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Retirement Plans for Small Business and the Self-Employed

By Mark S. Weis, Esq.

As part of the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA), small businesses and the self employed gained additional incentives to save for retirement through modernized and streamlined pension laws.
In a survey conducted by the Employee Benefits Research Institute and the American Savings Education Council, results indicated that many small business owners believe retirement plans are expensive and would bury them in paperwork and reporting requirements. Here, we will cover three types of plans: the simplified employee pension (SEP), the SIMPLE plan, and qualified plans, which are categorized as either defined contribution plans or defined benefit plans. It is possible for self-employed persons and small companies to participate in plans without a huge investment of time or money, largely due to revisions enacted in the 2001 Tax Act. Retirement plans can lower taxes for business owners and can boost the morale of employees.

A simplified employee pension (SEP) IRA is a plan that allows small employers and self-employed persons to make contributions toward retirement. The plan must be in writing. A SEP-IRA is set up by and for each eligible employee and it is owned and controlled by the employee. Contributions are made to the financial institution where the SEP-IRA's are maintained.

Eligible employees are those who are at least 21 years of age, have worked for at least of three of the last five years and have received at least $450 in compensation in 2005 (adjusted for cost-of-living in 2003 and beyond). Less restrictive, but not more restrictive, participation requirements may be applied.

To set up a SEP, there are three basic steps:

(1) There must be a formal written agreement stating benefits provided for all eligible employees. Many businesses can meet this requirement by completing IRS Form 5305-SEP (a simple two page application).

(2) Each eligible employee must be given certain information about the SEP. A copy of Form 5305-SEP will meet this requirement.

(3) A SEP-IRA must be set up for each eligible employee. This can be done with a bank, an insurance company or other qualified financial institution.

SEP plans can be set up for a particular year as late as the due date for tax filing. And SEP plans are usually excluded from filing annual retirement plan information returns.

The SEP rules allow annual contributions of up to 25% of the employee's compensation or $42,000, whichever is less. It is not necessary to make contributions each year, but employer contributions cannot discriminate in favor of highly compensated employees. In other words, the contribution level for each eligible employee is usually at the same percentage (based only on the first $210,000 of compensation).

Any employer contribution to the SEP-IRA is excluded from the taxable income of the employee. Employees may also withdraw contributions from their account.

If the funds are not rolled over or transferred within a 60-day period, however, they become includible in taxable income for the year. There may also be tax penalties for withdrawals before age 59 1/2.

A SIMPLE IRA (Savings Incentive Match Plan for Employees) is for businesses with up to 100 employees and can be operated at a very low cost. Under a SIMPLE plan, employees may elect to have up to $10,000 for 2005, from their pre-tax salary, contributed to the plan. The employer can match deferred dollars up to 3% of the employee's salary or the employer can contribute 2% to all eligible employees. Employees 50 and older are permitted a catch-up contribution up to $2,000 for the current year.

Like the SEP plan, SIMPLE plans are written arrangements in which a separate account is maintained for each eligible employee. Eligible employees are those who were compensated at least $5,000 during any two years preceding the current calendar year and who are expected to receive at least that amount during the current year. The income requirement also applies to the self-employed. Like the SEP plan, you may choose less restrictive eligibility requirements, (i.e. those who received $3,000 or more compensation during any preceding calendar year), but not more restrictive ones.

Setting up the plan includes completion of a form (either Form 5304-SIMPLE or Form 5305-SIMPLE), co-signed by yourself and the financial institution maintaining the accounts and copying a portion of the form as required notification to employees. SIMPLE IRA plans may be set up, with some exceptions, between January 1 and October 1 of a year.

Besides SEP Plans (Simplified Employee Pension) and SIMPLE Plans (Savings Incentive Match Plan for Employees), there are other "qualified" retirement plans which may be established by small businesses and self-employed individuals.

Qualified plans are categorized as either **defined contribution plans** or **defined benefit plans**. A defined contribution plan provides an individual account for each participant in the plan. A participant's retirement benefit is based upon a participant's share of employer contributions plus any income and losses allocated to a participant's account. Accordingly, under a defined contribution plan, plan participants bear the risk of the plan's investment performance.

Under a defined benefit plan, a plan participant's retirement benefit is based upon a predetermined formula which typically takes into account a participant's compensation and years of service. Contributions to defined benefit plans are actuarially determined based upon a work force's mortality and turnover, projected plan earnings and the benefits provided by the plan. Unlike a defined contribution plan, plan participants generally neither share in the benefit nor bear the risk of the plan's investment performance.

Contributions to a defined contribution plan, excluding earnings, cannot exceed the lesser of 100% of compensation or $42,000, subject to cost-of-living adjustments.

Under a defined benefit plan, annual contributions are determined by the benefits the plan intends to provide. The maximum annual benefit a defined benefit may provide is equal to the lessor of 100% of a participant's average three year compensation or $170,000.

Contributions to a defined contribution plan may be made at any time up until the due date, including extensions, of the tax return for the year in which the contribution relates. For defined benefit plans, contributions are generally required to be made on a quarterly basis.

Contributions to qualified retirement plan are deductible in determining the employer's taxable income. For defined contribution plans, deductions are limited to no more than 25% of the employer's paid compensation - - taking no more than $210,000 of compensation for any single employee. For defined benefit plans, the same limit applies or, if greater, the amount of the contribution needed to satisfy the plan's minimum funding requirements.

Qualified retirement plans may be set up by self-employed individuals, sole proprietors, partnerships, Limited Liability Companies (LLC) and corporations. Qualified retirement plans must be in writing and be communicated to employees. Furthermore, except in limited circumstances, all of a qualified plan's assets must be held in trust by one or more plan trustees.

Qualified plans are also subject to numerous requirements set forth in both the Internal Revenue Code and ERISA. For employer's willing to take on the responsibility of adhering to these rules, the tax and non-tax benefits are worthwhile.

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