Choosing a Retirement Plan That Maximizes Benefits for Owners and Key Employees

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 has Congress imposed so many restrictions on plans?

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 that the plan does not discriminate in favor of a firm’s highly paid employees. In some cases, the perhaps unintended effect of the restrictions has been to dampen enthusiasm for retirement plans because business owners question whether the benefits they will receive justify the expense of maintaining a plan.

What plans should a business owner who is concerned about funding his or her 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. The 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 $52,000 a year (in 2014) 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.

What else should a business owner consider?

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).

Where can business owners find out more about retirement plan options?

We are always willing to assist employers in any way we can. If you would like to find out more about our services and how they can benefit you and your employees, please call us soon.