

# Making Sense of Employer-Sponsored Retirement Plan Options



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## INTRODUCTION

# Making Sense of Employer-Sponsored Retirement Plan Options



Establishing a retirement plan for employees can pay off in big ways, and we're not just talking about the benefits for employees. Small business owners stand to benefit as well.

Small business benefits include:

- Retirement plans improve recruitment and retention of better employees. This is especially important now that COVID restrictions are being lifted, and employers are struggling to entice their best employees back into the office.
- Employer contributions are tax-deductible.
- Assets in the plan grow tax-free.
- Plan options are flexible.
- Tax credits and other tax relief can help offset costs.

Employee benefits include:

- Employee contributions can reduce their taxable income, lowering their taxes.
- Contributions and profits grow tax-free until they're withdrawn.
- Contributions can be automated through payroll deductions, making it easier to save for retirement.
- Through *compounding interest* (earning interest on savings and interest), contributions grow faster over time.

- Retirement accounts can be carried from one employer to another.
- Some employees may be eligible for the *saver's credit* – a federal income tax credit on top of the tax deduction already allowed for contributions to a retirement account.
- Some plans let employees defer a portion of their compensation into the plan, which can help employees save money on taxes.
- Employees have peace of mind knowing that they're improving their financial security for their future and retirement.

### Choosing the Right Retirement Plan to Offer Your Employees

After deciding to offer a plan, you face the challenge of choosing which plan delivers the most bang for the buck – for both you (the business owner) and your employees. Several options are available, which is great, but without knowing the differences, picking a plan can be so overwhelming that you put off the decision indefinitely.

With that in mind, in this *SWC Business Brief*, we describe the most common retirement plan options – from simplest to most complex – and present the key characteristics of each. As a small business owner, you'll want to adopt a plan that's tailored specifically to your business objectives and your employees' best interests.

**Note:** Due to a recent change in tax law – made possible by the Setting Every Community Up for Retirement Enhancement Act (SECURE Act), which was signed into law by then-President Donald Trump on Dec. 20, 2019 – businesses can now treat all qualified plans adopted after the close of their tax year (and as late as the extended due date for their tax return) as being adopted on the last day of that tax year. The extended deadline for establishing and funding a plan means it's not too late to adopt a plan and make tax-deductible contributions to the plan that can be deducted on your 2020 corporate tax return – assuming your business return is on extension and you act quickly.



## **Payroll Deduction IRA or Roth IRA**

Payroll deduction individual retirement accounts (IRAs) are easy to set up and maintain for businesses of any size. With a traditional IRA, contributions aren't taxed – the money is taxed only when it's withdrawn from the account. A Roth IRA is the opposite – contributions are made with income that has already been taxed, and money isn't taxed when it's withdrawn.

**Key advantage:** Easy to set up and maintain.

**Eligible employers:** Any business may set up a payroll deduction IRA.

**Employer's responsibilities:** You simply need to arrange for employees to make payroll deduction contributions and then transmit contributions to the employees' IRAs at each pay period. Best of all, there's annual filing requirement.

**Plan contributors:** Employee contributions are made through payroll deductions. Employer contributions are not allowed with payroll deduction IRAs or Roth IRAs.

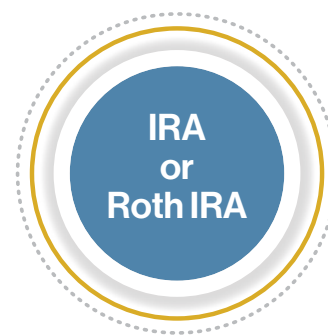
**Contributor's options:** Employee decides how much to contribute at any time.

**Maximum annual contribution (2021):** Employees can contribute the lesser of the employee's compensation or \$6,000 annually (\$7,000 if age 50 or older). Roth IRA contributions are not allowed if the employee's annual income exceeds \$140,000 (\$208,000 for married couples filing a joint return).

**Minimum employee coverage requirements:** No requirement. This is merely a convenience that can be offered to any or all employees.

**Withdrawals, loans, and payments:** Withdrawals are permitted at any time but they are subject to federal income tax and a possible 10 percent penalty if the participant is under the age of 59½. Loans from the IRA are not allowed.

**Vesting:** Immediate 100 percent vesting.



## ***Simplified Employee Pension (SEP) IRA***

A SEP-IRA (simplified employee pension individual retirement account) is a variation of a traditional IRA. Employees can receive employer contributions to their SEP-IRA and make regular contributions (outside the SEP-IRA) to a traditional or Roth IRA.

**Key advantage:** Simplified employee pension IRAs are easy to set up and maintain.

**Eligible employers:** Any business may establish one.

**Employer's responsibilities:** Your responsibility is discussed and agreed to when you set up plan by completing IRS Form 5305-SEP. And there's no annual filing requirement.

**Plan contributors:** Employer contributions only. Employees are prohibited from contributing to a SEP.

**Contributor's options:** You can decide whether to make contributions year to year.

**Maximum annual contribution (2021):** You can contribute the lesser of 25 percent of employee's compensation or \$58,000 annually. Again, employees are prohibited from contributing to a SEP.

**Minimum employee coverage requirements:** Must be offered to all employees who are at least 21 years of age, employed by the business for three of the last five years, and who have compensation of at least \$650 during 2021.

**Withdrawals, loans, and payments:** Withdrawals are permitted at any time and are subject to federal income tax and possible penalty. Employees under the age of 59½ may be subject to a 25 percent penalty if funds are withdrawn within the first two years of participation and a 10 percent penalty if withdrawn afterwards. Loans from an SEP are not permitted.

**Vesting:** 100 percent vested immediately.



### ***Savings Incentive Match Plan for Employees (SIMPLE) IRA***

A SIMPLE IRA plan (Savings Incentive Match Plan for Employees IRA) allows employees and employers to contribute to traditional IRAs set up for employees. It is ideally suited as a start-up retirement savings plan for small business owners not currently sponsoring a retirement plan.

**Key advantage:** With the SIMPLE IRA, salary reduction is handled with little administrative paperwork.

**Eligible employers:** Any business with 100 or fewer employees that doesn't currently maintain any other retirement plan.

**Employer's responsibility:** You set up the plan by completing IRS Form 5304-SIMPLE or 5305-SIMPLE. No annual filing requirement. And best of all – your bank or financial institution does most of the paperwork.

**Plan contributors:** Both the employee and small business make contributions to a SIMPLE IRA – employee contributions are handled through salary reduction contributions, and yours are handled as employer contributions.

**Contributor's options:** The employee decides how much to contribute. You as the employer must make matching contributions or contribute 2 percent of the employee's compensation up to the set maximum (see below for maximum amounts).

**Maximum annual contribution (2021):** Employee deferrals are limited to the lesser of 100 percent of their compensation or \$13,500 (\$16,500 if age 50 or older). Employers can either offer a 100 percent match of deferrals on up to 3 percent of compensation or 2 percent nonelective contribution on up to \$290,000 of compensation (max of \$5,800).

**Minimum employee coverage requirements:** If you offer a SIMPLE IRA, it must be offered to all employees who have compensation of at least \$5,000 in any previous two years and who are reasonably expected to earn at least \$5,000 in the current year.

**Withdrawals, loans, and payments:** Withdrawals from a SIMPLE IRA are permitted at any time but are subject to federal income



tax and, if the employee is under the age of 59½, may be subject to a 25 percent penalty if taken within the first two years of participation, and a 10 percent penalty if taken afterwards. Loans from SIMPLE IRAs are prohibited.

**Vesting:** 100 percent vested immediately.

### ***Defined Contribution: Profit Sharing***

With a *profit-sharing plan*, you (the employer) can contribute any amount at any time, regardless of whether the business has a profitable year. If you do make contributions, you will need to have a set formula for determining how the contributions are divided. And with a profit-sharing plan, money from the business goes into a separate account for each employee.

**Key advantage:** Profit-sharing plans allow you – the employer – to make large contributions for employees.

**Eligible employers:** Any business may participate in a profit-sharing plan.

**Employer's responsibility:** The IRS has no established model to follow. Advice from a financial institution on setting up a profit-sharing plan, or from an employee benefit advisor, is necessary. Annual filing of IRS Form 5500 Series return – an important compliance, research, and disclosure tool for the U.S. Department of Labor – is required.

**Plan contributors:** Employers are the only contributors to profit-sharing plans. Employees may not make contributions of their own.

**Contributor's options:** While employers make contributions as set by plan terms, those contributions can be redetermined each year *if* the profit-sharing plan provides for doing so.

**Maximum annual contribution (2021):** The lesser of 100 percent of your employees' compensation or \$58,000 annually is allowed. Amounts that don't exceed 25 percent of aggregate compensation for all participants can be deducted.

**Minimum employee coverage requirements:** Generally, if offered, a profit-sharing must be available to all employees at least 21 years of age who worked at least 1,000 hours in a previous year.

**Withdrawals, loans, and payments:** Profit-sharing plans may



permit loans and hardship withdrawals. Those withdrawals are subject to federal income tax and may be subject to a 10 percent penalty if the participant is under the age of 59½. Benefits are generally paid at retirement.

**Vesting:** May vest over time according to the plan's terms.

### **Defined Contribution: 401(k)**

When offered by a business, a 401(k) is a feature of a qualified profit-sharing plan that allows employees to contribute a portion of their wages to individual accounts.

**Key advantage:** With a 401(k), employees are permitted to contribute more than other options. And 401(k) contributions may be combined with an employer profit-sharing plan. *Safe harbor* (i.e., employer contributions are fully vested when made) and automatic enrollment options are available.

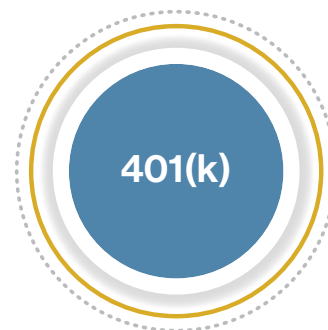
**Eligible employers:** Any business may offer a 401(k).

**Employer's responsibility:** The IRS has no established model to follow. Advice from a financial institution or employee benefit advisor is not only recommended – it's necessary. Annual filing of IRS Form 5500 Series return is required. You may also be required to submit to nondiscrimination testing *unless* you – the owner and/or your spouse – is the only employee, or a safe harbor plan is used.

**Plan contributors:** Employees participate through salary reduction contributions, while employers may contribute as well.

**Contributor's options:** The employee decides how much compensation to defer to their 401(k) up to a maximum amount set by plan. The business can make additional contributions, including matching, as set by the plan. For safe harbor plans, the employer must make specified matching contributions or a 3 percent contribution to all participants.

**Maximum annual contribution (2021):** Employees have a deferral limit of \$19,500 (\$26,000 if age 50 or older). The employer/employee combined contribution limit is the lesser of 100 percent of employee's compensation or \$58,000 (increased to \$64,500 if the employee is age 50 or older and to the extent an employee catch-up deferral is made).



**Minimum employee coverage requirements:** Generally, the 401(k) must be offered to all employees at least 21 years of age who worked at least 1,000 hours in a previous year. Check with your company's benefits advisor to ensure you're compliant.

**Withdrawals, loans, and payments:** Employee withdrawals are permitted after a specified event occurs (such as reaching the age of 59½, death, or separation from service). And depending on how the plan is set up, it may permit loans and hardship withdrawals. Keep in mind, however, that any withdrawals are likely subject to federal income tax and may be subject to a 10 percent penalty if participant is under the age of 59½. Benefits are generally paid at retirement.

**Vesting:** Employee contributions are 100 percent vested immediately. Employer contributions may vest over time according to the 401(k) plan's terms.

### **Defined Benefit Plan**

Defined benefit plans provide a fixed, pre-established benefit for employees at retirement. Small businesses can generally contribute (and therefore deduct) more each year than in defined *contribution* plans such as profit-sharing plans and 401(k) plans. However, defined benefit plans are often more complex and, thus, more costly to establish and maintain than other types of plans.

**Key advantage:** Defined benefit plans permit employers to contribute more than other plans and provide a fixed, pre-established benefit for employees.

**Eligible employers:** Any business may offer a defined benefit plan.

**Employer's responsibility:** The IRS has no established model to follow. As a result, advice from a financial institution or employee benefit advisor is necessary. You'll also need to annually file an IRS Form 5500 series return. And, an actuary – a business professional who deals with the measurement and management of risk and uncertainty – must determine your company's annual funding obligation.

**Plan contributors:** Primarily the employer, but a defined benefit plan may also require or permit employee contributions. It all depends on the plan's terms.



**Contributor's options:** You – the employer – makes contributions as set by the plan's terms. Contributions are usually required each year.

**Maximum annual contribution (2021):** The employer's contribution is established in the terms of the plan, and the employer may permit or require employee contribution.

**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.

**Withdrawals, loans, and payments:** Payment of benefits is made after a specified event, generally at retirement. May permit loans and early withdrawals subject to a 10 percent penalty if participant is under the age of 59½.

**Vesting:** May vest over time according to plan terms.

Deciding on which retirement plan is the best fit for your business and employees can often be confusing because of all the choices available and concern about the costs and complexities of each option. If you can't decide which plan is best or how to get started, the financial strategy professionals here at SWC can help. We'll meet with you, ask pertinent questions, examine your business, and help you choose a plan that has the cost-to-benefits ratio you're aiming for.

Don't wait to start exploring your options. Act as soon as possible, so you can start using a retirement plan to strengthen your business while maximizing tax savings and helping to build a respectable retirement nest egg for yourself and your employees.



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