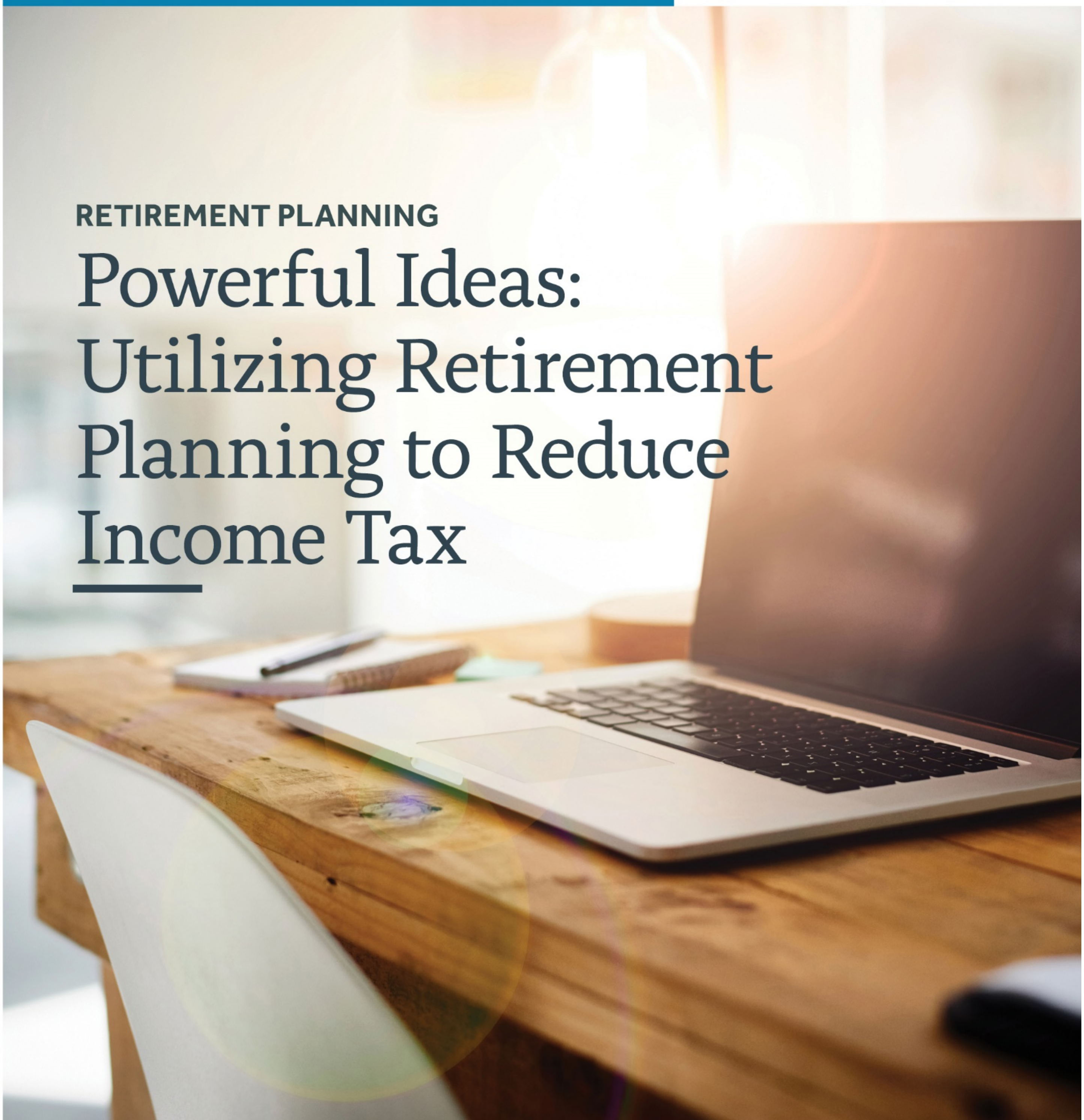
Navigating
Income Tax



RETIREMENT PLANNING

Powerful Ideas: Utilizing Retirement Planning to Reduce Income Tax

Utilizing Retirement Planning to Reduce Income Tax

Retirement planning - in general

Reducing taxable income provides an opportunity to reduce one's tax liability. Though many taxpayers relish the idea of reducing income taxes, most prefer not to reduce income to do so. However, engaging in retirement planning allows individuals to save for retirement in a manner that reduces current income, therefore reducing income tax liability. Generally, when contributions are made to a retirement plan, the employee does not include the amount of the contribution in his/her taxable income and the employer receives an immediate income tax deduction. Additionally, earnings on retirement plan balances are generally tax deferred.

What types of qualified retirement plans exist?

There are two categories of qualified retirement plans: defined benefit plans and defined contribution plans.

Defined benefit plan. Defined benefit plans specify the benefits payable to a participant at retirement. Each year the employer must contribute the actuarially determined amount necessary to provide the participant with the specified retirement benefit. With a defined benefit plan, the employer bears the investment risk and rewards of the plan. Defined benefit plans provide relatively greater income tax benefits for senior employees as compared to younger ones (since larger contributions are required to accumulate the necessary amount to provide the employee with the specified benefit).

Defined contribution plan. Unlike a defined benefit plan, a defined contribution plan does not specify the benefit a participant receives. With a defined contribution plan, the employer and/or the employee contributes a defined dollar amount or a percentage of compensation. The balance the participant receives will depend on contributions and investment performance. The employer is not responsible for the investment risk associated with a defined contribution plan.

A profit-sharing plan is a type of defined contribution plan that provides the employer with discretion in determining how much to contribute to the plan on an annual basis. Contributions to a profit-sharing plan will be allocated among the participant employees' respective accounts. A 401(k) plan is generally a profit-sharing plan which also provides for elective deferrals by the participants, i.e., participating employees would elect to either receive an amount from the company in cash (subject to current income taxes), or have the amount contributed to the company's 401(k) (not subject to current income taxes).

How much money can be contributed to a qualified retirement plan?

Deductible contributions to a defined benefit plan are based on the amount necessary to fund the benefit promised under the plan. Internal Revenue Code (IRC) §415 imposes a limit on the maximum benefit a participant may receive under a defined benefit plan to the lesser of 100% of the participant's average compensation for his/her three highest years, or $275,000 (in 2024).

IRC §415 limits annual contributions to a defined contribution plan to the lesser of 100% of the employee's compensation or $69,000 (in 2024), plus catch-up contributions. The elective deferral limit for 401(k)s (the amount that an employee can elect to have paid to his/her 401(k) as opposed to receiving as current income) is $23,000 (in 2024). Employees over the age 50 are allowed additional "catch-up" contributions of $7,500 (in 2024).

How can an individual retirement account help reduce income taxes?

In addition to a traditional defined benefit or defined contribution plan, individual retirement accounts (IRAs) can be used to fund retirement in an income tax-efficient manner.

Generally, anyone can establish an IRA. An IRA is a trust or custodial account that holds contributed funds for the benefit of the individual who sets up the account. Contributions to an IRA can only be made if the individual has compensation and contributions can be deductible or nondeductible. (If married filing jointly you may be able to contribute to an IRA even if you do not have compensation if your spouse has compensation.) Like qualified retirement plans, the individual owner of the account is not taxed until distributions are made from the account.

An individual can contribute up to $7,000 to a traditional IRA (in 2024). Individuals over the age of 50 are allowed additional "catch-up" contributions of $1,000. If an individual is not eligible to participate in an employee sponsored qualified retirement plan, contributions to his/her IRA will be deductible. If an individual participates in an employee sponsored qualified plan, deductible contributions will be reduced to the extent adjusted gross income (AGI) exceeds $123,000 if married filing jointly or $77,000 if single or head of household (in 2024). If AGI exceeds $143,000 for married filing jointly or $87,000 for single, no deduction is allowed for contributions to a traditional IRA. (AGI limitations differ for married couples if one spouse participates in an employer sponsored qualified plan.)

How can small business owners utilize IRAs to save for retirement in a tax-efficient manner?

Employers may establish IRAs for their employees that allow for larger contributions than traditional IRAs. Simplified employee pension (SEP) plans and SIMPLE IRAs are employer-funded IRAs that typically have lower set up and administrative costs, as compared to qualified retirement plans.

A SEP plan is an IRA funded with employer contributions. Each participating employee excludes the employer's contributions from his/her gross income and contributions to a SEP are tax deductible to the employer. An employer can contribute the lesser of 25% of an employee's compensation or $68,000 (in 2024) to a SEP. Employer contribution percentages must be the same for each eligible employee, i.e., an employer cannot pay himself/herself a higher percentage than any employee. All employees who are eligible to participate must be included. All employees over the age of 21 who have performed services for the employer in three of the previous five years are eligible to participate (if the employee earned over $750 of compensation).

A SIMPLE IRA is an IRA-based plan which allows for employer and employee contributions. With a SIMPLE IRA, an employee makes contributions to their account through a salary reduction election. Contributions to a SIMPLE IRA are excluded from the employee's income and are tax deductible to the employer. Employees can elect to defer up to $16,000 to a SIMPLE IRA (in 2024). An employee's available contribution may be reduced if he/she participates in another employer sponsored plan. Additional catch-up contributions of $3,500 are allowed for individuals over age 50. Additionally, employers generally must contribute to the plan through matching contributions, e.g., a 100% match of an employee's deferrals up to 3% of his/her compensation, or mandatory contributions of 2%. All employees who are eligible must be included. Each employee who received at least $5,000 of compensation during the prior two calendar years must be eligible to participate (regardless of age).