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BENEFITS

The Golden Question of Retirement Planning

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What is the one question, the golden question, that every person should ask to identify the right plan for their retirement? It's actually a rather simple one – and only the first of many questions – but it starts the conversation from the most realistic perspective.

The golden question of retirement planning is: How much income do you need or want for your lifestyle? Simple, isn't it? Then the difference between current and needed future income is the capacity for retirement savings.

If you are an advisor or accountant helping clients with retirement plans, then you will need to go deeper than that one question because it is only the first step. Disposable income is not the only factor to consider when identifying potential retirement plan strategies. Here's a quick checklist of what a good retirement plan should take into account:

- Size and type of retirement contributions
- Time horizon for retirement savings
- Value of tax savings now or in the future
- Amount and consistency of income
- Company structure for business owners
- Number of employees for business owners
- Type of employees for business owners

Each of these factors will have an impact on retirement planning and deserves a closer look.

Does Your Client Have a Business?

Business owners have a lot to consider when it comes to retirement planning. For instance, is their business a corporate entity or a sole proprietorship? Do they have employees, and would those employees be eligible to participate in a retirement plan? Does the business have consistent earnings or is it irregular and difficult to predict?

These are only a few big questions that will lead to more detailed information as retirement savings strategies start to take shape. Let's look at the structure of the business first because current and future entity structure can significantly impact which retirement plans are available and optimal for your client's goals.

Entity structure determines:

- What qualifies as earned income.
- What impact tax-deductible contributions will have on the company and the individual.
- If the business is part of a controlled or affiliated group.

Earned income is the amount of money eligible to contribute into a qualified retirement savings account. For a sole proprietorship, earned income is the net profit that a business earns. If the profit margin is low or inconsistent, then a rigid retirement plan may not be a good fit. Instead, consider a simple employee pension plan or profit-sharing plan. Corporate business structures – like a C corp or S corp business – do not include distributions as earned income, so only wages paid to the owner are eligible. So, if you are doing a reasonable compensation strategy for your clients, don't forget to factor in their desired retirement savings goals.

The value of tax-deductible contributions based on entity type and the number of businesses owned also has a significant impact, but those complicated topics can be explored at another time.

Do Employees Have an Impact?

Employees are a significant element for any business looking to establish a retirement plan. For example, a business with more than 100 employees is not eligible to set up a SIMPLE plan. Businesses with part-time employees or high turnover rates may not have many eligible participants, thus limiting the possible tax savings and increasing plan administration costs.

Perhaps the most important consideration for a business with employees is how nondiscrimination rules and testing may impact your client's retirement savings goals. The keys to meeting nondiscrimination requirements are to optimize retirement plan participation and to make business contributions as equitable as possible between highly compensated employees and those that fall below HCE threshold.

When identifying retirement strategies for a client with employees, it is important to understand these possibilities and know when to partner with a retirement administration expert to implement the details.

How Does the Amount to Contribute Matter?

The first question to ask after the golden question is how much money your client wants to contribute toward retirement on an annual basis. Contribution amounts will impact the best types of retirement plans for clients and how many retirement plans they may need.

Contribution amounts determine:

- Which plan types meet contribution needs.
- How many plans can be used for retirement savings.
- Which plans are optimal.

Clients that only have small sums to contribute, or only want to contribute small sums, may want to avoid high-cost retirement plans such as pensions and insurance savings vehicles. SIMPLE IRA or 401(k) plans may offer tax savings, retirement benefits, and low-cost solutions for these types of clients.

On the other hand, clients with aggressive savings goals or large amounts available to contribute toward retirement will find higher contribution limits with defined benefit plans and insurance retirement accounts more appealing. These types of retirement plans typically scale contributions higher as participants age.

Combining retirement plans is another powerful method to maximize retirement savings. Finding the right combination means that you need to know how different plans work, what contribution limits apply to what types of contributions and, of course, how much it will cost to implement and maintain the retirement plans.

Contribution Type Impacts Tax Savings

Retirement contributions are commonly thought of as pre-tax versus after-tax contributions, also referred to as traditional and Roth contributions, respectively. The implications of which contribution type is right for your clients go beyond a simple tax deduction.

The type of contribution impacts:

- Eligible retirement plan options.
- Current year tax deduction vs future year tax savings.
- Tax consequences of early withdrawals.
- Contribution limitations.
- Time horizon for retirement account growth.

Pre-tax contributions to a retirement account lower your gross income, saving you money on taxes. After-tax, or Roth, contributions do not generate an adjustment to gross income in the current year, but when drawing from a Roth retirement account the income is tax-free.

Typically, Roth contributions into a retirement plan are reserved for 401(k)s and IRAs. SIMPLE plans are the exception, as they do not allow Roth contributions. Clients wishing to make after-tax contributions to their retirement, thus planning on tax-free income in retirement, may not be suitable for defined benefits plans or strategies like profit-sharing plans. Additionally, high-income earners may not qualify to make Roth contributions directly into a retirement account.

This brings us to the second category of contribution types: personal and business contributions. There are a few key things to know about business versus personal contributions.

1. Personal contributions:

- a. Have a lower contribution limit than the maximum allowed under IRS rules, and individuals age 50 and older can make additional, catch-up contributions above the normal personal contribution limit.
- b. Are excluded from some nondiscrimination testing, which can be a good thing for some business owners.
- c. Lower personal income.
- d. Are the only way to make after-tax contributions.

2. Business contributions:

- a. Generate tax deductions for the business.
- b. Are the only way to maximize retirement contributions.
- c. Create employee incentives and additional compensation.
- d. Impact nondiscrimination testing.

The type of contribution that you and your client decide to use will be one of the most important factors in finding the right retirement strategy.

Types of Retirement Plans

Retirement accounts fall into two categories, defined contribution and defined benefit. Each category offers distinct benefits and important restrictions to understand.

Defined contribution plans include popular retirement strategies such as 401(k) plans, SIMPLE 401(k), SIMPLE IRA, self-directed IRA, profit-sharing, and simplified employee pensions (SEP). These types of retirement accounts are usually lower cost for employers and employees and offer more flexibility for investment options. If you and your client are interested in combining retirement strategies, then a defined contribution plan is likely to be in the mix.

Defined benefit plans, meanwhile, are commonly identifiable as pension plans, cash balance plans, and insurance plans. Defined benefit plans offer higher contribution limits, but may come with higher costs, more obligations and more potential penalties than defined contribution plans. If your client is interested in starting a defined benefit plan, be certain to discuss the benefits as well as the potential drawbacks before making a decision.

Pros and Cons of Contribution Types

Remember to always discuss the pros and cons of each decision. The benefits of business contributions are that they reduce business taxable income and allow maximum annual retirement contributions. However, there are some considerations for business contributions.

For instance, plan nondiscrimination rules may apply if a business has employees. Also, self-employment taxes still apply for Schedule C businesses. Remember that some plan types require regular contributions.

Business contributions are made to an employee's retirement account and come in two types: matching contributions and discretionary or nonelective contributions. Business contributions are commonly calculated as a percentage of the employee's wages or as a weighted average of total wages.

The only considerations for personal contributions to discuss would be if your client cannot achieve maximum contribution limits or if they may have lower tax savings than business contributions. Keep in mind that some retirement plans don't allow personal contributions.

The benefits of personal contributions include reducing gross income, allowing Roth contributions, not being subject to nondiscrimination rules, and providing for catch-up contributions. These topics should be discussed to determine which contribution and plan type suits your client.

Keep their savings goals, time horizon and tax impact front and center. For businesses, weigh the employee obligations, administrative costs and tax implications.

Know Retirement Plan Limits

Combining the right retirement plans increases savings potential and tax impacts. In order to match the right plan with the right client, you must know the numbers. For example, a 401(k) plan plus profit-sharing limit is \$61,000. A 401(k) plan plus a cash balance plan limit ranges from \$125,000 to \$433,500, depending on the participant's age.

Roth contributions typically favor savers with longer time horizons, but high-income earners may not be allowed to make Roth contributions. Earned income limits are \$129,000 to \$144,000 or \$204,000 to \$214,000, depending on filing status.

Putting It All Together

Putting together the right retirement plan for a client can be complex, but remember, it all starts with that one simple golden question: How much income do you need or want for your lifestyle? It's the first step on a journey of covering multiple topics to hone in on the best plan amid myriad choices.

Taking it one step at a time makes the process consistent and efficient. With so many tax benefits to proper retirement planning, every accounting firm should be proactive with their clients regarding getting a plan set up or improving on one already done.

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