How to Choose the Best Retirement Plan for You & Your Business

Setting up a retirement plan for your business may be the single best way to simultaneously save money on taxes, save for your future, and retain your employees. There are many options though, each with its own nuances, features, pros, and cons.

This guide will explain the relevant factors you should consider when establishing a retirement plan for your business, as well as a few of the most commonly used options.

Choosing the Right Retirement Plan

The right plan for you & your business will depend on several variables:

Personal & Organizational Goals

A good starting point is to consider exactly what you want your plan to accomplish. Most people running a business want to put as much money away tax deferred as possible, while minimizing the amount they're required to contribute for employees. Others might not be as concerned about maximizing their own contributions, and instead want to provide a fortified retirement plan in order to retain key employees and attract new ones.

Income Variability

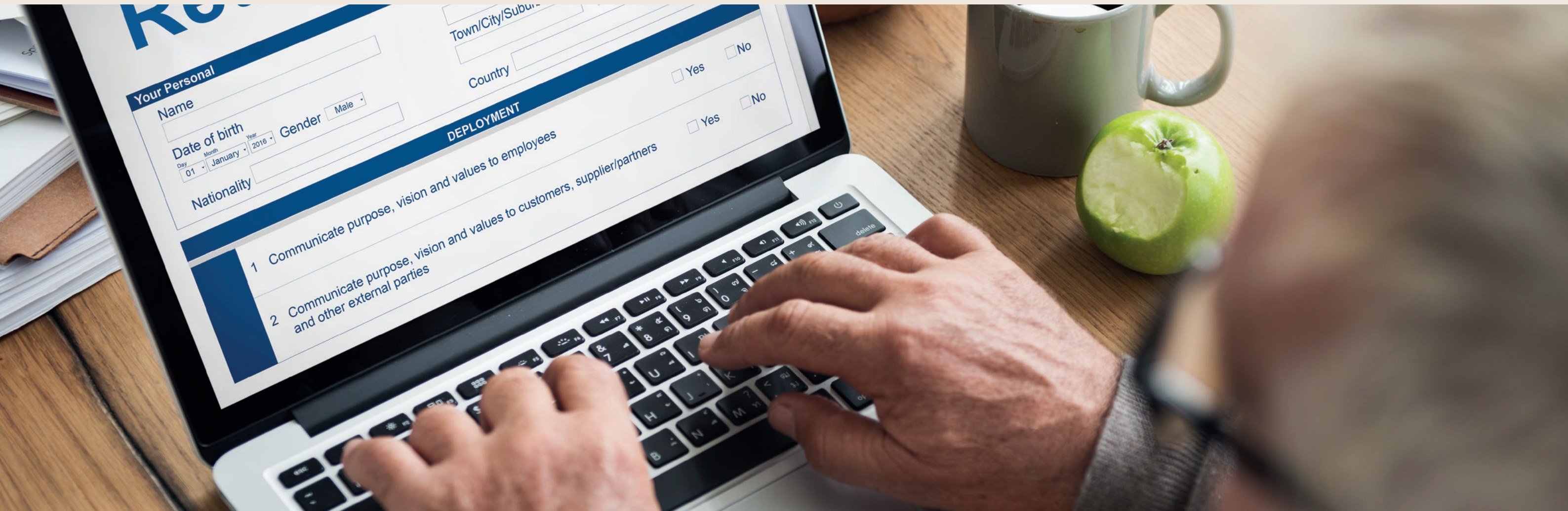
Many plans, including defined benefit pension plans, require businesses to make contributions each year regardless of your company's profitability or available cash. If your business is in the early stages and/or has profits that tend to fluctuate, you'll probably want a plan that offers some flexibility with regard to annual employer contributions.

Eligible Employees

Does your business have employees now? Do you plan to hire in the future? How might your growth aspirations affect your retirement plan? Some retirement plans have strict eligibility requirements, meaning that new employees become eligible for your plan shortly after or immediately upon being hired. This can increase the cost of hiring new employees, and is a factor worth considering.

Employee Deferrals

Some plans allow employees to contribute to their own retirement benefits by deferring funds from their own paychecks, while others rely solely on employer contributions. If your employees are knocking down your door for retirement plan options or you want your employees to be responsible for their own contributions, you'll probably want to provide a plan that offers employee deferrals. This will give your employees the ability to make their own contributions and take more control of their own benefits.



The Most Popular Options

There are many types of retirement plans available to business owners today. As mentioned above, the right plan should depend on you and your business's specific needs. Here are a few of the most commonly used options.

Solo 401(k)

Solo 401(k) plans are also known as solo-k's, individual k's, one participant k's, and a few other names. What's great about them is their flexibility and potentially large contribution limits.

The catch is that you can't have any eligible employees other than your spouse. Solo 401(k) plans have minimum employee eligibility requirements of 21 years of age, 1,000 or more work hours per year, and at least one year of service. This means that if you have employees that meet all three of these standards, you may not contribute to a solo 401(k) plan.

With 401(k) plans (solo 401(k)s included), business owners wear two hats: one as an employee and one as an employer. In 2022, employees can contribute up to $20,500 per year as an employee, plus an additional $6,500 catch up contribution for those over 50 years of age.

As an employer, you may also make profit sharing contributions to a solo 401(k) plan depending on your compensation. Sole proprietors and single member LLCs can make profit sharing contributions of up to 20% of net self-employment income. S-Corps, and C-Corps may contribute 25% of your w-2 compensation. In any event, the total limit between employee and employer contributions in 2022 is $61,000 ($67,500 with a catch up contribution).

The beauty of a solo 401(k) plan is that you get to benefit from the robust structure of a 401(k) plan without the administrative cost. Traditional 401(k) plans must undergo compliance testing each year to confirm that the plan doesn't benefit ownership moreso than the employees. But since there are no employees in a solo 401(k) plan, the compliance testing is unnecessary. For this reason solo 401(k) plans can be opened for free at most brokerage firms, eliminating a layer of complexity and cost.

SEP-IRAs

The SEP-IRA is another popular plan for small businesses due to its low cost and ease of administration. SEP-IRA plans also accommodate employees. The SEP-IRA allows business owners to contribute up to 25% of their own compensation each year on a tax deferred basis (again, 20% of net self-employment compensation for sole proprietorships and single member LLCs), with a max of $61,000 in 2022. Contributions are deposited into an account similar to a traditional IRA, where the owner has flexibility over how to invest the assets.

Additionally, business owners are required to contribute the same percentage of compensation for employees as they contribute for themselves. For example, a business owner might have net self employment earnings of $100,000 and contribute $10,000 to a SEP-IRA. Since they are contributing 10% of their earnings, they'd be required to contribute 10% of each eligible employee's compensation on their behalf as well.

SEP-IRAs have some flexibility surrounding which employees might be eligible, but can become expensive for businesses planning to hire and grow.

SIMPLE IRAs

While SEP-IRAs accommodate businesses with employees, they don't offer much flexibility when it comes to making contributions on behalf of those who are eligible.

Enter the SIMPLE IRA. SIMPLE IRAs can be sponsored by companies with 100 or fewer eligible employees that don't have another retirement plan. And unlike the SEP-IRA, SIMPLE IRAs allow for employee salary deferrals. Employees may defer up to $14,000 from their salary in 2022, plus an additional $3,000 catch up contribution if they're 50 or older. **In turn, employers are required to make one of two types of contributions on behalf of employees:**

1. A matching contribution, where employers match employee deferrals dollar for dollar, up to 3% of each employee's compensation. This matching contribution may be reduced to 1% of employee compensation in two out of any five years.

2. A 2% non-elective contribution. Regardless of whether employees contribute to the plan, the business must contribute a flat 2% of employee compensation on their behalf.

The SIMPLE IRA does require slightly more administrative work than SEP-IRAs, but is typically more cost effective for growing businesses.

401(k) Plans

Likely the most recognizable type of retirement plan, 401(k) plans allow for a combination of employee deferrals and employer contributions with a fair amount of flexibility.

401(k) plans are best suited for stable companies who want their employees to take part in funding their retirement benefits. Eligible employees, like the solo 401(k), can defer up to $20,500 of their salary into the plan in 2022, plus an additional $6,500 in catch up contributions if they're over 50. Your business can then contribute funds on their behalf in a number of different ways.

401(k) plans are popular because of their contribution limits and flexibility. You have discretion over eligibility requirements, vesting of company contributions, structure of employer contributions, and other features, which can be helpful in aligning the plan with your business objectives.

The downside of offering a 401(k) plan is that it's more costly and complex than a SEP-IRA or SIMPLE IRA. To establish a plan you'll need to engage a "third party administration" firm to help you structure the plan to your wishes and create and maintain proper documentation. Most businesses also prefer to engage a financial advisor for help maintaining the plan over time.

Summing It Up

The right retirement plan for your business should depend on a number of factors – many of which are presented in this guide. The right retirement plan for your business may change over time too, as your business changes and evolves.

The key to extracting maximum benefit from a retirement plan is to reevaluate your personal and business needs periodically. Retirement plans can be wound up and wound down as needed. Reconfirming that yours is functioning as you need it to is a wonderful way to maximize the benefit to your business and household finances.