



Small Business Owners and Retirement Savings Tax Incentives

The current tax incentives are a critical component in a small business owner's decision to set up and maintain a workplace retirement plan. The contribution limits are higher for employer-sponsored qualified retirement plans than for IRAs. However, in exchange for higher contribution limits qualified retirement plans are subject to coverage and non-discrimination rules that require employer contributions on behalf of employees in order to maximize contributions for the owner. For a small business owner, the ability to use tax savings on his or her contributions to generate all or part of the cash flow needed to pay required contributions for other employees is an important factor in the decision to establish and maintain a retirement plan.

Consider the following situation:

ABC Company has been in operation for 5 years. The owner has some retirement savings in an IRA, but has never taken time to think about retirement. The business has 4 other employees earning from \$35,000 to \$70,000. The owner takes compensation of \$10,000 per month during the year, then takes a year-end bonus equal to the amount of company profits to "clean out" the company. The owner pays individual income taxes on the full amount of the profits at a marginal rate of 28%.

The owner meets with a retirement plan consultant. The owner is older than most of the other workers, so the consultant recommends a safe harbor 401(k) plan with an additional "cross-tested" contribution. Thanks to the nondiscrimination rules that apply to qualified retirement plans, putting \$50,000 of the profits into the 401(k) plan for the owner means the owner must contribute at least 5% of pay for the employees. However, tax savings on the \$50,000 will be more than enough to cover that 5% contribution and the tax credit for the cost of setting up and operating a new plan that helps defray any startup and initial operating costs. Putting in the plan becomes a simple decision of "do you want to give that money to your employees? Or add it to the check you are sending to IRS?"

The result is that the tax incentives transform what would have been a bonus to the business owner, subject to income taxes, into a retirement savings contribution for the owner *and the employees*. Not only will the employees receive an employer contribution of 5% of pay, they are also very likely to make additional contributions on their own behalf. Because the tax incentive is a deferral, income taxes will be paid on the contributions, and investment earnings on those contributions, at a future date when the money is withdrawn.

In summary, the current system of tax incentives for retirement savings motivates small employers to not just offer a retirement savings vehicle to all the employees in the workplace, but make contributions on the employees' behalf. Reducing the incentive would literally reduce the cash the small business owner has to work with. Reduced incentives will mean fewer plans, or lower employer contributions for those plans remaining.

Current Law Tax Incentives

	<u>Compensation</u>	Elective <u>Deferral*</u>	3 % Safe <u>Harbor</u>	<u>Addl PS</u>	Total <u>Employer</u>	<u>Total*</u>
Owner	139,750.00	17,000.00	4,193	28,808	33,000	50,000
Employee 1	70,000.00	4,200	2,100	1,400	3,500	7,700
Employee 2	50,000.00	2,400	1,500	1,000	2,500	4,900
Employee 3	40,000.00	-	1,200	800	2,000	2,000
Employee 5	<u>35,000.00</u>	<u>600</u>	<u>1,050</u>	<u>700</u>	<u>1,750</u>	<u>2,350</u>
Total for Employees	195,000.00	7,200	5,850	3,900	9,750	16,950

<u>Owner's:</u>		Net with plan
Regular compensation	120,000	120,000
Profits to be paid as bonus	<u>62,500</u>	<u>19,750</u>
Total compensation - no plan	182,500	139,750

With plan:		
Regular compensation	120,000	
Bonus	<u>19,750</u>	(Note - \$17,000 will be contributed to the plan as an elective deferral)
Total compensation	139,750	
less elective deferral	<u>-17,000</u>	
Net taxable income	122,750	
Reduction in taxable income	59,750	
Tax savings before ee contribs	16,730	
cost for employees	<u>-9,750</u>	
Net cash gain before admin/setup	6,980	

* Employee amounts are shown to complete the illustration, but be higher or lower, depending on the employee's election.

20/20 Proposal

	<u>Compensation</u>	Elective <u>Deferral*</u>	3 % Safe <u>Harbor</u>	<u>Addl PS</u>	Total <u>Employer</u>	<u>Total*</u>
Owner	171,504.85	14,855	5,145	-	5,145	20,000
Employee 1	70,000.00	4,200	2,100	-	2,100	6,300
Employee 2	50,000.00	2,400	1,500	-	1,500	3,900
Employee 3	40,000.00	-	1,200	-	1,200	1,200
Employee 5	<u>35,000.00</u>	<u>600</u>	<u>1,050</u>	<u>-</u>	<u>1,050</u>	<u>1,650</u>
Total for Employees	195,000.00	7,200	5,850	-	5,850	13,050

<u>Owner's:</u>		Net with plan
Regular compensation	120,000	120,000
Profits to be paid as bonus	<u>62,500</u>	<u>51,505</u>
Total compensation - no plan	182,500	171,505

With plan:		
Regular compensation	120,000	
Bonus	<u>51,505</u>	(Note - elective deferral is made from this bonus)
Total compensation	171,505	
less elective deferral	<u>-14,855</u>	
Net taxable income	156,650	

Reduction in taxable income	25,850
Tax savings before ee contribs	7,238

cost for employees	<u>-5,850</u>
Net cash gain <u>before admin/setup</u>	1,388

* Employee amounts are shown to complete the illustration, but would be higher or lower, depending on the employee's election.