COLUMBUS BUSINESS FIRST

Small companies shouldn't stay out of the 401(k) pool

Scott Everhart

Safe Harbor provisions are calming the waters for small-business owners looking to wade into 401(k) plans.

Though 401(k) plans are wildly popular pension options, some businesses can be turned off by structures that have complicated rules requiring specific levels of employee participation.

In addition to removing these so-called non-discrimination restrictions, which allows owners and other highly-compensated employees to easily make maximum contributions, 401(k) plans that are modeled on Safe Harbor designs also provide excellent retirement savings options for sole proprietors.

By offering a Safe Harbor contribution to all employees, small-business owners are establishing a plan that vests all participants at 100 percent from the first day.

There are two ways to do this:

- Match 100 percent of the employee contribution for the first 3 percent, then match half of the employee contribution for the next 2 percent.
- Consider a non-elective contribution in which the business contributes 3 percent of pay to every eligible employee.

Not just a worker benefit

The benefit of instituting one of these popular plans is that owners and employees at the top level of the company can defer the maximum allowable amount for the tax year without relationship to the amount lower-level employees have contributed.

Since Safe Harbor rules establish a universal employer contribution for all employees, nondiscrimination is automatically assured.

In addition, 401(k) plans make more sense than ever for sole proprietors.

Bill Edwards, a certified public accountant at Clark Schaefer Hackett, explains that a sole proprietor, such as a consultant or free-lancer, can make a tax-deductible contribution of up to 25 percent of pay, and savings can be further increased because salary deferral of up to $12,000 doesn't count toward the maximum deductible contribution, as long as the total amount does not exceed $40,000.

Structures for 401(k) plans also allow catch-up contributions for people 50 and older so those approaching retirement can take advantage of savings opportunities they missed out on in the past. This increases the cap to $42,000.

All profit-sharing plans and 401(k) programs are known as defined contribution or account balance plans. For 401(k)s, which are not profit-sharing plans with a salary deferral provision included, this means a participant is entitled to whatever is accumulated in the individual account balance at retirement.

Participants who contribute a lot will have access to more money depending on the plan's performance; those who contribute less will see their balances lag.

Edwards says defined benefit plans are different because the balance at retirement is a guaranteed amount specifying exactly what will be available. This is a more expensive option to maintain for a business, but it may be appropriate if the need for a higher-end benefit maximum is anticipated.

Current tax law provides for an annual benefit limit of $160,000. This option can work well for employees who are close to retirement, or if the business only has a few employees.

Cost-effective administration

Years ago, 401(k) plans were cost-prohibitive for small business. This is no longer the case.

A common annual schedule might be a plan with 20 people with a base fee of $1,500, plus a $30-per-participant fee. For even smaller businesses, say with five participants or fewer who are willing to participate in individual accounts rather than a pooled account, the administration fee might only be $700 a year.

In addition to lower administration costs, in a group of five or fewer using individual accounts, participants can literally create their own brokerage accounts - an appealing option since practically any investment vehicle will be available versus limited options in a pooled plan.

A business with more than 10 employees will need a more typical 401(k) plan with perhaps a dozen choices among types of investment options.

The smaller the business, the greater the creativity and the lower the cost of 401(k) planning. Even for small companies that aren't so small, cost shouldn't prevent them from offering this valuable retirement savings vehicle.

Coupled with Safe Harbor regulations that simplify entrance into and administration of 401(k)s, small businesses that jump in will find the water fine.

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