

Retirement Plans for Business Owners

Conversation Starters

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Brain Teaser of the Month

Guess the next three letters in the series GTNTL

Answer on page 4

For many people, saving for retirement is as simple as contributing to their company's 401k plan. For those who are self-employed or business owners, there is a bit more up-front planning that needs to take place. Fortunately, there are also more options and the ability to structure a plan suited to the business's unique needs.

Below we provide a brief overview of several retirement plans that business owners can consider.

Factors to Consider

A retirement plan is a savings vehicle that can provide significant tax-savings over time. There are many factors to consider when evaluating a retirement plan for your business:

- How many years the company has been in business?
- How many employees work at the company, and are they full-time or part-time?
- What are the goals for this plan?

There is truly no "one-size-fits-all" approach, and even businesses with established retirement plans should review their options on an annual basis. As the business grows, or the employees change, it might be advantageous to design a new retirement plan.

Types of Retirement Plans

1. SEP IRA (Simplified Employee Pension IRA)

SEP IRAs are one of the easiest retirement plans to set up and maintain. In this plan, contributions are based on a formula, and will be limited to the lesser of (1) 25% of the employee's compensation or (2) \$61,000 (for 2022).

SEP IRAs are often a good choice for solo practitioners or those paid as independent contractors. This is because SEP IRAs must be offered to all employees who are at least 21 years old and have been working at the company for three of the last five years. Also, these plans are entirely funded with employer contributions (employees cannot make their own contributions).

2. Solo 401(k)

Solo 401(k)s are another plan option for business owners with no employees (other than a spouse). Under this plan, the individual is considered both the employer and employee, and contributions can be made in both capacities.

As an employee, the owner can make elective deferrals of up to 100% of compensation subject to a limit of \$20,500, with an additional \$6,000 catch-up contribution for age 50+ (2022). The employer is also able to make a contribution to the plan of up to 25% of compensation, although for the owner, the formula is a bit more complicated, and actually works out to be closer to 20% of compensation. The total contribution to the plan from both sources is limited to \$61,000, or \$67,500 if over age 50 (2022).

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

Similar to a SEP IRA, SIMPLE IRAs are another plan with minimal administrative requirements. These plans are typically used at smaller businesses, because SIMPLE IRAs are only permitted for companies with less than 100 employees.

Employers must contribute annually to an employee who earned at least \$5,000 during any 2 prior years and is expected to earn at least \$5,000 during the current calendar year. The employer must choose one of two funding options. They can either contribute 2% for every eligible employee regardless of employee contributions, or they can make 3% matching contribution – matching dollar for dollar on the first 3% of contributions.

Employees may choose to contribute as well, up to a maximum of \$14,000 with an additional \$3,000 catch up allowed for age 50+ for 2022. Since SIMPLE IRAs have lower salary deferral limits and smaller employer funding contributions, less money can be added each year to this type of plan.

4. Defined Benefit Plan

Defined Benefits plans are a type of pension plan. These plans promise a specific benefit at retirement - i.e., \$1,000/month for life. In these plans, the employer will contribute on behalf of the employee, and an actuary will determine the annual contribution amount.

While these plans can be very expensive for a business that has employees, they can be very attractive to high earning, self-employed workers. That is because the contribution amount is based on age and income, among other variables, and does not have the maximum contribution limits imposed on defined contribution plans. It is possible to make very high contributions of well over \$100,000 in some cases, and these plans can be combined with a 401(k) plan for even more tax advantaged savings.

Opportunities

There are some situations we come across regularly where it makes sense to reevaluate the retirement plan:

- **Individuals with side income should consider a SEP IRA** - SEP IRAs can act as an additional retirement plan for those who earn money from a side business. For example, consider an individual with a full-time job at an ad agency who freelances as a copywriter on the side. This side income could be used to fund a SEP IRA, completely separate from the retirement plan at the ad agency.
- **Solo Practitioners should consider a Solo 401(k)** - SEP IRAs can be a great solution for solo practitioners, but a Solo 401(k) may be even better. Business owners should consider a Solo 401(k) instead of a SEP IRA when they have the ability to save more than the SEP IRA formula allows. For example, consider a psychotherapist earning \$50,000 per year. A SEP IRA only permits a 25% contribution, or \$12,500. With a Solo 401(k), the contribution can be substantially higher. Plus, if that psychotherapist is age 50 or older, she can contribute an additional \$6,500 to the solo 401(k) plan.
- **High-earning, self-employed workers should consider a DBP plan** – This is an excellent plan for high earning individuals with stable incomes and without employees. It works particularly well for older workers who are looking to make substantial contributions to a plan in the years leading up to retirement. And for even more savings potential, it can be paired with a solo-401(k) for additional contributions.

If you have any questions or would like to discuss, please feel free to reach out.



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Answer – I, T, S. The complete sequence is the first letter of every word in the sentence.

Source:

- <https://www.irs.gov/retirement-plans/one-participant-401k-plans>

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CRC # 4142128 January 18,2022