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401(k)s for everyone

A wide variety of desirable plans are now available

The 401(k) plan isn't just for big companies anymore. These arrangements, which come in a wide variety, are now available for almost any business — from a one-person operation on up. And as more financial services companies have begun marketing retirement plans to small businesses, 401(k)s have become relatively simple to establish and maintain.

A new way

The newest option on the block is the individual (or solo) 401(k). It can be an excellent choice for self-employed individuals or businesses in which the owner or owners (for example, a married couple or business partners) are the only employees. The plan's appeal is simple: For many business owners, it offers higher contributions than other plans for the self-employed.

Owners can make both a salary deferral and a profit-sharing contribution. The precise limits for each component depend on whether a business is a corporation or a noncorporate entity, such as a sole proprietorship, but in either case the combined annual contribution is limited to the lesser of 100% of compensation or $41,000 in 2004. Be careful, though — this doesn't mean that you can shelter 100% of your compensation up to the $41,000 amount. There are other factors that will limit your maximum contribution. But remember that so long as they don't exceed 100% of compensation, those 50 and over can kick in an additional $3,000 "catch-up" contribution this year, $4,000 in 2005 and $5,000 in 2006. Other advantages include fully deductible contributions, modest annual fees and no forms to file with the IRS until plan assets reach $100,000.

Beyond the "owner-only" requirement, the solo 401(k) usually favors professionals who work as sole proprietors or in partnerships. Your income level is likely the most decisive factor in whether this plan makes sense for you. Above a certain level — anywhere from about $160,000 to $200,000, depending on how your business is structured — the advantage of the solo 401(k) tends to diminish. One caveat: The solo 401(k) must be created before the end of the year for which you're contributing.

The traditional route

If your business has nonowner employees, you might prefer a different type of 401(k). The most obvious choice is the traditional 401(k). It lets employees save for retirement on a pretax basis, which can help small businesses compete with larger companies in attracting and retaining talented workers.

The plans are also flexible — both your and participants' contributions can vary each year, and you need not make matching contributions. The total amount that participants can defer through salary reductions is $13,000 in 2004 and $14,000 in 2005. (Employees 50 and over can make an additional contribution of $3,000 in 2004 and $4,000 in 2005.) The combined employer-employee contribution limit is the lesser of 100% of compensation or $41,000 in 2004.

Perhaps the main drawback of traditional 401(k) plans is that they're subject to federal testing requirements. This ensures that they're offered fairly to all employees and that benefits for rank-and-file workers are proportional to those for owners or other highly compensated employees (HCEs).

Plan vendors usually handle testing, but employers must still achieve compliance and some companies

aren't good candidates. Smaller companies — those employing 10 or fewer employees — might not be able to afford the costs of, or will not want to deal with, the administrative requirements of a traditional 401(k).

Other options

Sometimes significant salary disparities exist between HCEs and rank-and-file workers. If this sounds like your company, you may want to look into a Safe Harbor 401(k). This plan *requires* employer contributions but also enables owners and HCEs to maximize their contributions. To make the safe harbor election, you must either:

- Contribute 3% of compensation to *all* eligible employees, even those who don't make contributions, or
- Match 100% of the first 3% of worker deferrals and 50% of the next 2% of deferrals.

The primary downside of a Safe Harbor 401(k) is that it can get expensive, because you must contribute. Moreover, employer contributions vest immediately, which could prove disadvantageous if you experience high turnover.

Yet another option is a Savings Incentive Match Plan for Employees (SIMPLE) 401(k). It's similar to a Safe Harbor 401(k) in that you must make fully vested contributions. But, also like that plan, doing so removes the need for testing, though the IRS does require an annual filing.

The SIMPLE 401(k) is for businesses with 100 or fewer employees. Eligible participants can defer up to $10,000 in 2005 ($12,000 for those 50 and over) with this plan, and you must either match contributions up to 3% of each employee's pay or make a nonelective contribution of 2% of each employee's pay regardless of whether they contribute.

Save more with a defined-benefit plan

If you wish to save even more than the $44,000 maximum (with "catch-up" contribution) that 401(k) plans will allow in 2004, you may want to consider a defined-benefit plan. Pension reforms have made these arrangements, which promise a specified benefit at retirement, much more attractive.

The maximum allowable annual payout from defined-benefit plans has increased from $160,000 to $165,000 in 2004. And the tax-deductible amount you can contribute is significant — often as much as $100,000 or more a year.

Owner-only businesses may benefit the most because owners can stockpile large amounts for themselves without having to make contributions for others. Defined-benefit plans usually best suit professionals in their peak earning years working for stable businesses.

The plans can even work for some moderate earners, such as a business owner making $60,000 a year who can defer his or her entire salary and live on a spouse's income. And many plans can be designed so they are cost-efficient enough to also appeal to owners of companies with employees.

The downside? Defined-benefit plans require a substantial funding commitment for at least three to five years. And because contributions must be actuarially determined each year based on various factors, including a participant's age, earnings history and expected retirement date, these arrangements can be complex to manage.

Nonetheless, for high-income earners with sizable riches or those who want to save aggressively for retirement, a defined-benefit plan may be just the ticket.

Final considerations

Deciding which 401(k) plan is right for your business — or whether to offer one at all — will depend on your individual goals, employee demographics, and the amount of time and money you want to spend managing the arrangement. Don't forget that there are other choices besides 401(k)s, too.

Ultimately, you may be surprised to find that starting a retirement plan for your business is easier than you think, and the payoffs for both you and your workers can be considerable. ❑

Steer clear of liability threats

7 ways to avoid running into a lawsuit

Many business owners worry about being sued. In fact, 16% of small business owners said they were "very concerned" about becoming defendants in a liability suit and another 31% said they were "somewhat concerned," according to a 2002 survey by the National Federation of Independent Business.

Their worry is understandable. The time and cost of fighting legal action can be devastating, even if a lawsuit is found baseless and dropped. But with the help of an attorney and other advisors (including your CPA), you can establish solid policies and procedures that may reduce the likelihood of litigation. Having adequate insurance with a reputable company is also a must.

> *If you're sued, your employment policy will provide protection only if you've been following it.*

Here are seven tips attorneys recommend for minimizing your business liability risks.

1. Develop a personnel manual

Creating a comprehensive policy manual sets clear standards for conduct and performance. Instruct your managers to discuss the manual as part of a formal orientation process, after which workers should sign a statement acknowledging that it was explained to them. Certain agencies, including the Occupational Safety & Health Administration, require such training sessions and signed statements.

Once you have employment policies in place, guard against applying them inconsistently or allowing them to become outdated. If you're sued, your policy will provide protection only if you've been following it. Periodically review and update your manual and distribute new copies to employees.

2. Gear up to avoid grievances

The most common workplace complaint is race related, followed by sexual- or gender-based charges, according to the Equal Employment Opportunity Commission (EEOC). Other frequent allegations include complaints of retaliation against workers for taking legal action or cooperating with an investigation, and age- or disability-related discrimination.

Ensure your and your employees' business practices are beyond reproach. Educate workers and managers about what constitutes harassment or discrimination and how to avoid it, and teach them what to do if they believe they've been harassed or discriminated against. The good news is that the EEOC finds many charges baseless.

It's especially important to train managers about these issues. Their actions (or lack thereof) could become a focal point if a grievance arises. Make sure your managers can confer with someone knowledgeable (such as an attorney or other advisor) about how to handle a particular situation.

3. Regulate computer use

Computers have introduced a new area of employer liability. That's why every business needs a policy that prohibits employees from using technology in any illegal, discriminatory, harassing or otherwise offensive manner. You may want to improve compliance by

using software that tracks activity, blocks access to objectionable Web sites and provides Internet-use reports.

Your policy should also require the use of licensed software. Committing software piracy — inadvertently or otherwise — can be expensive and embarrassing. Regularly review your licenses to make sure your company is not violating copyrights. You may incur substantial liability if your business is profiting from illegal software.

4. Avoid termination pitfalls

Good documentation is key. Every time a manager or supervisor communicates with an employee about a work-related issue, he or she should document the discussion and put it in the worker's file.

In turn, employees should sign off on their written performance reviews and disciplinary action reports, and receive copies. If you must fire an employee — especially one likely to file an EEOC claim — your ability to show a record of problems will enhance your protection.

Also, be honest with employees about why you're firing them. To spare a worker's feelings, managers sometimes downplay the situation or make it seem as though it's not really the employee's fault. This approach could increase the likelihood of a lawsuit.

One way to minimize potential problems is to offer terminated employees a severance package in exchange for a release waiving their right to any claims arising from the employment relationship. When asking workers over age 40 to sign such a release, be careful to comply with the Older Workers Benefit Protection Act.

5. Comply with labor regulations

Be careful about using independent contractors. The IRS considers many factors to distinguish whether a worker is truly independent, and an hourly or salaried worker will usually be deemed an employee. Review your independent contractor relationships carefully and structure these arrangements appropriately. One safeguard can be to establish an agreement with independent contractors before work begins that explains the nature and specifics of the relationship.

When it comes to your regular employees, learn the distinctions between exempt and nonexempt workers. The latter are entitled to the benefits and protections of the Fair Labor Standards Act (FLSA), which requires overtime pay. FLSA violations can lead to costly lawsuits or government enforcement actions. What's more, new rules regarding the exempt vs. nonexempt distinction just took effect in August 2004. Keep in mind that employees are also covered by workers' compensation and unemployment security.

6. Investigate employee complaints

Disgruntled employees sometimes sue their employers because they don't feel their complaints were taken seriously. That's why you always need to investigate and respond to worker complaints — whether a physical safety concern or an allegation that someone acted inappropriately in the workplace.

It's also important to close the loop with the complainant. Let him or her know about the investigation's outcome and any steps you're taking to resolve the situation.

7. Consider a liability review

Ask your professional advisors to help you pinpoint where your company may be most vulnerable to liability. Depending on the nature of your business and industry, some areas will pose more risks than others. For instance, a manufacturing business may be more vulnerable to premise liability lawsuits, while an office-based business may face more employment-related actions.

A liability review, performed by your lawyer with assistance from your CPA and any other advisors you feel would help, can enable you to identify and address weaknesses. It may also offer insights about how to best allocate your insurance dollars.

Don't become a defendant

Liability concerns rank as the second biggest problem facing small businesses, according to the National Federation of Independent Business. Fortunately, by being aware of potential problems and getting help from the right advisors, you can reduce your odds of becoming a defendant. ❑

Moneylines: News briefs for businesses and individuals

New law eliminates "floating" holidays for customers. Your business may be able to process customer checks faster. A law that took effect on Oct. 28, 2004 — the Check Clearing for the 21st Century Act (or "Check 21") — allows companies with disparate locations to consolidate all checking deposits within one bank. So a retailer with franchises in Georgia, New York, Illinois and Arizona could process all its checks through, say, an Atlanta bank each night. This is possible because businesses can now accept electronically imaged checks, instead of the original paper draft. But if you adopt this process, alert your customers: Transactions are virtually automatic and eliminate float time.

Many families overspend on insurance. The average family spends $871 a year on auto insurance, according to the Insurance Information Institute, but you may be able to pay substantially less. Increasing an auto-collision deductible from $200 to $500 could save 30%, says insure.com. Also consider waiving comprehensive and collision coverage on an older car. And remember that you may be eligible for discounts for low mileage, antitheft devices, antilock brakes and airbags.

Relocating your business can empower society while lowering taxes. Moving your company to a federally designated empowerment zone may qualify you for an annual tax credit of up to $3,000 for each employee who lives and works in that area. Plus, you can still take your normal employment expense deduction for items such as payroll taxes, insurance and training costs. The credit is available until 2009.

Don't toss out that free financial forecast. Your annual Social Security statement should appear in the mail two to three months before your birthday (assuming you're 25 or older and not already receiving Social Security benefits). It breaks out estimates of the retirement, disability and survivors benefits you're earning through ongoing contributions to the system. Just keep in mind that you'll likely need about 75% of your career income to retire comfortably — and Social Security replaces only about 40%. So use your statement as a reminder and planning tool to keep your retirement strategy on track.

Vacation homes can provide a *tax* getaway, too

Levon and Stacy are fortunate enough to own a vacation home near a championship golf course. They live elsewhere and rent out the property for most of the year.

Although the house yields a nice income for the couple, they've been getting clubbed at tax time. To see whether they can continue to rent out the home without going over par on their tax bill, Levon and Stacy visit their tax advisor.

The advisor explains that you can treat a home-away-from-home as a personal residence, a rental property or a mix of the two, depending on how much it's used and by whom. Under a special exemption, homeowners need not report rental income at all if they rent the house for 14 days or less annually.

But if they use the home for more than 14 days or 10% of the days the property is rented out (whichever is greater), the property is treated as a personal residence. In this instance, the homeowner can generally write off mortgage interest and taxes on Schedule A.

Owners must still, however, consider the home's rental portion independent of the personal-use percentage. For example, if Levon and Stacy rent out their vacation home for six months every year, they can deduct rental expenses (for items such as mortgage interest, real estate taxes, maintenance and utilities) against rental income.

Going all the way

Because they could write off much more — up to $25,000 in expenses above and beyond rental income — Levon and Stacy may want to go all the way and treat their vacation home as a rental property.

Becoming landlords would likely qualify them for a depreciation deduction, which increases along with the time they rent out the property, though phaseouts kick in when their adjusted gross income reaches $100,000. And if they were real estate professionals, the losses would be fully deductible regardless of the income limitations.

To avail themselves of the $25,000 allowance, the couple must actively manage the property. That means, for example, they need to make their own management decisions and screen would-be tenants, instead of delegating those calls to a third-party company.

If they don't qualify for the allowance, their deductions are generally restricted under special rules, which say that any excess rental losses above rental income can usually offset only other rental income until the property is sold. To make sure the home is classified as a rental property, they must avoid using it for more than 14 days or 10% of the total days rented, whichever is greater.

Maximizing the benefits

Levon and Stacy aren't alone in their dilemma. A record 445,000 second homes were bought last year, or 5.5% of all home sales, according to the National Association of Realtors. And more than one-third of owners rent them out, says the association. Yet buying and renting out a vacation home is the easy part. Maximizing the tax benefits is another matter entirely. ❑

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