DIVERSIFIED ASSET MANAGEMENT INC.

When Choosing a Retirement Plan, Don't Default to the 'Obvious' Choice

Key Takeaways:

- Qualified plans offer tax-advantaged savings benefits for your eventual retirement.
- Popular qualified plans include defined contribution plans such as SEP-IRAs and 401(k)s.
- Defined benefit plans, while less well known, may enable you to save large sums for retirement rapidly.

When sizing up retirement plans for your company, it can be tempting to go with the option that is easiest for you to administer and manage. After all, you've got a successful business to steer—why add yet another layer of complexity to your life?

But as is so often true, the easiest path is not necessarily the best path. Selecting a retirement plan because it may be "hassle free" or easy to understand intuitively could be the right choice for your situation, of course. However, it could potentially hold you back from being able to save aggressively for your own retirement—and generate significant tax benefits along the way.

The key is to understand and consider a range of retirement plan options as well as carefully assess your own goals and your company's financial situation. Armed with that information, you should be better positioned to make the appropriate choice for your business and your own life.

With that in mind, let's take a closer look at the world of qualified retirement plans—and their various implications for you as a successful entrepreneur.

The case for qualified plans

Chances are, you are familiar enough with the basics of tax-advantaged qualified plans to recognize their key benefits—which include the following:

- Contributions you (as owner) make to the plan are immediately tax-deductible.
- Earnings within the plan grow tax-deferred or possibly even tax-free.
- In general, assets in the plan are protected from creditors.
- Employees get a valuable benefit—helping you recruit and retain staff.
- You can diversify your assets away from your business into other asset classes.

As an owner, offering retirement plan benefits may allow you to accumulate sizable tax-advantaged savings for your own retirement. Indeed, a qualified plan can potentially (in some cases) be designed to drive the majority of the benefits to you as the owner.

And yet, it seems many businesses may be overlooking retirement plans altogether. A Pew Charitable Trusts survey estimates that just 53 percent of small-to-midsize businesses (those with five to 250 employees) offer a retirement plan.

However, there are some potential downsides. Example: If the ABLE account exceeds $100,000, the individual is no longer eligible for SSI.

There are two main types of qualified plans to consider:

- Defined contribution plans
- Defined benefit plans

Let's explore each one in detail—with an eye toward how you can benefit as an entrepreneur saving for retirement.

DEFINED CONTRIBUTION PLANS

A defined contribution plan enables you to regularly contribute some portion of your paycheck into an account meant for your retirement spending needs. You can choose to invest your savings in various ways based on the options available in the plan. The retirement benefit in a defined contribution plan is determined by the contributions to an account and that account's investment performance.

Some commonly considered categories of defined contribution plans include the following:

1. Simplified employee pension IRA. Business owners often like SEP-IRAs because they have lower startup and ongoing operating costs than many other types of plans as well as less paperwork. SEP-IRAs also allow employers to contribute toward their own retirements at higher levels than they can using a traditional IRA (which is not considered to be a qualified plan). Example: For 2022, the maximum annual contribution limit you can contribute as the business owner is $61,000 or 25 percent of compensation, whichever is less. Also, SEP-IRAs are flexible—you decide each year how much to contribute and you aren't required to contribute each year. That's one reason why businesses with highly variable revenues or cash flow from year to year may find SEP-IRAs attractive.

   That said, if you set up a SEP-IRA, you likely have to include all eligible employees in it—and each employee has to receive the same contribution as a percentage of salary as you give yourself. If you have many staffers, these rules could hamper your ability to make large contributions for yourself. Additionally, employees are always 100 percent vested in your contributions to their SEP-IRAs—a potential negative if your goal is to encourage employees to stick around for the long term.

2. 401(k) plans. Probably the most well-known type of defined contribution plan, a 401(k) plan is more complicated for a business to start up and run than is a SEP-IRA. Usually a third-party administrator needs to be involved to deal with compliance and plan testing to ensure the plan is following the rules. The good news: The SECURE Act of 2019 increased the business tax credit for plan startup costs and simplified some other aspects of plan management. So it may be time to revisit the 401(k) in light of these changes.

   Of course, the pros of a 401(k) for you as the employer are compelling: As with a SEP-IRA, you as the owner can contribute up to $61,000 in 2022. But unlike SEP-IRAs, 401(k) plans allow catch-up contributions if you're 50 or older—boosting your maximum to $67,500 this year, if you qualify. What's more, because 401(k) plans allow both employer and employee contributions, you can hit that maximum at a lower income level than with a SEP-IRA. And, of course, a 401(k) plan is designed to have employees—not just you—contribute to their retirement accounts.

Defined benefit plans

Another type of qualified retirement plan is a defined benefit plan. In general, defined benefit plans are much more complicated to set up than defined contribution plans, and they can require significantly more oversight and administration expenses as well. For example, you may need to hire actuaries and professional money managers to establish and run a defined benefit plan.

So why add this complex and relatively pricey option to your list of retirement plan possibilities? Simple: Potentially, a defined benefit plan can empower your ability to save for retirement in tax-efficient ways like no other option out there.

Example: With a defined benefit plan, you as the owner might potentially be able to make annual deductible contributions for your retirement of $100,000 or more—perhaps much more. Often DB contributions are two to four times greater than what you can defer in a SEP-IRA or 401(k).

The reason: Defined benefit plans are designed to provide a guaranteed lifetime income stream to be paid out of the plan starting at retirement—like an old-school pension, essentially. In order to fund the desired benefit amount by the time of your desired retirement age, hefty annual contributions may be necessary—allowing you to sock away big sums for your golden years that also reduce your current tax bills.

The upshot: A defined benefit plan could potentially enable you to save in just ten years an amount of money you'd need 20 years to save if you used a defined contribution or other type of retirement plan. Annual contribution requirements are calculated based on the benefit you'll receive at retirement, your age, your current salary and other factors. (There are limits to DB plans, however. For example, the annual income stream you receive in retirement from a DB plan cannot exceed $245,000.)

Therefore, defined benefit plans tend to be especially appealing to highly successful business owners who are fairly close to retirement age—say, age 50 and older—and whose businesses are generating plenty of cash flow to ensure they can meet the minimum required amount of funding that a defined benefit plan must satisfy each and every year to guarantee that eventual income stream. Such entrepreneurs can use the plan to essentially "play catch up" with their retirement savings.

Another important consideration is the number of employees a firm has, as any employees have to benefit from this type of plan as well—it can't exist only as a means for you as owner to bulk up your retirement savings balance. Without a high enough and reliable enough income, the requirement to make contributions on employees' behalf could boosts costs too much to make a defined benefit plan feasible. Many DB professionals recommend these plans to entrepreneurs with five employees or fewer—and often they prefer solo businesses with no employees at all.

Pro tip: If you earn a high income as an entrepreneur and are looking for estate planning strategies, consider a type of defined benefit plan known as a benefit focused plan, which—due to using insurance as part of the funding mechanism—can allow you to create a guaranteed income stream for both you and your surviving spouse after you die. Contributions are based on the amount it would take to provide a joint lifetime monthly retirement income, so be aware that required contributions will be particularly high.

Conclusion

Clearly, the world of qualified plans is a lot to navigate—we've really only scratched the surface here. They're a tool that we feel business owners should strongly consider, given their many broad-based benefits.
But to maximize the value you can potentially get from a qualified plan, take the time to evaluate the many options that exist. Don't choose a plan simply because you've heard of it, because it's popular or because it seems easy to understand. Doing some digging—with the help of a trusted financial professional—may help you identify a plan that can supercharge your retirement savings.

ACKNOWLEDGMENT

This article was published by the VFO Inner Circle, a global financial concierge group working with affluent individuals and families and is distributed with its permission.

3450 Penrose Place,Suite 160
Boulder,CO 80301

303-440-2906

info@diversifiedassetmanagement.com

DIVERSIFIED ASSET MANAGEMENT INC.