What Kind of Retirement Plans Are Available?

With the exception of health insurance, retirement plans are the benefit employees desire most. The good news is that small business owners have a variety of plan options from which to choose.

Most retirement plans fall into one of two major categories:

Defined Benefit plans. Commonly known as pension plans, defined benefit plans require employers to pay a fixed annual amount to eligible employees during their retirement years. They allow employers a high degree of tax savings, and in good times, favorable growth rates can reduce or eliminate the employer's contribution. However, they can be costly to administer and may require higher contributions in times of poor or negative investment returns. They provide the greatest degree of retirement income certainty for employees, since the employees take virtually no risk. The benefits are even guaranteed by the Federal Pension Benefit Guaranty Corporation up to certain amounts.

Defined Contribution plans. These plans allow employers and employees to contribute a set amount or percentage of pay, and retirement benefits are based on the actual performance of the funds. Defined contribution plans give the employer better cost control as the contribution is defined. The amount an employee can contribute is based on a percentage of their salary up to a maximum amount defined by law.

Defined contribution plans can take many forms, including:

401(k) and Profit-Sharing Plans. 401(k) plans allow employees, often matched in whole or in part by their employers, to set aside a portion of their salary for retirement. The employee is not taxed on this income until withdrawals are made, and the employer's cost is a tax-deductible business expense. Employees can select the investment vehicles into which their funds are deposited. Retirement benefits are not guaranteed, however, and while the sum at age 65 may be substantial, it can also be much less if the employee has made poor investment choices or the stock and bond markets have not performed as well as expected. Employees can borrow from their 401(k) plans for education, a new home, a medical emergency etc., although the loan must be repaid within a certain specified period of time. Sometimes employers elect to integrate the 401(k) plan with a discretionary profit sharing plan that can increase the employer's retirement contribution for employees.

SIMPLE Plans. This option for companies with 100 or fewer employees allows an employee to contribute a percentage of his or her salary up to a fixed maximum to an Individual Retirement Account (IRA). The employer may also make contributions on a fixed or matching basis. SIMPLE plans are easy to set up, require minimal paperwork, and have low administrative costs. Plus, employees retain their SIMPLE account even if they change jobs.

Simplified Employee Pensions (SEPs). Created with the small business owner in mind, SEPs allow employers to set up IRAs for themselves and their employees. The employer contributes a percentage of each employee's salary each year, up to a fixed maximum. SEPs have low administrative costs, and can even be started by those who are self-employed. Since the business owner can decide how much to contribute each year, this type of plan is often the answer for businesses that may want to adjust their contribution based on the health of the business.

Payroll Deduction IRAs. This type of plan, which requires no employer contribution, is designed solely to help employees fund their Individual Retirement Accounts. Employers set up a payroll deduction system that allows employees to regularly contribute to their IRAs. Contributions are tax-deductible to the employee, just as they would be with traditional IRA contributions. An insurance professional or accountant can help you determine the best plan for you.