21 years of age who worked at least 1,000 hours in a previous year
Vesting	Employee salary deferrals are immediately 100% vested. Employer contributions may vest over time according to plan terms
Participant loans	Plan may permit loans and hardship withdrawals
Withdrawals	Payment of benefits after a specified event occurs (e.g., retirement, plan termination). Early withdrawals subject to penalty

Source: Based on the booklet "401k Plans for Small Businesses," Department of Labor 2012, and "Retirement Plans for Small Business," IRS, Pub 560.

Profit-sharing

Your contributions as an employer to a profit-sharing plan are discretionary. Depending on the plan terms, there is often no set amount that an employer needs to contribute each year. As with 401(k) plans, profit-sharing plans can vary greatly in their complexity, and prototype plans offered by financial institutions can reduce the administrative burden on individual employers.

Profit-Sharing Plans	
Key advantage	Permits employer to make large contributions for employees
Employer eligibility	Any employer with one or more employees
Employer's role	No model form available. Advice from financial institution or employee benefit advisor may be necessary. Annual filing of Form 5500 is required
Contributors to the plan	Annual employer contribution is discretionary
Date to set up new plan	By year end (generally Dec. 31)
Date contributions are due	Due date of tax return, including extensions
Maximum annual contribution (per participant)	Employee: $17,000 ($22,500 for participants 50+) in 2012 The lesser of 100% of compensation or $50,000 in 2012. Employer can deduct amounts that do not exceed 25% of aggregate compensation for all participants
Contributor's options	Employer makes contribution as set by plan terms. Employee contributions, if allowed, are set by plan terms
Minimum employee coverage requirements	Generally, must be offered to all employees at least 21 years of age who worked at least 1,000 hours in a previous year
Vesting	Employee salary reduction contributions and most employer contributions are immediately 100% vested. Employer contributions may vest over time according to plan terms (5-year cliff or 3-7 year graded, or 2-6 year graded if top heavy)
Participant loans	Plan may permit loans
Withdrawals	Withdrawals permitted after a specified event occurs (e.g., retirement, plan termination). Early withdrawals subject to tax penalty

Source: Based on the booklet "Profit-Sharing Plans for Small Businesses," Department of Labor 2012, and "Retirement Plans for Small Business," IRS, Pub 560.

Defined benefit

Defined benefit plans provide a fixed, pre-established benefit for employees. This traditional type of pension plan is often viewed as having more value by employees and may provide a greater benefit at retirement than any other type of plan. However, defined benefit plans are more complex and therefore costlier to establish and maintain than other types of plans.

Defined Benefit Plans	
Key advantage	Provides a fixed, pre-established benefit for employees; allows higher tax-deductible contribution for older employees
Employer eligibility	Any employer with one or more employees
Employer's role	No model form available. Advice from financial institution or employee benefit advisor may be necessary. Annual filing of Form 5500 is required. An actuary must determine annual contributions
Contributors to the plan	Primarily funded by employer
Maximum annual contribution (per participant)	Actuarially determined
Maximum annual benefit	The maximum annual benefit at retirement is the lesser of $200,000 or 100% of final average pay
Contributor's options	Employer generally required to make contribution as set by plan terms
Minimum employee coverage requirements	Generally, must be offered to all employees at least 21 years of age who worked at least 1,000 hours in a previous year
Vesting	Right to benefits may vest over time according to plan terms
Participant loans	Plan may permit loans
Withdrawals	Payment of benefits after a specified event occurs (e.g., retirement, plan termination). Early withdrawals subject to penalty

Source: Based on the booklet "Choosing a Retirement Solution for Your Small Business," Department of Labor 2011, The IRS Retirement Plan Navigator: Defined Benefit Plan 2012.

Be aware that these plans often engender a long sales cycle. Because of their complexity and long-term nature (be prepared to keep them going indefinitely), they may appear disadvantageous at first blush. Since your position demands that you wear several hats, spending focus and energy on running the business rather than pondering the nuances of retirement plans, a Defined Benefit program may seem like too much extra work. But keep at it.

The SERS study indicated that, although most new plan sponsors approached the vendor rather than vice versa, they may not have made the approach if the groundwork had not been laid previously by other vendors. In other words, retirement plans are sold, not bought.

As director of retirement and life planning for Horsesmouth, Elaine Floyd helps advisors better serve their clients by understanding the practical and technical aspects of retirement income planning. A former wirehouse broker, she earned her CFP designation in 1986.