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Options for Small Business Owners to Consider in Selecting Retirement Plans

Editor's Note: This article will be of special interest to our commercial members who own or work for small businesses.

Some people look forward to it; others dread it. Some people prepare carefully for it; others don't bother.

The subject is retirement. And for the owner of a small business, it's a very complicated subject indeed.

Whether we like it or not—or whether we're ready or not—the time eventually comes, for most of us at least, when we'll have to "hang it up."

Our best wish for retirement years is good health. Second to that is financial security. The former is something we don't have much control over. The latter is where preparation comes in.

A rule of thumb states that something like 65 to 80 percent of preretirement income is required to maintain a standard of living in retirement comparable to that of working years. The question is, where will that amount of money come from? For most people it will come from three sources: Social Security, a work-related retirement or pension plan and personal savings or investments.

If one of the three is missing or underfunded, a retirement plan is like an airplane with one of its engines out: it might take you where you want to go, but you're not going to feel comfortable about it.

Retirement Planning

Retirement planning today should consider several factors:

Inflation—After 20 years of retirement, and an average annual hypothetical 3.5% inflation rate, $50,000 of annual income will be worth only $24,520.

Uncertainty about Social Security—It's not likely that Social Security will be abolished, but its contribution percentage to the typical retirement plan may diminish. That's because it is projected by various studies that as Baby Boomers retire, there will be more and more retired people drawing from the program and proportionately fewer productive workers paying into it.

Uncertainty about employer-sponsored pensions—Traditional pension plans are becoming more expensive to fund and administer. Some companies are eliminating or drastically altering them.

Longer life spans—This is a good news/bad news story. We'll live longer, and the longer we live, the more money we will need for retirement.

Many small business owners neglect planning for their retirement. They may be too busy building their business to think 25 or 30 years down the road, or they may feel they need to plow all their available cash back into their company.

Whatever the reason, the business owner who does not plan for retirement may come up short on at least one, possibly two, of the three traditional sources of retirement income. Not only does he lack a company pension, but also his personal investments may be woefully inadequate. Equity in the business would replace investments, but there's no way to know how much the company will be worth when he is ready to retire. Some businesses do well while the owner is active but are worth little or nothing without the owner's energy and expertise.

In addition to providing for their own retirement, many business owners are finding that they must provide retirement programs for their employees. Otherwise, they can't compete with larger companies for the best people.

Retirement Plan Options

Several options are open to a small business owner who wants to start a company retirement program. There is no "right" one, each has advantages and disadvantages. Selecting the best-suited plan is a matter of considering funding costs, tax consequences, administrative requirements and, of course, the needs of the company and its employees.

Generally an owner can consider some type of "qualified" or "tax-qualified" plan. Employer contributions to a qualified plan are tax-deductible, and there's no tax on income earned by the plan's assets until the employee begins receiving payments.

A qualified plan can be a "defined benefit" or a "defined contribution" plan. Basically, a defined benefit plan is one in which the amount the participant will receive upon retirement is set (defined) by a formula. The formula usually is derived from the retiree's length of service and average pay over the last several years of employment. A common form of defined benefit plan is the traditional company pension that pays retirees a guaranteed sum for life.

The employer makes contributions to the plan in amounts prescribed by the Internal Revenue Code, and which are necessary to ensure that the plan will have money to pay the defined benefits that will be available when the employee retires. If the fund's investments don't perform well, the employer might have to contribute more money to meet the plan's commitment to employees.

Although tax benefits to the company can be significant, the risks may be great and the administrative costs may be high. One significant cost is for fees paid to the Federal Pension Benefit Guaranty Corporation to provide a limited guarantee that some benefits will be paid as promised if eligibility requirements are met.

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For these reasons, defined benefit plans are used less frequently in small businesses. In recent years, even large corporations have begun to move away from these plans in favor of defined contribution plans.

A defined contribution plan is one in which the employer's annual contribution to the fund, rather than the retiree's benefit, is set (defined) at a particular level by a formula of some kind; an example is a percentage of compensation. The employer bears no responsibility for the fund's performance. Thus, the employee is the one who stands to lose if the fund's investments don't prosper. It works both ways, of course: if the fund does well, the employee might retire with higher benefits than he would have under a traditional defined benefit pension.

Defined contribution plans include profit-sharing, 401(k) plans, thrift plans, ESOPs and others. Generally, qualified retirement plans must be available to all full-time and certain part-time employees. Therefore, they are not suitable for a small business owner who wants to cover only himself and a few key employees.

Personal Insurance and Retirement Plans

A retirement program that's rapidly gaining favor with small business owners is the personal insurance and retirement plan (PIRP) funded by a life insurance contract. Although the tax benefits may not be as favorable as those associated with qualified retirement plans, PIRPs are generally easy to set up and administer, and the owner can choose to cover only key employees.

There are several variations on the PIRP concept, but generally, this is the way they work: the company buys a life insurance policy and names the employee as the owner. Premiums are deductible to the company but taxable to the employee. Cash values, however, are allowed to accumulate tax-deferred. The life insurance policy can be funded so that cash values, over time, have the potential of exceeding the amount of premiums, in which case the employee can retire with a substantial asset to draw upon for retirement income. Withdrawals and loans will reduce the policy's cash value and death benefit and increase the chance that a policy may lapse.

If the retired employee elected to "cash in" the policy, a tax liability would be incurred. However, if eligible, he can *borrow* against the cash values. Policy loans do not result in current income for policies that are not modified endowment contracts, and the loans should not result in taxable income if the policy is kept in force through the death of the insured and not permitted to lapse. When the retiree dies, the loans are repaid from the policy's death benefit.

As with other important financial decisions, selecting the right retirement program for an individual or a business requires careful "examination of all options." This article is intended only to touch briefly on some of the options available to small business owners and self-employed people. Unless you're thoroughly familiar with applicable laws and procedures, you should consult appropriate professionals (tax advisors or other financial advisors and legal advisors) before deciding what's best for you and your business.

A little planning today can make a world of difference tomorrow.

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GE-23991(06/02) (Exp. 06/04)