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Subject: Kenn Tacchino - Picking the Best Retirement Plan for a Business

"New financial planners may be hesitant to advise small-business owners about which retirement plan to sponsor because this decision requires specialized knowledge. However, the practice of suggesting the optimum plan choice is an essential financial planning skill. What's more, small-business owners crave suitable advice. In an effort to start planners on the journey to helping plan sponsors choose the best retirement plan for their clients, we present 10 examples regarding 'plan choice' issues with some introductory context concerning several topics."

We close the week with commentary by **Kenn Tacchino** that reviews the factors that go into picking the best retirement plan for a business. His content was original published in the May 2021 issue of the *Journal of Financial Service Professionals* and is reprinted here with permission.

Kenn Tacchino JD, LLM, is a professor of taxation and financial planning at **Widener University**. He is a four time winner of the School of Business Distinguished Graduate Teaching Award. He has also won the Distinguished Research Professor Award and the Distinguished Service Award. Professor Tacchino is director of Widener University's Master of Taxation and Financial Planning (MSTFP) program. in 2018 he was awarded Widener University's Distinguished University Professor Award.

Professor Tacchino has been the editor of the Journal of Financial Service Professionals since 2001. The Journal reaches a broad audience of financial planners. It is a blind-peer review publication with a competitive nature for publishing applied research for over 73 years. Professor Tacchino was formerly a full time faculty member and a consultant to The American College (1986-1991 full time and 1991-2013 consultant). He was a contributing author to two textbooks for the College, which have been used at over 250 colleges nationwide. Professor Tacchino was the former

Director of the New York Life Center for Retirement Income at the American College. Under his leadership, and with the help of leading industry experts, the New York Life Center created a popular website on retirement income and the state of the art Retirement Income Certified Professional (RICP) designation. Kenn is also the author of numerous articles on retirement topics published in academic and professional journals. He is often quoted in retirement planning articles and has made appearances on radio and television. Kenn writes for the Wall Street Journal's MarketWatch publication. His columns are popular reading for consumers seeking advice about retirement.
He received his BA from Muhlenberg College, JD from Western New England College School of Law, and LLM from Widener University School of Law.

Here is his commentary:

EXECUTIVE SUMMARY:

New financial planners may be hesitant to advise small-business owners about which retirement plan to sponsor because this decision requires specialized knowledge. However, the practice of suggesting the optimum plan choice is an essential financial planning skill. What’s more, small-business owners crave suitable advice. In an effort to start planners on the journey to helping plan sponsors choose the best retirement plan for their clients, we present 10 examples regarding “plan choice” issues with some introductory context concerning several topics.

COMMENT:

Benefits of a Qualified or Tax-Advantaged Retirement Plan

New planners should stand ready to educate plan sponsors about the tax benefits of a qualified plan or tax-advantaged retirement plan.[1] For example, Emily quit her job at the end of last year to pursue her lifelong dream of opening a bakery in her favorite seaside resort. Her planner determines that she will be financially capable of saving $1,000 each month for her retirement from the proceeds of the business. She would like to know whether to use a qualified plan or to just try saving for retirement without a plan. Her planner can point out that she will be able to make before-tax contributions to the plan, she will enjoy tax-deferred growth on

plan assets, and perhaps most importantly, she will get to invest money for retirement that otherwise would have gone to pay current taxes (analogous to getting an "interest-free loan" from the government). The following example helps to illustrate these advantages:

> *Example 1*—Kim is a licensed social worker who acts as a solo practitioner providing counseling services to clients. She sees the value in saving part of her earnings for retirement but does not understand the reasons to set up and install a traditional retirement plan that meets IRS requirements. Her planner recommends a simplified employee pension (SEP) plan and then calculates for her the extra savings she will have based on this "interest-free loan" from Uncle Sam. If she contributes $10,000 to an SEP and is in a combined 25 percent federal, state, and local tax bracket, she will save $2,500 in taxes and have $10,500 at the end of the year after she earns a 5 percent rate of return. If Kim had tried to save outside the SEP, she would have lost $2,500 in taxes. Her $7,500 savings would have grown the same 5 percent (total interest equals $375) but then she may have lost $93.75 in taxes on the interest she earned. At the end of the year, her account balance be would only $7,781.25. Her planner emphasizes that she will have $10,500 versus $7,781.25, which is $2,718.75 more at the end of the year because an SEP was used! Her planner than calculates that because she got to invest money that would have been lost early on to taxes, she will accrue over $32,000 more for retirement by using an SEP even after she pays taxes on the retirement distributions.

Planners should also be ready to espouse the value of after-tax Roth contributions to a 401(k) plan. Although the initial tax savings are sacrificed, the client will not have to pay any taxes on growth of the contributed funds assuming the owner complies with IRS requirements.[2] As a general rule, conventional wisdom says to choose a Roth option if the client's tax rates are expected to be higher in retirement and to use a before-tax contribution if the tax rate is expected to be lower in retirement. However, be aware that Roth contributions are accessible without tax consequences and will not trigger extra taxes on Social Security benefits (the so-called tax torpedo) and provide for "tax diversification" of retirement withdrawals.

In addition to delivering tax advantages for the business owner and employees of the business, planners may also want to point out several

other benefits of a retirement plan. For one thing, a retirement plan will help to attract and retain employees. Secondly, the plan will allow for a graceful transition in the workforce. In other words, long-service employees will have the wherewithal to retire and can be replaced by younger employees at lower salaries. Third, the retirement plan is part of effective compensation planning. And finally, the plan will provide the business owner protection if they find themselves having to go bankrupt. The following examples help to demonstrate these last two attributes:

> *Example 2*—Gregg owns a regional accounting firm, and he believes that the cost of providing deferred compensation is an add-on to his existing payroll obligations. However, Gregg's planner shows him that shifting to a program that pays both current and deferred compensation makes the most sense for effective compensation planning. After all, it's not how much the client pays employees, but how he pays them! For example, if Gregg's planner establishes a 401(k) plan with a matching contribution of 50 cents on a dollar up to 4 percent, it will be the same as giving his employees a 2 percent raise. One way to look at this is to consider if Gregg were going to give a 5 percent raise, he should instead give a 3 percent raise and the match just described—then costs remain the same. If he does it for 3 years in a row, then the plan sponsor has successfully switched from providing only current compensation to providing both current compensation and a 401(k) plan that provides a 50-cent-on-a-dollar match up to 6 percent of the employees' pay. Notice the employer did this without incurring significant extra costs.

> *Example 3*—Your client Rick owns a pizza place. He fears that at some point in the future competition may cause business problems and possible bankruptcy. If Rick contributes to a qualified plan, his plan funds will be exempt from the bankruptcy estate and protected from his creditors.

Unit-Credit Defined-Benefit Plans

A lot has been written about the demise of the traditional unit-credit defined-benefit pension plan. In fact, some new planners might think that a discussion of this plan is unnecessary. However, *these plans are essential in the small-plan market for some affluent clients*. But first some basics:

- The formula to fund a plan participant's benefit is often written as "accrual rate (e.g., 2 percent) times years of service (YOS) times final average salary (FAS)." So, a person with 30 years of service and a final average salary of $200,000 would get a $120,000 ($10,000 per month) pension.
- Annual contributions to the plan are actuarially computed and are equal to the amount necessary to fund the benefit promised to all plan participants. These annual contributions are mandatory under ERISA.3
- The plans use unallocated (or pooled) funding instead of individual accounts. In other words, money is put in a trust for all employees and not in an individual account for each employee.
- The preretirement investment risk falls on the employer, so if the markets plummet, it is the employer, not the employee, who must come up with additional funding to meet the need for promised benefits.
- Plan participants are entitled to the "normal form of benefit" provided by the plan. The normal form of benefit for a married participant is the qualified monthly paid joint and survivor annuity. The normal form of benefit for a single individual is usually a monthly paid life annuity commencing at normal retirement age.
- In addition to a joint and survivor or life annuity, alternative forms of benefits are available, such as lump-sum distributions or different types of annuities.
- No matter what type of payout is provided under the plan, clients should be made aware that it is the actuarial equivalent to an alternate form of payout. In other words, a life annuity may give a larger benefit than a joint and survivor benefit; however, their actuarial values are the same.

So why is the unit-credit defined-benefit plan an essential tool in the toolbox? The unit-credit defined-benefit plan allows a small-business owner to stockpile larger tax deductions than all of the plans that fall into the defined-contribution category. This is because all other plans (except the cash-balance plan mentioned below) limit the amount that can be contributed to $58,000 and defined-benefit plans are not restricted this way.[4]

Example 4—Virginia is the new planner's 52-year-old client who is self-employed as an IT consultant. She wants to save as much as possible for retirement. Virginia has $300,000 in net earnings. She plans to retire at 62. According to one actuary, a defined-benefit plan allows a $138,000 contribution to fund the benefit. This is a $51,060 tax savings in the 37 percent bracket. Virginia will accrue $2.36 million with a yearly benefit of $195,000. This far exceeds the tax shelter and retirement savings that are possible in a defined-contribution plan.

Example 5—A couple, Joseph and Elizabeth, are business partners in a small dental practice. Joe is 60 and Elizabeth is 58. Each earns $245,000. They plan to retire in 5 years. According to one actuary, $365,300 can go into the plan. This represents $135,161 in tax savings at the 37 percent bracket. Even better, after 5 years, they may have $2.26 million for retirement.

Two final points. First, business owners are often looking to skew plan contributions to benefit their own self-interests, and the choice of a unit-credit plan will be able to tilt annual contributions to business owners. Second, a second type of defined-benefit plan could also be considered to pile up annual tax shelter and retirement funds for a well-to-do client. This is a cash-balance plan. The cash-balance plan is a hybrid plan that provides the high contribution limits of a defined-benefit plan, but it avoids the common risks and potential runaway costs in a unit-credit plan. These plans are designed to look like a defined-contribution plan. The benefit is a hypothetical "account balance" which increases with stipulated contributions and guaranteed investment experience (e.g., 5 percent of salary per year is contributed by the plan sponsor plus a credit of, for example, 4 percent for investment earnings). Note that the cash-balance formula mitigates the interest rate risk of a unit-credit defined-benefit plan and also the cost volatility associated with these plans. In addition, it is a less expensive choice for the business because it focuses on career average earnings and not final average earnings.

401(k) Plans

The most popular type of employer-sponsored retirement plan is undoubtedly the 401(k) plan. In a 401(k) plan, the choice of a contribution formula must include elective deferrals, otherwise known as employee-

salary deferrals, where a plan participant can choose to take their full salary in cash or save some of it for retirement.[5] In addition, the plan's contribution formula can include either matching contributions (an incentive used by employers to entice plan participation and meet nondiscrimination testing or safe harbor requirements) and/or nonelective contributions (employer contributions to the plan not contingent on an action by the employee).[6] Employee contributions to the 401(k) plan as well as matching contribution and nonelective contributions (when applicable) are put into a plan participant's individual account and the participant typically selects from a menu of investment options offered by the plan and allocates monies to available accounts as they see fit (called self-directed investing).

> *Example 6*—Your client Arthur owns a small service company that offers compliance software to businesses. Arthur chose to sponsor a 401(k) plan that allows employees to contribute up to 10 percent of their salary to the plan and he also provides a 5 percent dollar-for-dollar match and a 5 percent nonelective contribution. Arthur's hope is that his employees will be able to achieve enough for retirement if they join the plan early and stick with it.[7]

> *Example 7*—Your client Katie owns a small high-end home building company. She fears that some employees won't contribute to her plan and she will end up either having to limit her salary deferrals or she will not pass nondiscrimination tests that are required by the IRS. Katie's planner recommends a safe harbor contribution formula. Under a safe harbor 401(k) plan, the plan sponsor can either match each participant's contribution, dollar-for-dollar, up to 3 percent, and also match 50 cents on the dollar for the participant's contribution that is between 3 and 5 percent. Alternatively, the plan sponsor can make a nonelective contribution equal to 3 percent of compensation to each participant's account. What's more, other safe harbor design alternatives are also available. In any case, Katie will be able to maximize her salary-deferral contributions without triggering nondiscrimination testing that might limit her salary deferrals.
> Instead of a 401(k) plan, some clients choose an alternative plan known as a simple incentive match plan for employees (SIMPLE). SIMPLE plans are only available if your client has 100 or fewer employees.[8] These plans are easier to set up and less costly to administer.[9] However, the simplicity comes at a price.

Example 8—Your client Rose owns a small flower shop and is deciding between a SIMPLE and a 401(k) plan. The 401(k) plan seems to be the better choice because it is a better tax shelter. The 401(k) allows larger elective deferrals, $19,500 ($26,000 for those 50 and older) versus $13,500 ($16,500 for those 50 and older). In addition, the 401(k) plan allows larger matching and larger nonelective contributions. Also note that a SIMPLE can only have a match or nonelective contribution, but not both. Finally, the 401(k) can have a companion plan; the SIMPLE cannot.

One final note, new financial planners working with school districts, other government organizations, and not-for-profit organizations (e.g., hospitals and private colleges) might end up working with a first cousin to the 401(k) plan, known as a 403(b) plan.

SEP

Many small employers and salaried employees who also have Schedule C earnings are only looking to save a modest amount of their income. For these people, financial planners often recommend an SEP. An SEP has the advantage of being easier and less costly to establish and administer than most other alternatives.[10] It also has other advantages:

- An SEP can be established after a calendar year to apply the prior calendar year's earnings.
- In addition to low start-up and administration costs, the SEP does not need to establish a trust for plan funds. Instead, funds can be directly deposited into an IRA.
- Employers who sponsor an SEP can avoid future plan contributions. In other words, annual contributions can be skipped in this type of plan.

Example 9—Kevin works full time in the maintenance department of ABC Company and also paints houses on the side. He makes $10,000 extra each year. Kevin may decide to set aside $1,500 annually in an SEP. (Note: because of the so-called Keogh rules, the maximum contribution is limited to 20 percent of income from self-employment.) Kevin contacts any financial firm, fills out a minimum of paperwork, picks an appropriate investment option, and voila…he has saved taxes and increased his retirement nest egg.

Solo-k (Also Called Uni-k)

For a small business or a person who seeks substantial savings from their Schedule C income, the so-called solo-k plan might make sense because, unlike other plans, it allows employees to put in the maximum elective salary deferral in addition to regular plan contributions.[11]

> *Example 10*—Sally is a 35-year-old IT professional who has $20,000 in Schedule C consulting income in addition to her salary at ABC Company. She can contribute the entire amount of her consulting income ($20,000) to her solo-k ($4,000 under the 20 percent Keogh limit, plus $16,000 in elective salary deferrals).

Two other factors favor choosing a solo-k: the solo-k may utilize a Roth feature. When this is the case, there are no immediate tax savings, but qualifying distributions may be received tax free. In addition, the solo-k can have a loan feature.

Conclusion

New planners may want to think of retirement plan options in terms of their main attributes. One way to categorize plans is that all plans are either defined-benefit or defined-contribution. A second way to categorize plans is that they all are either pension plans or profit-sharing plans. Table 1 may help to summarize the differences.

TABLE 1

Retirement Plan Categories

Defined-Benefit (DB) Plans	Defined-Contribution (DC) Plans
1. Specifies the benefits an employee receives	1. Specifies the contributions an employee receives
2. The maximum is $230,000 per year in 2021 (called the Section 415 limit). This is *not* the amount put in, but the amount that can be funded. Actuarial contribution	2. The maximum in 2021 is the lesser of 100% of salary or $58,000 (called the Section 415 limit). This allows for a great deal

examples of the amount that might be put in the plan are $112,000 at age 45, and $187,000 at age 60	of tax shelter, but not nearly as much as a defined-benefit plan
3. Deduct the full 415 contribution. Whatever the actuary says to contribute	3. Deduct 25% of aggregate participant payroll (this effectively limits contributions)
4. Involves no individual accounts	4. Provides an individual account similar to a bank account
5. Unallocated funding and typically *employer* investing	5. Funding allocated to individual accounts. This is typically *employee* invested—called self-directed
6. Assigns the risk of preretirement investments to the *employer*	6. Assigns the risk of preretirement investments to the *employee*
7. Can provide for past service (funded over 10 to 30 years). This allows for even greater tax shelter	7. No past service funding. If the $58,000 was good enough, it is not important. However, doctors and others trying to shelter as much as possible will be better in a DB plan

Pension Plans	**Profit-Sharing Plans**
8. Annual funding required	8. Discretionary funding possible. (The plan sponsor can skip years)
9. No in-service withdrawals allowed	9. In-service withdrawals allowed
10. Limits on the investment of company stock (10%)	10. No limits on the investment of company stock

New planners may also want to have a partial list of the plan options from which they can choose when working with a client to determine what the optimal plan choice is for their organization.[12] The list provided in Table 2 may help.

TABLE 2

Overview of Retirement Plan Options

Plan	DB or DC/Pension or Profit-Sharing (PS)	Sample Formula
1. Unit-credit DB plan	DB/Pension	Accrual rate x YOS x FAS
2. Cash Balance	DB/Pension	Hybrid, e.g., 6% ER contribution; 3% ROR
3. 401(k) Plan	DC/PS	3 types of contributions are possible: salary deferral (also called elective contributions), matching contributions, and/or profit-sharing (also called nonelective) contributions
4. 403(b) Plan	DC/PS	3 types of contributions are allowed: salary deferral (elective) contributions, matching contributions, and/or nonelective contributions
5. SIMPLE	DC/PS	2 types of contributions are allowed: salary deferred *and* matching (3%) *or* nonelective (2%) contributions; poor man's 401(k) plan
6. SEP	DC/PS	Employer-paid percentage of salary (408 not 401 rules)

7. Solo-k (sometimes called uni-k)	DC/PS	Elective contributions do not count against 20% Keogh cap

HOPE THIS HELPS YOU HELP OTHERS MAKE A *POSITIVE* DIFFERENCE!

Kenn Tacchino

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[1] Qualified plans are governed by IRS Code Section 401 and include defined-benefit plans, 401(k) plans, profit-sharing plans, and others. Tax-advantaged plans include simplified employee pensions (SEPs), savings incentive match plan for employees (SIMPLEs), and 403(b) plans.

[2] For distributions to be qualified as tax-free, they must be made after the 5-year-tax-period beginning with the first tax year after the 5-year period beginning with the first tax year for which a contribution was made to the

account. A second requirement is that the tax-free status only applies after the participant attains age 59 1/2, is disabled, or is paid out to a beneficiary after death.

[3] ERISA is the law governing retirement plans. It is formally known as the Employee Retirement Income Security Act of 1974.

[4] In a unique circumstance, a uni-k plan can exceed the $58,000 415(c) limit. This is discussed later in the article.

[5] The annual contribution limit for elective deferrals in 2021 is $19,500 ($26,000 for a person aged 50 or older).

[6] Nonelective contributions are sometimes thought of as profit-sharing contributions.

[7] Many experts believe a “safe-savings rate” for employees who start saving early in their career is between 15 and 20 percent of their salary. This plan accomplishes this goal.

[8] An employee is anyone who had $5,000 in compensation in the prior year.

[9] Planners use IRS form 5304-SIMPLE or 5305-SIMPLE, which are easy to navigate.

[10] Planners will find the IRS form 5305-SEP used to establish these plans short and user friendly.

[11] Most plans limit contributions to the deductible amount of 25 percent of aggregate participant payroll. Solo-k plans allow Code Section 402(g) salary deferrals on top of the regular limits. In 2021, the salary-deferral limit is $19,500 ($26,000 for those aged 50 and older).

[12] Our discussion is an overview that does not cover some important plan options. Crucial alternative plan choices (e.g., employee stock ownership plans (ESOPS), cross-tested profit-sharing plans, age-weighted profit-sharing plans, “points” profit-sharing plans, money-purchase plans, target-benefit plans, etc.) exist and should also be considered in certain circumstances. Planners should look at IRS Publication 560 for a more comprehensive list of plan options.