Season 1 – Episode 22 – Maximizing Retirement Contributions: A Guide for Business Owners to SEPs, SIMPLEs, and 401(k)s

Date: November 17, 2023

Host: Daniel J. Rohr, CPA/PFS, EA, M.S. Tax

Welcome to Tax Blueprints, a Rohr CPAs podcast. I'm Daniel Rohr, the managing shareholder of Rohr and Associates, a premier CPA firm based in California. I'm a CPA, Personal Financial Specialist and Enrolled Agent. I have extensive experience advising individuals and business owners with tax minimization and personal financial planning strategies. On each episode of Tax Blueprints, I delve into the intricacies of tax laws, explain the subtleties of business tax planning, and guide individuals towards a path of financial stability. Whether you're a business owner navigating the murky waters of taxation or an individual planning for a worry-free retirement, Tax Blueprints will provide you with the tools and knowledge you need. I hope you enjoy this episode.

You today we're focusing on a crucial topic for business owners on how to maximize your retirement contributions through various plans like SEP IRAS, Simple IRAS, Solo 401 Ks and 401 Ks. Let's start with SEP IRAs or simplified employee pension. Individual retirement arrangements SEP IRAs are fantastic for self employed individuals or small business owners, especially if you're looking for flexibility and simplicity. For 2023, the contribution limit is a lesser of 25% of compensation or 66,000. For 2024, the number goes up to 68,000. So imagine that you're a freelance graphic designer earning 100,000. This year you could contribute up to 25,000 to your SEP IRA. Now remember though, if you have employees, you must contribute equally for them as a percentage of their compensation. In practice, I don't see SEP IRAs utilized when the business has multiple employees.

Most of the time the employer of the business wants to offer benefits to their employees, but not necessarily as high of a benefit as they do for themselves as the owners. And so for a SEP, as I mentioned, you must contribute to the employee's SEP account in the same percentage as your own. So if you want to max your contributions as the employer, it can get pretty expensive to offer the same benefit for your employees. So let's move on to simple IRAs, which are savings incentive match plan for employees. This is ideal for small businesses with fewer than 100 employees and is very common. It's low cost and low maintenance. The contribution limit for 2023 is 15,500 with a catch up contribution of 3500 for those individuals over 50.

For 2024 it will be 16,000 and the catch up contribution remains the same at 3500. As an employer, you're faced with two choices for contributing to your employee's simple IRA, either matching contributions or something called nonelective contributions. So let's start with matching. Matching contributions. In the simple IRA framework, it means that you're obligated to match each employee's contribution up to 3% of their compensation. And it's of course, a requirement of the plan. So let's say that you own a thriving bakery and an employee earning 50,000 decides to contribute 3% of their salary, which equals one $500. Your role is to match this with another 1500 since it's 3%. And this would mean that they then have 1500 coming out of their pocket and 1500 coming out of the employer's pocket. And so they have a $3,000 contribution to their simple IRA.

Now, if the employee only contributed 1% of their salary as the employer, you would only be required to match up to the 1%. This is where the simple can be a low cost option. If you have employees that decide not to contribute to their retirement at all, your match is, of course, zero. Now, the 3% match can be adjusted if you have down years and for two out of the five year period, you can choose to lower the match down to 1%. Now, it's crucial that you inform your employees about these changes. So let's say you're running a bookstore and you have a bad year. You might reduce the match to 1%. So if an employee contributes $900, 3% of a $30,000 salary, your matching contribution would be 300 for that year. Now, an alternative with the non elective contribution.

This means that you would contribute 2% of each eligible employee's compensatioN, regardless if they have their own contribution. So even if it's zero, you would still do 2% of their salary. So, as an example, let's say you have a consulting firm and the employee has a $40,000 salary. That means that you would contribute, even if they didn't do anything, out of their own pocket, out of their own salary, you would contribute, as the employer, $800 to their Simple IRA. All contributions to a simple IRA, including your employer contributions, are immediately 100% vested in the employee. Now, these contributions, of course, offer you a tax benefit as a deductible from as business expenses, reducing your taxable income. Now it's imperative that you follow IRS guidelines concerning contribution limits and deadlines, and regular monitoring adherence are key to leveraging the tax advantages of simple IRAs.

Typically, by the end of the year, you need to give the employees an updated 53 five form for the Simple IRA to let them know the plan for this coming year. For are you doing the 3% matching? Are you doing the non elective contributions and you allow the employee to then let you know how much they want to contribute to their own simple IRA. And like I mentioned, Simple IRA offer a valuable opportunity for small businesses to offer competitive retirement plans and join the tax advantages while minimizing your costs in case there are employees who don't take advantage of the retirement plan. And you can then still contribute a maximum amount to your own as the owner. So let's move on to solo 401 ks. Now these are tailor made for self employed individuals with no employees other than a spouse.

The contribution limit for 2023 is 66,000 or 73 500 if you're over 50. This includes 22 500 as an employee and the rest as an employer contribution. And for 2024, the numbers go up to 69,000 or 76,500 if you're over 50, and the employee deferral amount goes up to 23,000. So let's say you and your spouse run a consulting firm as an S corp. Both of you draw a salary, so both of you can contribute to your solo 401K, which essentially doubles your retirement contributions. This can be extremely powerful. Now let's finally discuss 401 Ks, which are, of course, widely used by many businesses. As a business owner, offering a 401K plan is a great way to secure your own financial future while also providing an invaluable benefit to your employees. But with various options available, it's crucial to understand what each type entails.

So let's explore the Safe Harbor 401K plan and a traditional 401K plan. So regarding Safe Harbor 401K plans, these plans are designed to automatically satisfy nondiscrimination tests. So what does this mean for you? If you choose this plan, you are required to make mandatory contributions to your employees, which can be either matching or nonelective, similar to the simple so, for example, you run a digital marketing agency, you might opt to match 100% of employee contributions up to 4% of their salary. This not only encourages participation, but also spares you the headache of annual nondiscrimination testing. Now, regarding traditional 401K plans with nondiscrimination testing, these plans are a bit different. They require annual testing to ensure the benefits don't disproportionately favor high earners. Now, what's the downside?

This testing can be complex and costly, potentially leading to refunds or additional contributions based on the test outcomes. The choice between Safe harbor and traditional plans hinges on your business's specific needs. Safe harbor plans offer ease and certainty with set contributions, while traditional plans provide flexibility but come with added responsibilities and potential risks. Whether you choose a safe harbor or a traditional 401K. As an employer, you have the opportunity to contribute to your employees plans. This isn't, of course, just a generous benefit. It's a strategic decision that can significantly impact your business and your employees futures. Now, there are employer matching options, so you can go for a dollar for dollar match, up to a percentage of the employee's salary or a partial match.

For instance, in your marketing agency, 100% match on the first three to 5% of an employee's salary can be a powerful incentive. Or like as in a construction company, offering 50% match up to 6% of the salary can also be appealing. Now the vesting schedules. You have this choice to set them up and this determines when employees gain full ownership of your contributions and can be a great tool for retaining your employees. Now, of course, these contributions are tax deductible for your business, which can, of course, lead to significant tax savings. So when choosing your 401K plan, factor in the potential administrative costs, especially with traditional plans that require nondiscrimination testing. These tests can be expensive and complex, like I said, so understanding them is key to make an informed decision.

In conclusion, offering a 401K plan as a business owner is not just about enhancing your benefit package. It's a strategic decision that requires careful consideration of your business's unique needs, financial capacity and your long term goals. Now, Safe harbor plans offer simplicity and certainty, while traditional plans offer the flexibility but come with more administrative responsibilities and potential risks. Now, in summary, each of these retirement plans seps simples, solo 401 ks, safe harbor 401 ks, and traditional 401 ks. They all have unique features that can be tailored to different businesses size and structures. And as a business owner, it's vital to understand these options to maximize your retirement savings and offer competitive benefits to your employees.

That's all for this episode of Tax Blueprints of Rohr CPAs podcast. You can find us online at Rohrcpas.com/podcast and don't forget to subscribe on Apple podcasts or Spotify. If you enjoy the show, please consider rating or reviewing us wherever you listen. I'm your host, Daniel Rohr. Thanks for listening.

ROHR & ASSOCIATES
CERTIFIED PUBLIC ACCOUNTANTS