Plan Sponsor

Digest

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Your Challenge, Our Solutions™

Choosing a retirement plan that maximizes benefits for owners and key employees

Business owners may want to consider setting up a tax-qualified retirement plan that can help them fund their own retirement.

With the various restrictions and limitations on retirement plan contributions and benefits, small business owners and professionals may wonder whether it is possible to fund adequate retirement benefits for themselves using a tax-qualified plan. In many cases, it is—if the most appropriate plan design is chosen.

Why so many restrictions?

Many of the restrictions and limitations added to the federal tax code in the pension area have been aimed at making plans nondiscriminatory—i.e., making sure the plan doesn't discriminate in favor of a firm's highly paid employees. In some cases, the unintended effect of the restrictions has been to dampen enthusiasm for retirement plans because business owners question whether the benefits they receive justify the expense of maintaining a plan.

What plans should a business owner who is concerned about funding their own retirement consider? Several possibilities are discussed below.

Age-based profit sharing plan

One type of plan that may be appropriate for many small business owners and professionals is the age-based profit sharing plan. This plan combines the traditional benefits of a profit sharing plan with the ability to allocate employer contributions to participant accounts using factors that consider both compensation and age. In contrast, traditional profit sharing plans allocate contributions based only on compensation, with each participant receiving a flat percentage of pay.

If employee demographics favor the age-based approach, more of the annual profit sharing plan contribution is shifted to the accounts of the older owner(s) and key employees participating in the plan. In some instances, the total plan contribution can be lowered while allocations to the owner and the key employees remain at the same levels—or even increase.

Target benefit plan

This type of plan is a cross between a defined benefit pension plan and a money purchase plan. It uses actuarial assumptions—including assumptions about remaining years to retirement—in determining the amount to be contributed for each participant. As with an age-based plan, no more than $56,000 a year (in 2019) can be added to each employee's account, regardless of compensation or age. However, the plan is not as flexible as an age-based plan in that an annual employer contribution is generally required.

Defined benefit pension plan

If the per-employee cap on additions to a plan account is a source of concern, a traditional defined benefit pension plan can often provide more lucrative benefits. With this type of plan, the closer a participant is to retirement age and the larger the promised retirement benefit, the higher the plan contribution, all else being equal.

Other considerations?

Before deciding to implement any of these plans, the effect of the tax law's top-heavy rules should be analyzed. These rules generally are triggered when key employees hold more than 60% of the account balances or accrued benefits in all plans sponsored by the employer. When a plan is top heavy, every active participant must receive a minimum contribution or benefit (3% of pay for a defined contribution plan).

Considering a Roth 401(k)?

Sponsors should know these rules and requirements before adding a Roth 401(k) option to their plans.

The Roth 401(k) option is becoming increasingly popular with plan sponsors. According to the 60th Annual Survey of Profit Sharing and 401(k) Plans from the Plan Sponsor Council of America, 63.1% of 401(k) plans offered Roth 401(k) deferrals in 2016. What general rules and requirements should sponsors know about when considering to add this feature?

Benefits of a Roth 401(k)

Although traditional 401(k)s and Roth 401(k)s have many similarities, they have many important differences. With a traditional 401(k), participants make retirement plan contributions with pretax dollars. For 2019, participants may contribute up to $19,000 ($25,000 if age 50 or older). Taxes on contributions and earnings are deferred until participants take distributions. At that point, withdrawals are included in income, and participants pay taxes based on their tax rate at that time.

In contrast, a Roth 401(k) combines certain features of a traditional 401(k) and a Roth individual retirement account (IRA). As with a Roth IRA, contributions to a Roth 401(k) are made with after-tax dollars. Qualified distributions of contributions—as well as any earnings—from a Roth 401(k) account are income tax free. To qualify for tax-free treatment, a Roth 401(k) distribution must be made after a five-tax-year period beginning with the first tax year for which the participant made a designated Roth contribution under the same plan. Additionally, the participant must have reached age 59½ or the distribution must be made after the participant's death or because of disability. Unlike Roth IRAs, Roth 401(k)s do not allow a qualified distribution for a first-time home purchase.

The maximum annual contribution to a Roth IRA for 2019 is $6,000 ($7,000 if age 50 or older), and eligibility for Roth IRA contributions is phased out as income rises. No such income limits apply to a designated Roth 401(k) account—a feature that might appeal to highly compensated employees. Moreover, plans may allow eligible participants to make designated Roth contributions up to the limits set for traditional 401(k) plans. These limits will apply to pretax and after-tax Roth contributions combined. Employers may make matching contributions on designated Roth contributions, but they must allocate any matching contributions to a pretax account.

A plan may not consist solely of designated Roth accounts—if offering a Roth 401(k) option, the sponsor must also offer a traditional 401(k) plan. Participants may then be allowed to designate some or all of their elective deferrals as Roth 401(k) contributions.

Implementing a Roth 401(k)

When considering a Roth 401(k) option, sponsors should be aware of the need to comply with additional administrative requirements. To implement a Roth 401(k), the sponsor must adopt an appropriate plan amendment by the end of the plan year for which the amendment is effective. Participants must receive amended plan notifications, including an updated summary plan description and election forms. Educational materials may need to be updated as well.

Plans must keep separate accounts for each participant's Roth 401(k) and traditional 401(k) accounts, and employers will need to change their payroll systems to accommodate Roth contributions. If recordkeeping is outsourced, service providers will need to properly account for Roth 401(k) contributions and any earnings.

In-plan rollovers

Sponsors may also want to amend their plans to allow participants to make "in-plan Roth rollovers" from their traditional 401(k) accounts to their Roth 401(k)s. Participants who choose to make in-plan Roth rollovers will be subject to income tax on any previously untaxed amounts that are rolled over. However, the 20% withholding requirement that generally applies to eligible rollover distributions does not apply to direct in-plan rollovers. Also, in-plan Roth rollovers are generally not subject to the 10% additional tax on early distributions.

Plans may choose to allow in-plan Roth rollovers even where the amounts are not otherwise distributable under the plan's terms. However, once the rollover is completed, any distribution restrictions that applied before the rollover will again apply to both the rolled over amount and any earnings thereon.

Nondiscrimination testing

Plans may not discriminate in favor of highly compensated employees when offering a Roth 401(k). Additionally, designated Roth 401(k) contributions are treated as elective contributions for purposes of the actual deferral percentage test.

The foregoing is a broad overview of the relevant rules. If you are considering adding a designated Roth contribution option to your plan, consult your advisor.

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