PROS AND CONS OF *EMPLOYER SPONSORED* RETIREMENT PLANS

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Establishing a retirement plan for your company is a decision that could make a great difference in the retirement preparedness of your employees, and yourself.

The Federal Reserve's 2015 Report on the Economic Well-Being of U.S. Households in 2014 found that only 31 percent of non-retired survey respondents had no retirement savings whatsoever. Only 46 percent of those surveyed had access to an employer-sponsored retirement plan. Federal retirement benefit programs such as Social Security Income are strained. In fact, an August 2015 article from Pew Research forecasts that Social Security's reserves will be depleted by 2034 based on current demographic and economic trends.

As the Department of Labor states, "It's not going to be your parents' retirement – rewarded at 65 with a gold watch, a guaranteed pension and health insurance for life." In reality, Americans are living longer and can no longer count on their employers or the government to fund their retirements. Therefore, it's important that individuals take control of their own financial futures. Employers can help by making retirement savings options easily accessible.

THE PROS

Several plan options available. Retirement plans can be extremely simple, such as Payroll Deduction IRA, or quite complex like a defined benefit pension plan. Some require mandatory employer contributions regardless of the profitability of the company. Others, like a SEP (Simplified Employee Pension Plan), allow the employer to decide year-to-year whether to contribute, and if so, how much to contribute. Choosing the plan that is right for the business requires forethought and planning. The Plan Feature Comparison Chart from the IRS can help you assess your options.

The Federal income tax deduction. This may be the most compelling reason for the small business owner and the self-employed to offer a qualified pension plan. Employer contributions are deductible from the employer's income. Even contributions to the employer's retirement account may be claimed as a deduction, subject to IRS rules and calculations. The IRS also offers a tax credit to employers establishing a retirement plan for the first time, which is intended to offset the cost of the initial set-up, administration, and employee education. The credit is limited to employers of 100 or fewer employees.

Greater contribution maximums. The maximum contribution to a private IRA is $5,500 ($6,500 if 50 or older). The employee maximum contributions for most employer- sponsored plans are significantly more. Only the Payroll Deduction IRA applies the same maximum contributions as a private IRA. For example, an employee participating in a 401(k) plan may contribute up to $19,000 tax-deferred in 2019. As of this writing, contributions to a Profit Sharing 401(k) may be 100% of compensation or $56,000 whichever is less, based on a maximum compensation of $280,000. Retirement plans that allow employer contributions also have generous per employee maximums.

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Tax incentives extend to employees. Employees also earn a tax advantage for participating in a qualified plan. With the exception of a Roth IRA, employee contributions are excluded from taxable wages. Contributions and asset growth are taxable but not until a distribution is taken. Lower income employees participating in the plan may qualifyfor the Saver's Credit (retirement contribution savings credit). This tax credit is for individuals with an AGI (adjusted gross income) of $30,500 or less who file as single or married filing separately. Joint filers may not exceed an AGI of $61,000 to qualify.

Tax deferred growth. Assets in the plan grow without incurring income taxes. Ultimately, pre-tax contributions and asset growth are taxable but not until distributions begin in retirement.

Talent attraction and retention. Less than half of Americans employed by small businesses have an employer sponsored retirement plan. Yet close to half the workforce is employed by small businesses according to SBA.gov. An employer-sponsored retirement plan can be a differentiator to job applicants and contributes to employee retention. According to the 2011 Towers Watson Retirement Attitudes Survey, 57 percent of employees participating in a defined contribution plan are motivated to stay with their employers until they retire. When a defined benefit plan is offered that number jumps to 69 percent.

Matching contributions. Matching contributions can benefit both the employer and plan participants. An employer who matches employee contributions is likely to increase employee participation rates, which can reduce plan non-discrimination concerns, if applicable. The employer matching also emphasizes to employees the importance of saving for retirement. Some 401(k) plans allow discretionary employer contributions, similar to profit sharing. Employees benefit from increased value of the employee account and increased employee contributions in order to maximize the employer match.

Tax-deferred compound earnings. Compound earnings are available in many savings plans. However, a tax-favored plan can heighten the impact of compound earnings. Consider the future value of a $600 ($50 monthly) annual contribution that grows over time without decreasing the account value to pay income tax:

Annual Contribution, earning 4%	5 Years	10 Years	20 Years
$600	$3,249	$7,203	$17,866

Guaranteed lifetime income. Retirement benefits vary by type of plan. However, most share the requirement to offer a lifetime annuity. Some plans offer the participant choices in the form of a lump sum distribution. Defined contribution plans usually have more flexibility than defined benefit plans.

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Option to convert savings into a Roth IRA. Roth IRA conversion features can be very attractive as a tax planning strategy for employees and business owners alike. How does it work? You can take a portion of the funds you've saved in the employer-sponsored retirement account and convert them to a Roth IRA. You claim the converted amount of pretax savings as income on your taxes at the time you convert, and then you enjoy the benefits of tax-free growth on the Roth IRA. Usually Roth IRA distributions are tax-free as long as the money has been in the Roth account for at least five years and is taken at age 59 ½ or later. Conversions require some careful planning and can occur over several years. Roth IRA rules still restrict contributions based on income but conversions are viewed differently. IRS Guidance Notice #2014-54 provides further details.

Designated Roth Account. Within a 401(k), 403(b), or 457(b) account, participants may designate a separate Roth account. The option allows taxed and non-taxed contributions to be managed in a single plan. Because the designated Roth account is within a qualified plan, participants benefit from increased contribution maximums and do not have the income restrictions Roth IRAs do. The maximum plan contributions apply to combined participant contributions. Like a Roth IRA, distributions from the designated Roth account are usually tax-free although designated Roth accounts are subject to required minimum distributions. The IRS website provides details.

Plan assets are protected. In the event of bankruptcy of the business, assets in a pension plan are usually protected from creditors. Contributions made by the employer to employee retirement accounts including the employer's retirement account are sequestered from other assets of the business. Plan participants immediately become 100 percent vested for the full value of their account.

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THE CONS

Administrative expenses. Some employer-sponsored retirement plans, such as the SEP or Payroll Deduction IRA, have virtually no set-up expenses. Others require dedicated administrative staff and actuarial expertise to ensure the plan remains compliant and properly administered. Consider the administration requirements and expenses involved before choosing the plan for your company.

Restricted employer contributions. Some plans restrict employer contributions. For example, if earning a tax deduction for employer contributions is the primary reason to establish a retirement plan, then the Payroll Deduction IRA may not be the right choice, as employer contributions are not allowed. Conversely, a SIMPLE IRA allows the employee to decide how much to contribute, subject to maximums, and requires the employer to match the contribution or contribute 2 percent of salary for each eligible employee. Again, carefully research the employer contributions allowed and required before deciding on a plan.

Underfunded liability complications. In a defined benefit plan, the employer bears the entire risk for funding the account. If investments perform poorly or the interest rate environment is stagnant, the portfolio may not perform as expected. Ultimately, the employer must make the fund whole. A good actuary and plan administrator are essential to avoid undesirable situations. Even defined contribution plans must be careful to avoid underfunding. Some firms plan for employer contributions in their operations cash flow. Others make required employer contributions out of the employer's income. Plan carefully to avoid penalties for underfunded plans.

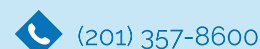
Penalties for early distributions. All retirement plans that allow withdrawals and distributions prior to retirement apply a penalty tax for early distributions.

Required distributions. All retirement plans require a minimum distribution (RMD) at age 70 ½, including designated Roth accounts. Only a Roth IRA does not impose an RMD on the original owner. However, inherited Roth IRAs do require RMDs.

NEXT STEPS

For many employers, the advantages of employer-sponsored retirement plans outweigh the disadvantages. Whichever path you choose, make sure to collaborate with financial and tax professionals who are versed in the products, administration, and funding rules for pension plans. With a wide variety of employer-sponsored retirement plan types and features, you should be able to identify a plan that accomplishes your business objectives. Some retirement plans can be established in a few business days, while others require more legwork and selection of an administrator and actuary. If needed, your financial partner can recommend firms specializing in pension administration.

For even more information on employer-sponsored retirement plans and how they may be a fit with you and your company, please reach out to us for a private consultation.


(201) 357-8600

info@kaspiangroupinc.com

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