



**SELECT PORTFOLIO  
MANAGEMENT, INC.**  
Integrated Wealth Management  
A Registered Investment Advisor



White Paper

*Retirement Plans for Businesses*

[www.selectportfolio.com](http://www.selectportfolio.com) • Toll Free 800.445.9822 • Tel 949.975.7900 • Fax 949.900.8181

Securities offered through Securities Equity Group Member FINRA, SIPC, MSRB

# Table of Contents

---

Retirement Plans for Businesses.....	3
Introduction .....	3
General benefits of retirement plans .....	3
Qualified plans vs. nonqualified plans .....	4
Defined benefit plans vs. defined contribution plans.....	5
Questions to consider when choosing a retirement plan.....	6
Determine which plan meets your goals .....	7
Disclosures .....	11

---

# Retirement Plans for Businesses

---

## Introduction

As an employer, you may want to establish one or more retirement plans for yourself and/or your employees. Having a plan can provide significant benefits for both you and your employees (if any). There are many different types of retirement plans, however, and choosing the right one for your situation is a critical decision. You want a plan that will meet both your goals as the employer and the needs of any employees you may have. In addition, it is important to balance the cost of establishing and maintaining a plan against the potential benefits.

## General benefits of retirement plans

By establishing and maintaining a retirement plan, you can reap significant benefits for both your employees (if any) and yourself as employer. From your perspective as an employer, one of the main advantages of having and funding a retirement plan is that your employer contributions to the plan are generally tax deductible for federal income tax purposes. Contributing to the plan will therefore reduce your organization's taxable income, saving money in taxes. The specific rules regarding deductibility of employer contributions are complex and vary by type of plan, however, so you should consult a tax advisor for guidance.

For many employers, perhaps the greatest advantage of having a retirement plan is that these plans appeal to large numbers of employees. In fact, offering a good retirement plan (along with other benefits, such as health insurance) may allow you to attract and retain the employees you want. You will save time and money in the long run if you can hire quality employees, and minimize your employee turnover rate. In addition, employees who feel well rewarded and more secure about their financial future tend to be more productive employees, further improving your business's bottom line. Such employees are also less likely to organize into collective bargaining units, which can cause major business problems for some employers.

So, why are retirement plans considered such a valuable employee benefit? From the employee's perspective, key advantages of a retirement plan may include some or all of the following:

- Some plans (e.g., 401(k) plans) allow employee contributions. This gives employees a convenient way to save for retirement, and their contributions are generally made on a pretax basis, reducing their taxable income. In some cases, the employer will match employee contributions up to a certain level.
- Funds in a retirement plan grow tax deferred, meaning that any investment earnings are not taxed as long as they remain in the plan. The employee generally pays no income tax until he or she begins to take distributions. Depending on investment performance, this creates the potential for more rapid growth than funds held outside a retirement plan.

**Caution:** Distributions taken before age 59½ may also be subject to a 10 percent federal penalty tax (25 percent in the case of certain distributions from SIMPLE IRA plans).

- Some plans can allow employees to borrow money from their vested balance in the plan. Plan loans are not taxable under certain conditions, and can provide employees with funds to meet key expenses. Plan loans are not without potential drawbacks, however. For more information, see Loans from Employer-Sponsored Retirement Plans.
- Funds held in a 403(b), 457(b), SEP, SIMPLE, or qualified employer plan are fully shielded from an employee's creditors under federal law in the event of the employee's bankruptcy. This is in contrast to traditional and Roth IRA funds, which are generally protected only up to one million dollars under federal law, plus any amounts attributable to a rollover from an employer qualified plan or 403(b) plan. (IRAs may have additional protection from creditors under state law.) Funds held in qualified plans and 403(b) plans covered by the Employee Retirement Income Security Act of 1974 (ERISA) are also fully protected under federal law from the claims of the employee's and employer's creditors, even outside of bankruptcy.

## Qualified plans vs. nonqualified plans

If you are an employer who is considering setting up a retirement plan, be aware that many different types of plans exist. The choices can sometimes be overwhelming, so it is best to use a systematic approach to narrow your options. Your first step should be to understand the distinction between a qualified retirement plan and a nonqualified retirement plan. Virtually every type of retirement plan can be classified into one of these two groups. So what is the difference?

Qualified retirement plans offer significant tax advantages to both employers and employees. As mentioned, employers are generally able to deduct their contributions, while participants benefit from pretax contributions and tax-deferred growth. In return for these tax benefits, a qualified plan generally must adhere to strict IRC (Internal Revenue Code) and ERISA (the Employee Retirement Income Security Act of 1974) guidelines regarding participation in the plan, vesting, funding, nondiscrimination, disclosure, and fiduciary matters.

In contrast to qualified plans, nonqualified retirement plans are often not subject to the same set of ERISA and IRC guidelines. As you might expect, this freedom from extensive requirements provides nonqualified plans with greater flexibility for both employers and employees. Nonqualified plans are also generally less expensive to establish and maintain than qualified plans. However, the main disadvantages of nonqualified plans are (a) they are typically not as beneficial from a tax standpoint, (b) they are generally available only to a select group of employees, and (c) plan assets are not protected in the event of the employer's bankruptcy. See Nonqualified Deferred Compensation Plans.

Most employer-sponsored retirement plans are qualified plans. Because of their popularity and the tax advantages they offer to both you and your employees, it is likely that you will want to evaluate qualified plans first. (See below for a discussion of types of qualified plans.) In addition to providing tax benefits, qualified plans generally promote retirement savings among the broadest possible group of

employees. As a result, they are often considered a more effective tool than nonqualified plans for attracting and retaining large numbers of quality employees.

**Tip:** There are several types of retirement plans that are not qualified plans, but that resemble qualified plans because they have many similar features. These include SEP plans, SIMPLE plans, Section 403(b) plans, and Section 457 plans. See below for descriptions of each type of plan.

## Defined benefit plans vs. defined contribution plans

Qualified retirement plans can be divided into two main categories: defined benefit plans and defined contribution plans. In today's environment, most newer employer-sponsored retirement plans are of the defined contribution variety.

### Defined benefit plans

The older-style defined benefit plan is a qualified employer-sponsored retirement plan that guarantees the employee a specified level of benefits at retirement (e.g., an annual benefit equal to 30 percent of final average pay). As the name suggests, it is the retirement benefit that is defined. The services of an actuary are generally needed to determine the annual contributions that the employer must make to the plan to fund the promised retirement benefits. Defined benefit plans are generally funded solely by the employer. The traditional defined benefit pension plan is not as common as it once was, as many employers have sought to shift responsibility for retirement to the employee. However, a hybrid type of plan called a cash balance plan has gained popularity in recent years. For more information, see Defined Benefit Plan.

### Defined contribution plans

Unlike a defined benefit plan, a defined contribution plan provides each participating employee with an individual plan account. Here, it is the plan contributions that are defined, not the ultimate retirement benefit. Contributions are sometimes defined in the plan document, often in terms of a percentage of the employee's pretax compensation. Alternatively, contributions may be discretionary, determined each year, with only the allocation formula specified in the plan document. With some types of plans, employees may be able to contribute to the plan. A defined contribution plan does not guarantee a certain level of benefits to an employee at retirement or separation from service. Instead, the amount of benefits paid to each participant at retirement or separation is the vested balance of his or her individual account. An employee's vested balance consists of: (1) his or her own contributions and related earnings, and (2) employer contributions and related earnings to which he or she has earned the right through length of service. The dollar value of the account will depend on the total amount of money contributed and the performance of the plan investments. For more information, see Defined Contribution Plan.

## Questions to consider when choosing a retirement plan

There are many different factors to consider when choosing a retirement plan for your company. In some cases, more than one type of plan will meet your needs in one vital area. If this is the case, you will need to further refine your choices by looking at how each type of plan meets your needs and their limitations in other key areas.

You can zero in on the key areas of importance and take the first step to finding the right plan by answering the following questions:

- ✓ What kind of a business entity do you have? Do you have a sole proprietorship, a partnership, a corporation, a limited liability company filing a corporate return, or a limited liability company filing a partnership return? Some plans are more appropriate for certain types of business entities than for others.
- ✓ How many employees do you have right now? How many do you expect to have in one year, three years, and five years from now? Some plans impose limits on the number of employees you can have.
- ✓ What is your current compensation and the current compensation range for your employees? What do you expect your compensation and the compensation range for your employees to be over the next year, three years, and five years?
- ✓ How old are you, and what is the age range for your employees? Some plans allow contributions to be allocated based on age.
- ✓ How much do you want to put away in the retirement plan each year for yourself and/or your employees?
- ✓ Who do you want to fund the retirement plan contributions? Just you as the employer? Just the employees? Both the employees and you as the employer?
- ✓ If you as the employer are funding at least some of the contributions, what percentage of employee compensation do you want to contribute each year?
- ✓ How important is it for you to minimize the amount of contributions to rank-and-file employees, as compared to those for you and other executives?
- ✓ How stable or unstable have your company's profits been in the last few years?
- ✓ What are the company's expected profits in the next year? Three years? Five years?
- ✓ How important is it for you to have flexibility in the amount of retirement plan contributions you make each year, as opposed to contributing a fixed amount or fixed percentage of employee compensation regardless of the company's bottom line?
- ✓ How important is it to you to delay vesting and employee control of contributions made by you as the employer?
- ✓ How important is it that the retirement plan be simple to understand?
- ✓ How important is it that the retirement plan be relatively inexpensive to set up and administer?
- ✓ How important is it for the plan to be competitive to attract and/or retain employees?
- ✓ How important is it to reduce the current taxable income of you and your employees through employer and employee contributions?

- ✓ Do you have a stable workforce or a high turnover rate among your employees?

## Determine which plan meets your goals

Here is where your answers to the above questions can be utilized to determine the most appropriate and beneficial plan for your company. Every type of plan has its own advantages and disadvantages. You can find the right type of plan for your company by:

- Seeing how they stack up against one another in certain key areas, and
- Becoming aware of the benefits and potential drawbacks of each type of plan

To make it easier for you, we have prepared the essential information for you in more than one way. First, we have identified seven key areas that can be used to determine how each type of plan stacks up against other types of plans. In addition, we have provided a brief overview of each type of plan that links to a more detailed discussion of pros and cons and other information. Finally, we have listed types of plans that are generally considered appropriate for certain types of employers.

**Tip:** In addition to your own research, it is best to have a tax advisor and other professionals help you evaluate your options and select an appropriate retirement plan.

## Seven key areas to compare

You can determine the best plan for your company by first seeing how the various types of plans compare in these seven key areas:

1. Maximizing yearly contributions/building retirement benefits for you as the owner
2. Maximizing/weighting contributions for you and other highly compensated employees rather than for lower-compensated employees
3. Flexibility in making contributions each year
4. Building retirement benefits for employees
5. Using the plan as a recruiting tool to attract employees
6. Using the plan to discourage employees from seeking employment elsewhere
7. Utilizing income tax deferral on plan contributions and investment earnings

To determine the right retirement plan for your organization, keep your most important goals in mind as you evaluate plans in terms of these seven key areas.

## Specific types of retirement plans

- **Defined benefit plan:** A defined benefit plan is a qualified retirement plan that guarantees the employee a specified level of benefits at retirement. As the name suggests, it is the retirement benefit that is defined, not the level of contributions to the plan. The services of an actuary are generally needed to determine the annual contributions that the employer must make to the plan to fund the promised retirement benefits. Contributions may vary from year to year,

depending on the performance of plan investments and other factors. Defined benefit plans allow a higher level of employer contributions than most other types of plans, and are generally most appropriate for large companies with a history of stable earnings.

- **Cash balance plan:** A cash balance plan is a type of retirement plan that has become increasingly common in recent years as an alternative to the traditional defined benefit plan. Though it is technically a form of defined benefit plan, the cash balance plan is often referred to as a "hybrid" of a traditional defined benefit plan and a defined contribution plan. This is because cash balance plans combine certain features of both types of plans. Like traditional defined benefit plans, cash balance plans pay a specified amount of retirement benefits. However, like defined contribution plans, participants have individual plan accounts for record-keeping purposes.
- **Simplified employee pension (SEP) plan:** A simplified employee pension (SEP) plan is a tax-deferred retirement savings plan that allows contributions to be made to special IRAs, called SEP-IRAs, according to a specific formula. Generally, any employer with one or more employees can establish a SEP plan. With this type of plan, you can make tax-deductible employer contributions to SEP-IRAs for yourself and your employees (if any). Except for the ability to accept SEP contributions from employers (allowing more money to be contributed) and certain related rules, SEP-IRAs are virtually identical to traditional IRAs.
- **SIMPLE IRA plan:** A SIMPLE IRA plan is a retirement plan for small businesses (generally those with 100 or fewer employees) and self-employed individuals that is established in the form of employee-owned IRAs. The SIMPLE IRA plan is funded with voluntary pre-tax employee contributions and mandatory employer contributions. The annual allowable contribution amount is significantly higher than the annual contribution limit for regular IRAs but less than the limit for 401(k) plans..
- **SIMPLE 401(k) plan:** A SIMPLE 401(k) plan is a retirement plan for small businesses (generally those with 100 or fewer employees) and self-employed persons, including sole proprietorships and partnerships. Structured as a 401(k) cash or deferred arrangement, this plan was devised in an effort to offer self-employed persons and small businesses a tax-deferred retirement plan similar to the traditional 401(k), but with less complexity and expense. The SIMPLE 401(k) plan is funded with voluntary employee pre-tax contributions (and/or after-tax Roth contributions) and mandatory employer contributions. The annual contribution limits are less than the limits applicable to regular 401(k) plans.
- **Keogh plan:** A Keogh plan, sometimes referred to as an HR-10 plan, is a qualified retirement plan for self-employed individuals and their employees. Only a sole proprietor or a partnership business may establish a Keogh plan--an employee or an individual partner cannot. Keogh plans may be set up as either defined contribution plans or defined benefit plans.
- **Profit-sharing plan:** A profit-sharing plan is a qualified defined contribution plan that generally allows for some discretion in determining the level of annual employer contributions to the plan. In fact, the business can often contribute nothing at all in a given year if it so chooses. The amount of contributions may be based on a written formula in the plan document, or may be

essentially at the employer's discretion. With a typical profit-sharing plan, employer contributions range anywhere from 0 to 25 percent of an employee's compensation.

- **Age-weighted profit-sharing plan:** An age-weighted profit-sharing plan is a type of profit-sharing plan in which contributions are allocated based on the age of plan participants as well as on their compensation. This type of plan benefits older participants (generally, those having fewer years until retirement) by allowing them to receive much larger contributions to their accounts than younger participants.
- **New comparability plan:** A new comparability plan is a variation of the traditional profit-sharing plan. This type of plan is unique in that plan participants are divided into two or more classes, generally based on age and other factors. A new comparability plan can often allow businesses to maximize plan contributions to higher-paid workers and key employees and minimize contributions to the other employees.
- **401(k) plan:** A 401(k) plan, sometimes called a cash or deferred arrangement (CODA), is a qualified defined contribution plan in which employees may elect to defer receipt of income. The amount deferred consists of pretax dollars (and/or after-tax Roth contributions) that are invested in the employee's plan account. Often, the employer matches all or part of the employees' deferrals to encourage employee participation. The 401(k) plan is the most widely used type of retirement plan.
- **Money purchase pension plan:** A money purchase pension plan is a qualified defined contribution plan in which the employer makes an annual contribution to each employee's account in the plan. The amount of the contribution is determined by a set formula that cannot be changed, regardless of whether or not the corporation is showing a profit. Typically, the business's contribution will be based on a certain percentage of an employee's compensation.
- **Target benefit plan:** A target benefit plan is a hybrid of a defined benefit plan and a money purchase pension plan. It resembles a defined benefit plan in that the annual contribution is based on the amount needed to fund a specific amount of retirement benefits (the "target" benefit). It resembles a money purchase pension plan in that the annual contribution is fixed and mandatory, and the actual benefit received by the participant at retirement is based on his or her individual balance.
- **Thrift/savings plan:** A thrift or savings plan is a qualified defined contribution plan that is similar to a profit-sharing plan, but has features that provide for (and encourage) after-tax employee contributions to the plan. The employee must pay tax on his or her own contributions before they are invested in the plan. Typically, a thrift/savings plan supplements after-tax employee contributions with matching employer contributions. Many thrift plans have been converted into 401(k) plans.
- **Employee stock ownership plan (ESOP):** An employee stock ownership plan, a type of stock bonus plan, is a qualified defined contribution plan in which participants' accounts are invested in stock of the employer corporation. This type of plan is funded solely by the employer. When a plan participant retires or leaves the company, the participant receives his or her vested balance in the form of cash or employer securities.

- **Payroll deduction IRA plan:** A payroll deduction IRA plan is a type of arrangement that you can establish to allow your employees to make payroll deduction contributions to IRAs (traditional or Roth). It can be offered to your employees instead of a more conventional retirement plan (such as a 401(k) plan), or to supplement such a plan. Each of your participating employees establishes and maintains a separate IRA, and elects to have a certain amount deducted from his or her pay on an after-tax basis. The amount is then invested in the participant's designated IRA. Payroll deduction IRAs are generally subject to the same rules that normally to IRAs.

In addition, there are two types of retirement plans that are especially popular with tax-exempt organizations:

- **Section 403(b) plan:** A Section 403(b) plan, also known as a tax-sheltered annuity, is a type of nonqualified plan under which certain government and tax-exempt organizations (e.g., schools and religious organizations) can purchase annuity contracts or contribute to custodial accounts for eligible employees. There are two types of 403(b) plans: salary-reduction plans and employer-funded plans. Even though section 403(b) plans are not qualified plans, they are subject to many of the same requirements that apply to qualified plans. For more information, see Section 403(b) Plan.
- **Section 457(b) plan:** A Section 457(b) plan is a type of nonqualified deferred compensation plan for governmental units, governmental agencies, and non-church-controlled tax-exempt organizations. It is similar to a 401(k) plan and subject to some of the same rules. For more information about this type of plan, see Section 457 Plan.

## Retirement plans most appropriate for small businesses and the self-employed

If you are self-employed, a sole proprietor, or a partner and want to establish a retirement plan, there are five types of plans you should consider:

- Keogh plan
- Simplified employee pension (SEP) plan
- SIMPLE IRA plan
- SIMPLE 401(k) plan
- Individual 401(k) plan

## Retirement plans most appropriate for corporations

If your form of business entity is a corporation and you want to establish a retirement plan, you should consider the following types of defined contribution plans:

- 401(k) plan
- Profit-sharing plan
- Age-weighted profit-sharing plan
- New comparability plan

- Money purchase pension plan
- Thrift/savings plan
- Employee stock ownership plan (ESOP)
- Simplified employee pension (SEP) plan
- SIMPLE IRA plan
- SIMPLE 401(k) plan

In addition, you might consider establishing a defined benefit plan for your corporation.

## Retirement plans for tax-exempt organizations

If you are involved with a tax-exempt or government organization and you want to establish a retirement plan, your options typically include the Section 403(b) plan and/or the Section 457 plan.

## Disclosures

This material does not constitute the rendering of investment, legal, tax or insurance advice or services. It is intended for informational use only and is not a substitute for investment, legal, tax, and insurance advice.

State, national and international laws vary, as do individual circumstances; so always consult a qualified investment advisor, attorney, CPA, or insurance agent on all investment, legal, tax, or insurance matters.

The effectiveness of any of the strategies described will depend on your individual situation and on a number of other factors. After reviewing your personal situation, we may recommend that you not use any strategy in this document but instead consider various other strategies available through our practice.

Securities offered through Securities Equity Group, member FINRA, SIPC, MSRB

Copyright 2006 Forefield, Inc. All rights reserved.