A Quick Guide to Retirement Plans for Small Business Owners

–Elaine Floyd, CFP and Amy E. Buttell

As a business owner, you may be surprised to find that offering the right retirement plan may significantly benefit both you and your employees. Here's an overview of all the major features of each kind of retirement plan, including SIMPLE, SEP, 401(k), defined-benefit, and profit-sharing plans.

The vast majority of businesses in the U.S. employ fewer than 100 workers, yet these employees have less access to retirement planning vehicles and other benefits than those who work for larger companies. That means about 50% of Americans don't have the same opportunity to save for retirement via tax-advantaged vehicles that many others have.

In fact, a recent survey of small business owners reveals that only about half of all small businesses offer a retirement plan, although that number has been steadily increasing. It's likely that those businesses would be more attractive to potential employees if they offered a retirement plan. And many small business owners may not realize that retirement plan options have become more affordable in recent years, as more options have become available. Additionally, the SECURE Act of 2019 created or expanded several tax credits that can total up to $5,500 per year ($16,500 for 3 years) for small business that create or enhance their retirement plans.

Overview of small business retirement plans

In choosing the right plan, it pays to have a working familiarity with the different kinds of retirement options. Below, we've compiled the major features of each type of plan, along with an overview of benefits.

Another good source of information on retirement plans can be found at the Department of Labor's website. And, of course, the plan providers you work with should be able to provide you with educational materials.

Simplified Employee Pension (SEP)

A SEP will allow you to set up a type of IRA for yourself and each of your employees. You must contribute a uniform percentage of pay for each employee, although you won't have to make contributions every year. SEPs have low start-up and operating costs and can be established using a two-page form. As a small employer, you can also decide how much to put into an SEP each year, offering flexibility when business conditions vary.

Simplified Employee Pensions (SEP)	
Key advantage	Easy to set up and maintain
Employer eligibility	Any employer with one or more employees including sole proprietors, partnerships, corporations and S corporations
Employer's role	Set up plan by selecting a plan sponsor and completing IRS Form 5305-SEP. No annual filing requirements for employer
Contributors to the plan	Employer contributions only; 100% tax-deductible
Date to set up new plan	By due date of tax return (including extensions)
Date contributions are due	Due date of tax return (including extensions)
Maximum annual contribution (per participant)	Up to 25% of W-2 wages or 20% of net adjusted self-employment income for a maximum of $58,000 in 2021
Contributor's options	Employer can decide whether to make contributions year-to-year
Minimum employee coverage requirements	Must be offered to all employees who are at least 21 years of age, were employed by the employer for 3 of the last 5 years and had earned income of more than $600
Vesting	Contributions are immediately 100% vested
Participant loans	Not allowed
Withdrawals	Withdrawals permitted anytime subject to federal income taxes; early withdrawals subject to tax penalty

Sources: "SEP Retirement Plans for Small Businesses," Department of Labor, and "Retirement Plans for Small Business," IRS.gov

SIMPLE

SIMPLE (Savings Incentive Match Programs for Employees of Small Employers) plans are usually set up as IRAs. They are easy to establish and inexpensive to administer. Your contributions as an employer are flexible: you can either match employee contributions dollar for dollar—up to 3% of an employee's compensation—or make a fixed contribution of 2% of compensation for all eligible employees.

Simple Plans	
Key advantage	Employers who set up a new plan may be eligible for a tax credit of up to $500 a year for the first 3 years to help defray the costs of starting the plan. File IRS Form 8881
Employer eligibility	Any employer with 100 or fewer employees that does not currently maintain another retirement plan
Employer's role	Set up plan by completing IRS Form 5304-SIMPLE or IRS Form 5305-SIMPLE. No annual filing requirements for employer. Bank or financial institution processes most of the paperwork.
Contributors to the plan	Employee salary reduction contributions and employer contributions
Date to set up new plan	Generally by 10/1 of the year before the start of the plan
Date contributions are due	Due date of tax return, including extensions; elective deferrals by participants due 30 days after the last day of the month for which contributions are made
Maximum annual contribution (per participant)	Employee: Up to $13,500 in 2021 ($16,500 if age 50+). Employer: Either match employee contributions 100% of first 3% of compensation (can be reduced to as low as 1% in any 2 out of 5 years); or contribute 2% of each eligible employee's compensation (up to $290,000 of compensation in 2021).
Contributor's options	Employee can decide how much to contribute. Employer must make matching contributions or contribute 2% of each employee's compensation (up to $290,000 of compensation in 2021).
Minimum employee coverage requirements	Must be offered to all employees who have earned income of at least $5,000 in any prior 2 years and are reasonably expected to earn at least $5,000 in the current year
Vesting	Employer and employee contributions are immediately vested 100%
Participant loans	None allowed
Withdrawals	Can occur any time after contribution is made, but 25% penalty if withdrawal occurs during 2-year period beginning on the first day of participation

Sources: "SIMPLE IRA Plans for Small Businesses," Department of Labor, "Retirement Plans for Small Business," IRS.gov, and "SIMPLE IRA Plans for Small Businesses," IRS Publication 4334

401(k)

401(k) plans—both traditional and Roth—have become a widely accepted retirement savings vehicle for small businesses. They can vary significantly in their complexity. However, many financial institutions and other providers offer prototype 401(k) plans, which can greatly lessen the administrative burden on individual employer.

401(k) Plans	
Key advantage	Permits higher level of salary deferrals by employees
Employer eligibility	Any employer with one or more employees
Employer's role	No model form available. Advice from financial institution or employee benefit advisor may be necessary. Annual filing of Form 5500 is required. Also may require annual nondiscrimination testing to ensure plan does not discriminate in favor of highly compensated employees.
Contributors to the plan	Employee salary reduction contributions and/or employer contributions
Maximum annual contribution (per participant)	Employee: \$19,500 (\$26,000 for participants 50+) in 2021. Employer/employee combined: The lesser of 100% of compensation or \$58,000 (\$64,500 including catch-up contributions for 50+) in 2021.
Contributor's options	Employee can elect how much to contribute pursuant to a salary reduction agreement. The employee can make additional contributions, including possible matching contributions, as set by plan terms.
Minimum employee coverage requirements	Generally, must be offered to all employees at least 21 years of age who have completed a year of service with the employer
Vesting	Employee salary deferrals are immediately 100% vested. Employer contributions may vest over time according to plan terms.
Participant loans	Plan may permit loans and hardship withdrawals.
Withdrawals	Withdrawals permitted after a specified event occurs (e.g., retirement, plan termination). Early withdrawals subject to tax penalty.

Source: "401(k) Plans for Small Businesses," Department of Labor, "Retirement Plans for Small Business," IRS, Publication 560

Profit-sharing

Your contributions as an employer to a profit-sharing plan are discretionary. Depending on the plan terms, there is often no set amount that an employer needs to contribute each year. As with 401(k) plans, profit-sharing plans can vary greatly in their complexity, and prototype plans offered by financial institutions can reduce the administrative burden on individual employers.

Profit-sharing	
Key advantage	Permits employer to make large contributions for employees
Employer eligibility	Any employer with one or more employees
Employer's role	No model form available. Advice from financial institution or employee benefit advisor may be necessary. Annual filing of Form 5500 is required.
Contributors to the plan	Annual employer contribution is discretionary.
Date to set up new plan	By year end (generally Dec. 31)
Date contributions are due	Due date of tax return, including extensions
Maximum annual contribution (per participant)	The lesser of 100% of compensation or \$58,000 in 2021. Employer can deduct amounts that do not exceed 25% of aggregate compensation for all participants.
Contributor's options	Employer makes contribution as set by plan terms. Employee contributions, if allowed, are set by plan terms.
Minimum employee coverage requirements	Generally, must be offered to all employees at least 21 years of age who worked at least 1,000 hours in a previous year.
Vesting	Employee salary reduction contributions and most employer contributions are immediately 100% vested. Employer contributions may vest over time according to plan terms (5-year cliff or 3-7 year graded, or 2-6 year graded if top-heavy)
Participant loans	Plan may permit loans
Withdrawals	Withdrawals permitted after a specified event occurs (e.g., retirement, plan termination). Early withdrawals subject to tax penalty.

Sources: "Profit-Sharing Plans for Small Businesses," Department of Labor; "Retirement Plans for Small Business," IRS Publication 560; and "Choosing a Retirement Plan: Profit Sharing Plan," IRS

Defined benefit

Defined benefit plans provide a fixed, pre-established benefit for employees. This traditional type of pension plan is often viewed as having more value by employees and may provide a greater benefit at retirement than any other type of plan. However, defined benefit plans are more complex and therefore costlier to establish and maintain than other types of plans.

Defined Benefit Plans	
Key advantage	Provides a fixed, pre-established benefit for employees; allows higher tax-deductible contribution for older employees
Employer eligibility	Any employer with one or more employees
Employer's role	No model form available. Advice from financial institution or employee benefit advisor may be necessary. Annual filing of Form 5500 is required. An actuary must determine annual contributions.
Maximum annual contribution (per participant)	Actuarially determined
Maximum annual benefit	The maximum annual benefit at retirement is the lesser of \$230,000 in 2021 or 100% of final average pay
Contributor's options	Employer generally required to make contribution as set by plan terms
Minimum employee coverage requirements	Generally, must be offered to all employees at least 21 years of age who worked at least 1,000 hours in a previous year
Vesting	Rights to benefits may vest over time according to plan terms
Participant loans	Plan may permit loans
Withdrawals	Payment of benefits after a specified event occurs (e.g., retirement, plan termination). Early withdrawals subject to penalty.

Sources: "Choosing a Retirement Solution for Your Small Business," Department of Labor, The IRS Retirement Plan Navigator: Defined Benefit Plan

A final word

Of all the retirement planning vehicles available for small business owners, SEP and SIMPLE plans offer the easiest solutions for those looking to quickly, inexpensively and easily start a retirement plan for themselves and their employees. Both 401(k) and defined benefit plans are more complex, but also have advantages for employers and employees.

Before deciding whether to offer a plan or what kind of plan to offer, consult with several plan sponsors to determine the best plan for the business and the employees.

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