2319 N Andrews Avenue Ft. Lauderdale, FL 33311 (800) 382-1040 franchiseaccounting.com

Qualified Retirement Plans

For business owners, the funding of a qualified retirement plan is possibly the best deduction that exists. You get immediate tax savings benefits since the dollar amount funded can be written off against your other income. Also, any income made while in the retirement plan is not subject to current taxes, so the tax-deferral effect on the compounding of this money over the years can be quite significant compared to saving outside the retirement plan.

Unfortunately, the majority of small businesses do not take advantage of this tax saving opportunity. In fact, according to 1997 statistics from the US Census Bureau, only 29% of small businesses have any form of qualified retirement plan.

The secret is to view a retirement plan as a required business expense(like rent, insurance, supplies) instead of an optional one. Otherwise, the tendency is to "put it off" until the cash flow situation improves. The problem with this thinking is that it seems to be inherent in human nature to put most optional decisions off forever!

In any event, it's important for a business owner to have a working knowledge of the qualified retirement plan options that may be available. Note that we are discussing "Qualified" plans as opposed to non-qualified plans. A qualified plan is one that has met a series of IRS guidelines so as not to be discriminatory in favor of certain employees/employers.

What Is A Qualified Plan?

This is a written plan which allows contributions for you and your qualified employees to be deducted when funded, and not taxable until they are distributed according to IRS definitions of taxable distributions.

There are numerous qualification rules within this general guideline, some of which are:

How the contributions and benefits must be calculated
Investment guidelines within the plan
Who must be covered under the plan
The nature of the vesting requirements
Non-discrimination rules within the plan and involving related, controlled companies

Prototype Plans: The rules to ensure a qualified plan can be quite complex–and ever changing. However, you may elect to use a prototype plan to make it easier. This is a pre-approved plan by the IRS. These are available through a number of financial service establishments such as banks, brokerage houses, trade organizations, insurance companies, mutual funds, etc. In effect, these "off the shelf" plans have already been qualified under IRS rules and regulations. As long as you follow the plan rules, you have a qualified retirement plan to use. Setting one up is merely a matter of filling out a few documents.

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You have a right to set up your own "customized" plan as well. There are specialists in this field who can advise you on the advantages and disadvantages of using a customized plan instead of a prototype. Two of the main reasons for going to a customized plan are: First, it may allow for a bigger retirement plan deduction, hence larger current tax savings; Second, it may create more benefits for the highly compensated individuals than the other employees.

Types of Qualified Plans

According to IRS classification, qualified plans fall into two main categories: defined contribution plans, and defined benefit plans.

A defined benefit plan works almost in reverse. A qualified defined benefit plan must provide a set benefit. The contributions to the plan must equal a certain amount in order to achieve that future benefit goal. This is based on IRS approved actuarial calculations. Normally, the defined benefit plan can result in larger contributions on behalf of the recipients, especially if the recipients are closer to retirement age. In addition, these plans usually require the continuing services of professionals such as actuarial consultants and attorneys.

Because these defined benefit plans are usually quite complex, involve customization, and are not used by the vast majority of small businesses, space doesn't permit extensive detail at this time. Instead, let's review the more commonly used options under the defined contribution plan guidelines.

Defined contribution plans base the benefits to the recipients on the amount contributed in their individual behalf. In effect, you end up getting a retirement distribution which depends on the amount of contributions and accumulated earnings made within the plan over the pertinent time frame. The more contributions and accumulated earnings, the more you'll get. The less contributions and accumulated earnings, the less you'll eventually get. In effect, the exact dollar amount of your future retirement benefit is not guaranteed in advance.

There are three basic types of defined contribution plans: profit sharing; money purchase; and stock bonus plans.

Profit Sharing: This is the most common type from a statistical standpoint. The contributions to the plan are based on a percentage of the profits of the business. You can set the profit percentage within allowable guidelines. If there are no profits for any given year, there are no retirement fund contributions. In fact, for most profit-sharing plans, even if there are profits, you can usually "elect out" of making retirement plan contributions anyhow. So this type of plan affords the small business owner more flexibility than most others. In effect, you can fund the plan or not in any given year at your discretion.

Money Purchase: With this plan, the contribution is a stated amount, or a stated formula amount that is not so discretionary as the profit sharing. It is not based on profits so much as it is on compensation or earnings. Therefore, retirement plan contributions must usually be made on a regular basis whenever any qualified earnings and compensation occur for the given year. In short, this type of plan locks you in much more so than the profit sharing plan.

Stock Bonus Plan: This is similar to a profit sharing plan except that company stock is used to fund the retirement plan instead of money. This option is primarily only available to corporations.

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The Most Common Retirement Plans

Once you have established the kind of qualified plan–defined contribution vs defined benefit–you select the particular retirement plan vehicle to implement the plan. This choice depends in part on the type of business you have(unincorporated vs incorporated), and how complicated you elect the plan to be. Listed below is an overview of the three most commonly-used qualified retirement plan choices.

Keogh Plan

This is available to sole proprietorships (unincorporated businesses) and partnerships. Corporations cannot use a Keogh plan. You do not have to have employees to set this up. In the eyes of the IRS a sole proprietor is both an employer AND an employee, so the Keogh can be used whether or not you have employees.

Basically you can put a percentage of the net earnings from the business into the plan for yourself, and a matching percentage of your employees taxable compensation. This contribution becomes a tax deduction for you, and the money earned from the contributions to the Keogh plan escapes current income taxes. What are these "net earnings" that are used in the calculation? According to the IRS definition, net earnings are the gross income minus allowable deductions from a business in which your personal services are a "material income producing factor." Thus, in the case of a partnership, to take a Keogh deduction you must be a "working partner" as opposed to a limited partner.

Keogh Contribution Amounts: The amount you can contribute for each plan participant varies according to the type of plan–defined contribution vs defined benefit. For a defined contribution(the most common type) the maximum amount per year you can fund is $30,000. This is subject to further limitations depending on if the plan is a profit sharing or money purchase and depending on the compensation/net earnings for the year.

A profit sharing Keogh allows for a maximum of 15%(before adjustments) of up to $170,000 in compensation adjusted for inflation. A money purchase allows for a maximum contribution of 25% of up to $170,000 in compensation.

A defined benefit plan may allow for higher retirement plan contributions depending on the actuarial calculations set forth within the plan and the other customized features. However, the contribution is usually limited to a calculation based on a maximum defined benefit of $135,000 per year, adjusted for inflation.

A Keogh plan usually requires an annual filing of the details of the plan and its activities with the IRS. This is a 5500 series filing, and it can be quite simple or quite complex depending on the type of plan, and the participants covered.

SEP: Simplified Employee Pension (Previous to the "SIMPLE" Plan)

As the name indicates, this is a simpler plan than the Keogh in several ways. First, it is usually simpler to set-up. Second, you do not have to file complicated annual IRS returns similar to the 5500 return required for a Keogh. In addition, a SEP is available for corporations as well as unincorporated businesses.

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The drawbacks to this plan center around three main issues compared to a Keogh: The SEP has a more limited allowable contribution amount per employee; it has stricter rules on which employees can be excluded from the plan, and how much must be contributed on behalf of the qualifying ones; and, certain lump-sum income tax averaging methods are not available like they are in a Keogh. Like the Keogh, you contribute a percentage of the net compensation/earnings from the business on behalf of each participant. In this case, however, the maximum amount you can contribute is limited to the smaller of either 15% (before adjustments) of the employee compensation/earnings amount. Like the Keogh, this compensation amount is further limited to a maximum of approximately $170,000 per year. The net result is that the maximum SEP contribution per year is usually $25,500 vs $30,000 for a defined contribution Keogh.

Similar to a Keogh profit sharing plan, employer contributions are not required each year; they can be at the discretion of the business owner. So this gives some flexibility from a cash flow standpoint.

SAR-SEP: Salary Reduction Plan (Previous to the 1997 enacted "SIMPLE" Plan)

This is an interesting feature that is not available with a Keogh plan. This is a form of salary reduction or elective income deferral in which employees can have a part of their pay contributed to the SEP–and not pay income tax on the amount contributed. This is a voluntary contribution on their part–not yours as the business owner–and it can be a significant tax deduction for them. There are restrictions on this type of arrangement, most notably three: 1) The business can have no more than 25 eligible employees; 2) At least 50% of the employees make the election; and, 3) highly compensated employees may be limited in this election depending on various calculations.

401(k) Plans

This is a form of a qualified profit-sharing plan that allows participants to make salary reduction or elective income deferral contributions of up to a maximum of 15% of their qualified compensation, subject to a cap of $10,500 adjusted for inflation.

The employer can then contribute as well, or not, depending on the plan. The total annual amount that can be contributed in this way is $30,000(effective January 1, 1997). This gives the employee a nice tax deduction in that the money contributed from the employee's compensation comes "off the top" for income tax purposes. If the employee makes $30,000 for the year, and has $3500 put into the 401(k) plan, then only $26,500 is subject to federal income tax for that year.

Some advantages: The business is not restricted to 25 or fewer qualified employees for this plan. Participants may be able to borrow a portion of their designated plan contributions and earnings for specific purposes such as buying a house, education, medical bills, etc. They then pay themselves back at stated interest rates and stated time tables to avoid paying tax on this type of distribution. It is available to nearly all forms of business organizations. Special 5 year and 10 year lump sum tax averaging methods may apply to distributions, saving taxes.

Some disadvantages: It is usually complicated to set up, and administer. IRS reporting requirements can be quite complex. Highly compensated employees must meet strict non-discriminatory tests to participate equally.

"SIMPLE" Plan

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Effective from January 1, 1997, and on, this new option combines some of the features of a SEP with a 401(k) to provide what is supposed to be a simpler plan to set-up and administer, hence the acronym "SIMPLE".

Basically, it is available to a business with 100 or fewer employees. The employee can elect to defer from taxes up to $6,000 in compensation in a given year. For the matching provision, the employer must contribute the lesser of up to 3% of wages, or $6,000.

Supposedly, this SIMPLE plan is easier to set-up and administer than a 401(k) plan. It is supposed to have more selectivity for the employer as to which employees must be covered. Also, the "top-heavy" rules as to contributions and deferral amounts of owners and/or controlling shareholders/officers are supposed to be much more lenient than a 401(k) plan. This would be quite an advantage for owners of small businesses.

However, the SIMPLE plan is relatively new, so some time will be needed for certain rulings and interpretations to absolutely clarify (and quantify) this area.

Advantages and Disadvantages Of Qualified Retirement Plans

As you can see, there may be a number of choices when you consider a retirement plan for your business. The goal is to try to match the plan choice to your individual business requirements and your cash flow, both current, and projected down the road.

First, some potential disadvantages, or caveats. The cash flow of the business is not always predictable, especially years down the road. Thus, the types of plans where you must commit a certain amount each year can become burdensome if your business hits some snags. The money put in retirement in not always available to withdraw for emergencies or unplanned cash flow problems without some heavy consequences. Premature withdrawals(if it is even possible) may create a stiff tax bill and/or tax penalties. Thus, it requires some serious "crystal ball" analysis, especially if you are young.

In addition, if your eventual tax bracket when you withdraw the retirement money is higher than when you made the tax deductible contributions, the tax saving benefits disappear.

However, a retirement plan can have tremendous advantages. It can create significant tax write-offs for you, thus reducing your tax liability. The earnings from the contributions once they are in the plan can accumulate tax deferred, which accelerates the compounding effects–and helps you to reach your retirement goal faster.

If you have employees, it is a fringe benefit that can keep you competitive with other employers, thus reducing your employee turnover which can be quite a drain on a business.

Finally, if it is handled with a certain attitude, it becomes a form of "forced savings" thus helping to insure you will have a retirement nest egg to fall back on. In fact, it is very rare that a business owner will look back at retirement and say "I wish I hadn't set up that retirement plan." It's usually just the opposite. Most retiring business owners lament the fact that they never set up an adequate retirement plan. After all, it can make a difference between very happy golden years, and frightening ones.

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