Retirement Plans for Small Businesses

Introduction to SEP & SIMPLE IRAs

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Small business owners face a myriad of stresses in the daily operation of a company. They must find, train and retain good employees, navigate uncertain economic conditions, plan and adapt to ever-changing tax policies, stay ahead of competitors and find ever more creative ways to grow and sustain the business. Probably last on a long list of concerns is planning for retirement. Fortunately, there is an often overlooked mechanism for small business owners to address a number of these concerns – a company retirement plan.

While not a panacea for the challenges facing small business owners, a company sponsored retirement plan can help business owners attract and retain good employees, mitigate the impact of income taxes on the personal and business level and help build longer term wealth for both them and their employees. Most employers think of the 401(k) when they envision a retirement plan, but for small companies, whether run as an S-corporation or sole proprietor, there are other options.

While the 401(k) remains a very popular option and certainly merits implementation for certain businesses, the unique advantages of SIMPLE IRAs (Savings Incentive Match Plan for Employees) and SEP IRAs (Simplified Employee Pension) often make them a better fit depending on the goals of the organization. As such, there are a number of questions which must be answered when selecting a retirement plan. Does the business owner want a plan funded only by employer contributions? By employee contributions? Both? A plan with the lowest costs? Easiest administration? The flexibility to skip employer contributions in less profitable years? The answers to such questions guide the plan selection process.

SEP and SIMPLE plans are IRA-based retirement plans as opposed to "qualified" plans like 401(k)s, profit-sharing plans, and defined benefit plans. Qualified plans are generally more complex and expensive to maintain than IRA-based plans because they must comply with specific Internal Revenue Code and ERISA (the Employee Retirement Income Security Act of 1974) requirements in order to qualify for tax benefits. In addition, qualified plan assets must be held either in trust or by an insurance company and require the oversight of a third party administrator. Employers with such plans typically require employees work a certain number of years before employer contributions are vested.

With IRA based plans, employees are in essence contributing to their own IRA and all employer contributions vest immediately. Like a qualified plan, IRA based plans have the benefits of tax deferred growth and contributions are deductible when made. As with other tax qualified retirement plans and traditional IRAs, both SEP and SIMPLE IRA withdrawals are taxed at the individual's ordinary income tax rate and a 10 percent penalty applies on withdrawals prior to age 59½ . Both plans have a required minimum distribution (RMD) commencing at age 70½.

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Overall, both plans can provide an effective retirement plan solution for small businesses. For employers looking for a low cost, low maintenance plan, an IRA-based plan like the SEP or SIMPLE IRA can be a very beneficial tool. The SIMPLE IRA is best for owners who want a plan that allows employees to defer a portion of their salary with a consistent company matching percentage. The SEP IRA, much like a profit sharing plan, best fits owners looking for a flexible plan that does not require consistent contributions from year to year and offers the potential for higher contribution amounts. At the very least, small business owners should explore the options available for a company retirement plan. Not only do these plans offer a way to incentivize employees and reduce company turnover, they provide a very effective means of saving for retirement, reducing income taxes, and ensuring future financial stability.

The SEP IRA

The Simplified Employee Pension, or SEP, is an IRA based retirement plan that can be very advantageous for small business owners. When setting up a SEP IRA plan it is important to follow certain IRS guidelines. Set up, overall, is easy and requires filing out IRS form 5305, along with account opening paperwork for each eligible employee. Additionally, when adopting a SEP, the employer and each employee set up their own IRA, and the employer contributes a uniform percentage of pay across all the participants, including themselves. This is the primary IRS Section 415 rule governing a SEP - employers and employees must share the same contribution percentage to prevent top-heavy contributions by an owner.

For 2016, SEP contributions are limited to the lesser of 25 percent of pay or $53,000 and the plan must cover any full or part-time employee age 21 or older who has worked for the employer 3 of the past 5 years and earns more than $550. Similar to the flexibility found in a profit- sharing plan, employers may make SEP contributions on a discretionary basis and may choose, in any tax year, to make no contribution to the plan. This is beneficial when business conditions vary. One important note for owners taking an S-Corp election is that SEP contribution percentages must be based on W2 earnings (salary). Distributions or pass through income from the S-Corp are not included as income for determining the contribution amount.

Another less-known feature of SEP IRAs is that employees can make deductible IRA contributions to their SEP. The amount of annual contribution that the employee may make is limited only by the maximum amount permitted and whether or not he or she is eligible to make catch-up contributions. The limits for 2016 are $5,500 or $6,500 with catch-up for individuals age 50 or older. An employee may take a tax deduction for contributions he or she makes to a SEP IRA under the same rules that apply to a tax deduction for contributions made to a traditional IRA. Specifically, if the employee is an active participant in his or her employer's retirement plan, the deduction is phased out based on the individual's adjusted gross income (AGI). An employee is considered an active participant in a SEP IRA if any employer contribution is made during the taxable year. For single filers the deduction is phased out with AGI of $61,000-$71,000 and for joint filers between $98,000 and $108,000. In any year where no employer contribution is made a fully deductible employee contribution can be made.

From a strategic planning standpoint, a number of benefits exist for employers seeking to establish either SEP. Along with providing a wealth building vehicle for employer and employee alike, these IRA-based retirement plans afford employers the opportunity to reduce taxable income and grow assets on a tax-deferred basis. At the business level, employers receive a tax deduction for contributions to employees while simultaneously reducing their personal taxable income.

For business owners opting to take an S-Corp election, a SEP IRA can be particularly beneficial as the owner can adjust the amount of income taken as salary each year to increase or decrease the amount available to contribute toward the plan. As an example, a business owner taking a salary of $40,000 and receiving $70,000 of pass-through income from an S-Corporation could make a 25 percent contribution ($10,000 = 25 percent of $40,000). The $10,000 contribution becomes in essence a deduction at the business level by decreasing the overall amount of pass-through income, and it is not income taxable on the W2. Should the business have a very profitable year, the owner could elect to take more of the business' income as salary and thereby increase the overall potential contribution to the SEP. The caveats here are that whatever contribution percentage the employer takes must also be provided to each employee, and that FICA taxes must be paid on the amount contributed to the SEP. The FICA taxes paid on contributions can be viewed as both a positive and negative as the increased salary equates to more taxes in the present, but also an increased Social Security benefit in retirement.

Employers can establish a SEP for a year as late as the due date (including extensions) of their business income tax return for the year they want to establish the plan. It is important to note that SEP assets can be rolled to any IRA or qualified plan other than designated Roth 401(k) plans or a SIMPLE IRA and a SEP can accept assets from any plan other than a Roth IRA or designated Roth 401(k).

The SIMPLE IRA

In contrast to a SEP IRA, a SIMPLE IRA offers the ability for employees to make salary deferral contributions and receive a set matching percentage from the employer. This is an important distinction between the two plans. As an example, if an individual participating in a SEP IRA plan makes $40,000, and the employer makes a 5 percent contribution, the employee has in essence been paid $42,000 for the year, but the $2,000 contribution to the SEP is not taxable. With a SIMPLE IRA, the employee could defer 5 percent of their $40,000 salary, or $2,000, and they would only be taxed on $38,000 of their salary. SIMPLE IRA plans require employers to make a dollar for dollar match up to 3 percent of salary for those participating in the plan or a non-elective 2 percent match for all eligible employees whether they are actively deferring salary or not. In the previous example, the employee deferring 5 percent of their salary would receive a $1,200, or 3 percent match, from the employer on top of the $2,000 in deferred salary for a total tax-free contribution of $3,200 for the year.

The SIMPLE IRA plan is available for employers with 100 or fewer employees. The pretax salary deferral contribution limits for 2016 are $12,500 or $15,500 with catch-up for individuals age 50 or older. Employees who earn $5,000 in any two prior years, and who are expected to earn at least $5,000 in the current year, must be allowed to participate in the plan.

Taking early withdrawals from any retirement plan can be costly, and even more so with the SIMPLE IRA as it carries an increased penalty amount in the first two years. The premature distribution tax penalty is 25 percent of the amount includable in income if withdrawn before the employee has two years of participation in the SIMPLE plan; on and after the first two years of participation, the penalty is reduced to 10 percent prior to age 59 ½ . Additionally, the 25 percent penalty applies to any rollover from the SIMPLE IRA in the first two years other than to another SIMPLE IRA plan. Individuals can roll funds from a SIMPLE IRA to a traditional IRA, SEP IRA, or any tax qualified retirement plan (401(k), 403(b), 457) that is not a designated Roth account. However, only assets from another SIMPLE IRA may be rolled to a participants current SIMPLE IRA. 401(k) plan assets and other retirement plan assets cannot be rolled to a SIMPLE IRA.

When setting up a SIMPLE IRA it is important to follow certain IRS guidelines. Set up, overall, is easy and requires filing out IRS form 5305, along with account opening paperwork for each eligible employee. As with a SEP, participants can set up their own accounts at their preferred institution or all employees may create accounts under one custodian along with the employer. The employer's SIMPLE IRA contributions/match can be made up to the employer's tax filing date, including valid extensions. Employers can establish a SIMPLE IRA plan effective on any date from January 1 through October 1 of a year, provided they did not previously maintain a SIMPLE IRA plan. This requirement does not apply to a new employer that comes into existence after October 1 of the year in which the SIMPLE IRA plan is established as long as the plan is set up as soon as administratively feasible after the business comes into existence. If an employer previously maintained a SIMPLE IRA plan, they can set up a SIMPLE IRA plan effective only on January 1 of a year. A SIMPLE IRA plan cannot have an effective date that is before the date the employer actually adopts the plan. ☐

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