COVERITY

The 12 Things Business Owners Need to Know About Retirement Plans

Many American employees consider their company's retirement plan to be the primary tool to accumulate assets for retirement. Many business owners consider retirement plans to be a big fat headache. Owners have good reasons to be frustrated: time-consuming enrollment and education, incomprehensible investment performance, and high administrative costs. Small to medium size businesses often lack in-house benefits professionals, leaving the owner to fend for himself. Perhaps the biggest disappointment occurs if the owner cannot personally contribute significant funds because the plan failed anti-discrimination tests or because the federal government's contribution limits are too low for his or her needs.

Despite this, properly designed retirement plans in many cases present a powerful tool to tax-efficiently build wealth outside of the business. In many situations retirement plans can provide substantial benefits for the business owner—in the years up to and even after the owner has exited from the business.
Below are the top 12 things business owners need to know about retirement plans.

1. **Retirement plans can enable owners to take money out of their business on a pre-tax basis.**
   Most owners have from 50-90% of their net worth tied up in the business. Eventually, owners need to unlock the wealth tied up in the business and convert it to personal assets. Taking money out of the business as compensation or dividends typically creates higher incomes taxes in the current year. Retirement plans can enable owners to take money out of the business without paying taxes until the owner one day withdraws the proceeds from the plan.

2. **Funds inside retirement plans grow on a tax deferred basis.**
   Investments that grow tax deferred have the opportunity to accumulate faster because you do not pay taxes on the investment growth along the way. Taxes are paid at the time proceeds are withdrawn from the plan—and that can be many years in the future such as after the owner has exited from the business.

3. **There are many different types of retirement plans, and some benefit business owners more than others.**
   Many owners are unaware that there are a wide variety of retirement plans and retirement plan features to choose from—it is not just all 401(k) plans out there. Examples of lesser known retirement plans and plan features include profit sharing plans, safe harbor plans, integrated plans, cross-tested plans, defined benefit plans, and more. Choosing and configuring the best plan is called "plan design" and is a specialized area of financial expertise.

4. **The standard 401(k) is often not the best choice to meet a business owner's needs.**
   Over the last several decades, 401(k) plans have come to dominate the retirement plan landscape, to the point that the term "401(k)" is nearly synonymous with retirement savings. As a result, many owners (and advisors) assume that a 401(k) will adequately meet an owner's needs. Often this is not the case. In many situations owners cannot put as much money into a 401(k) plan for themselves as they might like. An owner's contributions can be further limited if rank and file employees do not sufficiently contribute into the 401(k) plan.

5. **Owners often do not have to treat all the employees the same way within the retirement plan.**
   One of the more common retirement plan myths is that the business owner must receive the same benefit within a retirement plan as all of the other employees. This is true with some types of plans, but not true with others. All retirement plans must comply with a set of federal “anti-discrimination” regulations designed to make sure rank and file employees receive proportionate benefits from the plan. However, some types of plans permit higher current contributions or greater future benefits for certain participants, such as older employees or more highly compensated employees. (And often the business owner is one of the oldest and most highly compensated employees.) There are limits, but in many situations the retirement plan can be designed to create significantly greater current contributions or future benefits for the business owner.

6. **Retirement plans other than a standard 401(k) may enable an owner to take tens to hundreds of thousands of dollars per year out of the business on a pre-tax basis.**
   Different retirement plans have different limitations on either how much money can go into the plan per year for each participant, or how much the plan may provide to each participant in the future at retirement age. Either way, owners are not limited to the just the amount they can defer into a 401(k) account — $19,000 in 2019 ($25,000 if the participant is age 50 or older.) Some types of plans such as profit sharing plans permit contributions up to $56,000 per person each year ($62,000 if the participant is age 50 or older.) Defined benefit plans such as pension plans can create annual contributions of several hundred thousand dollars per year. In all cases, the retirement plan still must comply with anti-discrimination testing and regulations, which means contributions for eligible rank and file employees are typically required.

7. **Not all employees have to be included in the retirement plan.**
   The lesser the number of employees included in the plan, the easier it may to maximize the plan’s benefits for the business owner. Most retirement plans are permitted to set rules that govern which employees participate in the plan. For example, some plans can stipulate a minimum age of 21, one year of service, and full time employment before an employee is eligible to participate. Restricting participation can enable the plan to provide proportionally greater benefits for the owner.

8. **Owners do not have to invest their retirement plan funds in the stock market.**
   Many business owners are uncomfortable investing in aggressive stocks for fear of losing some of their hard-earned money. Today, most types of retirement plans allow each plan participant to pick his or her investments from a range of choices. These choices are often mutual funds (or ETFs—exchange traded funds) that range from more aggressive stock funds to more conservatives funds that invest in bonds or cash. Owners, like other plan participants, can chose the investment options that meet their personal risk preferences.

9. **Retirement plans can play an important role in the business owner’s exit planning.**
   Retirement plans give owners a potential means to take money out of the business on a pre-tax basis prior to exit. This can reduce the owner’s dependency on the business, which in turn reduces risk and increases exit options. Retirement plans can also play a role after the owner has exited from the business. For example, when selling a business it is not unusual that the buyer includes in the terms a consulting agreement for the selling owner. If the selling owner does not currently need the income from the consulting payments, he or she can consider setting up a retirement plan for that consulting income.

10. **Retirement plans offer strong creditor protection.**
Business owners need to prudently consider steps to protect their business and personal assets from unwarranted creditors. Retirement plans offer immense asset protection. Under federal law, most creditors cannot take any retirement plan assets. (There are exceptions, such as the IRS, alimony and child support.) This unlimited protection makes retirement plans one of the strongest ways to protect a business owner's wealth.

11. **There are important dates and deadlines governing retirement plans.**
Retirement plans are subject to a number of dates and deadlines that business owners and their advisors should know about. For example, some types of plans must be established by October 1st of a given year. Other types of plans can be set up by December 31st. In addition, there are other important dates throughout the year that govern how retirement plans operate.

12. **Retirement plans are complicated, and there is help available.**
Retirement plans are complicated tools, but there are advisors who specialize in plan design, administration, and investment services for retirement plans. Many of these advisors offer their services on a fee-only basis, creating transparency for the business owner. Also, many retirement plan specialists embrace the status of a plan fiduciary, meaning they have a legal duty to give advice and services in the best interests of the plan's participants. Like any complicated issue, owners should consult their tax, legal, and financial advisors before taking any action to determine what is best in their situation.

Qualified retirement plans are complex, and the landscape constantly changes: laws are amended, the business's employee population evolves, and market conditions change. These changes affect retirement plan design and maintenance. At Persium, we work with business owners to evaluate which plan best meets the owner's objectives, and annually review the plan and its performance. For more information, contact us at www.persiumgroup.com.