BusinessManagement DAILY

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Introduction to 401(k)s for small businesses

Setting up a 401(k) for employees can be a daunting task for small business owners. It is one of the most highly regulated employee benefits. However, it's also one of the most important.

Small businesses can often feel like a family, as you may spend years or even decades growing your business with your loyal employees. It's important to take care of the people that work to keep your business alive, and helping them plan for their retirement is a great way to do that.

401(k)s allow employees to set aside a percentage of their salary to plan for their future retirement. Retirement planning is incredibly important for today's workforce amid uncertainty about the future of social security, making it a great way to set your business apart from small businesses that don't offer such benefits.

What is a 401(k)?

401(k)s are one of the most popular employer-sponsored retirement benefit options. They have largely replaced pensions as the primary method of retirement planning. With a 401(k), employees can elect to have a percentage of each paycheck deposited directly into an investment account. These funds may be deducted on a pre-tax basis depending on the type of 401(k) plan.

Funds deposited in a 401(k) account can be allocated across a variety of investments including stocks, bonds, mutual funds, and more in order to grow the account.

Do employers have to offer a 401(k) to employees?

Federal law does not require employers to offer 401(k) or retirement plans. You should note, however, that state and local laws vary. Some states, including California, Illinois, and Oregon, require employers of certain sizes to enroll in a state retirement savings program or offer their own 401(k) or qualifying retirement plan. Retirement benefits may also be negotiated and required under some union agreements.

Why should employers offer a 401k?

While you may not be required to offer your employees a 401(k), there are many reasons to do so.

Standing out to candidates

Candidates weigh a variety of factors when deciding where to apply or accept a job; compensation, room for growth, company culture, and of course benefits. A 401(k) is a fairly standard piece of a full employee benefits package. Not all small businesses offer them, but those that do will be more appealing to potential employees.

Most small businesses start with health insurance as the main facet of their benefits plan, but as you grow it's a good idea to expand to include retirement, dental, vision, life insurance, and other major offerings. There is a reason specific benefits are often listed in job postings; applicants really do care and weigh these along with the pay rate to determine whether they want to bother applying to work for you.

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If your company operates in a particularly competitive labor market, you may even want to take it a step further and offer generous employee matching to stand out further.

Improving retention

A great benefits plan can help encourage employees to stay at your small business. Employees that feel like they are being taken care of and are satisfied with their benefits are less likely to look elsewhere. A 401(k) also allows employers to offer some unique retention incentives through vesting.

A 401(k) vesting schedule allows employers to dictate how long an employee must work for their company before the employee fully owns the employers’ 401(k) contributions. Vesting can be immediate, or it can be spread over several years. With a cliff vesting schedule, an employee does not own the contributions until they reach a certain number of years of service. With a graded vesting schedule, they earn a percentage of the contributions each year until they get to 100%. A graded or cliff vesting schedule incentivizes employees to stay and earn their full employer contributions.

How much does it cost to offer a 401k

The exact cost to the employer varies heavily depending on what service provider they decide to partner with to offer a 401(k). There are administrative fees that can be in the hundreds or thousands. Employers may also be charged a setup fee. Plan participants (employees) are also often subject to administrative or management fees.

There are some tax credits that can help offset the initial costs of offering a 401(k). Employers may be able to claim a $5,000 tax credit for the first three years that the plan is offered. Employers can also deduct contributions to employee 401(k)s on their company's federal income tax return within approved limits.

Employers may also contribute to their employees’ accounts in the following manners.

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Contribution matching

Employers may also contribute funds to the employees' 401(k) accounts. Typically this is done through employer matching. The employer may match all or part of the employees' contributions to the 401(k), up to legal limits.

For example, an employer may state that they will match employee contributions of up to 5% of the employee's salary each pay period. An employee may elect to contribute 5% of their paycheck and the employer will match that 5%, or that may elect 3% and receive 3% matching. If the employee chose a higher number to contribute, the employer contribution would still be capped at 5%. Occasionally employers will offer a set contribution percentage regardless of employee selections, but most employers opt to go the matching route.

Profit-sharing

Instead of matching contributions, some employers use a profit-sharing method for their 401(k) contributions. Profit-sharing allows companies to make a pre-tax contribution to their employees' 401(k) accounts after the end of the year. These contributions are tax-deductible for the business on the prior year's return. This approach gives businesses more leeway in determining how much money they have available to allocate to 401(k) contributions.

This can be a good option for startups who are unsure about whether they have the funds to contribute to employee 401(k)s. If a small business has a bad year, they can make no contribution or smaller contributions based on the company's annual profit or lack thereof rather than committing a set percentage of contribution matching.

Despite the model's name, profit sharing doesn't have to be based on the company's profits. For example, a start-up may choose this method if they need to see what the results of an upcoming funding round are before deciding how much they can afford to contribute to employee 401(k)s.

Types of 401k Plans

Traditional 401k

A traditional 401(k) is the standard 401(k) plan. Employee contributions are deducted from their paychecks on a pre-tax basis, meaning that they reduce the employee's taxable income, but withdrawals from the 401(k)

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account will be taxed.

Traditional 401(k)s do have required minimum distributions. Once a plan participant reaches a certain age they will be required to withdraw a percentage of their 401(k) balance each year, unless they have not retired. Not taking out the required minimum distributions can have tax consequences.

Simple 401k

A simple 401(k) is a plan designed specifically for small businesses. If you have under 100 employees and plan to contribute to their accounts, this may be a good option. A Simple 401(k) does not require employers to conduct nondiscrimination testing nor does it grant them fiduciary responsibility.

If you're feeling overwhelmed by plan administration and compliance requirements, this can be a great starting point for offering your employees a 401(k) without jumping too far into unfamiliar territory. It is worth noting that Simple 401(k)s do have lower contribution limits though, so employees may not be able to set aside as much as they would like.

Roth 401(k)

A Roth 401(k) is another option with different tax implications. Contributions to a Roth 401(k) are deducted from the employee's paycheck on an after-tax basis.

Contributions are calculated and deducted after income taxes have been deducted. This means that employees don't get the immediate tax savings that they would under a traditional 401(k). Where they do get the tax savings is at the time of withdrawal. No additional taxes are due on the withdrawals or the investment growth of the account.

Safe Harbor 401(k)

A Safe Harbor 401(k) allows you to skip some of the compliance requirements, but you may only offer this type of plan if you plan to contribute to employees' accounts. With a Safe Harbor 401(k), employers do not have to conduct annual nondiscrimination testing. However, they do still need to file IRS Form 5500 each year.

How to offer a 401k

1. Pick which type of 401(k) you plan to offer

Think about what plan or plan options you would like to offer and whether you intend to offer any employer contributions such as matching or profit-sharing. Not every partner will offer all plan types. Many employers also choose to provide multiple options, such as a Roth and Traditional 401(k).

2. Choose a 401(k) partner

Most employers work with a 401(k) service provider to offer a 401(k) and manage the plan. Talk to your current benefits partners and payroll service, as they may have their own 401(k) offerings or preferred partners that they can recommend. Pick very carefully, as while the partner may handle most of the administration, the employer will still be listed as the plan sponsor and hold a fiduciary duty to the enrolled employees.

3. Create a written 401(k) plan

It's always a good idea to have your policies and benefits offerings in writing - and in the case of 401(k)s it's actually required. The IRS requires employers to have a written plan in place regarding their offered 401(k) plan(s). List out the plan design including eligibility, contribution limits, vesting schedules, and enrollment periods. Then, distribute your plan document so that employees can use it to understand the plan.

4. Enroll your employees

401(k)s are often one of the more complex and confusing components of your benefits package. As such, you may want to take extra care in educating employees about their options during the enrollment period. Many employers have the service partner and/or an investment advisor come to speak to employees during the enrollment period.

Help each employee through the enrollment process and allow them to choose their contribution percentages. Be sure to check the IRS annual contribution limits as they can change. Employees over 50 may also elect to make catch-up contributions if they need to set aside additional funds as they get closer to retirement.

Note that some employers choose to use automatic enrollment. This means that employees are automatically enrolled and have to opt-out if they don’t wish to participate, rather than being required to opt into the plan.

5. Stay compliant

Be sure to keep up with all of the compliance requirements. Many 401(k) plans, including traditional 401(k) plans require annual nondiscrimination testing. You’ll also need to file IRS Form 5500 each year. This form includes information about the company, plan assets, the retirement plans offered, and the number of enrolled participants.

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