Employee Retirement Plans Matter And Here Is Why

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What are employee retirement plans?

A pension plan is a retirement plan that requires an employer to make contributions to a pool of funds set aside for a worker's future benefit. The pool of funds is invested on the employee's behalf, and the earnings on the investments generate income to the worker upon retirement. Some pension schemes have a voluntary investment aspect, in addition to the mandatory contributions from an employer. A pension plan will allow a worker to contribute a portion of his current wage income to an investment plan to help fund retirement. The employer can also match up to a certain percentage or dollar amount of a portion of the worker's annual contributions (Kagan,2019).

According to IRS (2020), retirement can last for 30 years or more and an employee may need up to 80% of their current annual income to retire comfortably. A retirement plan has lots of benefits for employees, the business, and the employer. Retirement plans allow employers to invest now for financial security when their employees and themselves retire. As a bonus, employers and their employees get significant tax advantages and other incentives.

Several benefits come with *employee retirement plans* and these include the reduction of current taxable income by employee contributions. Contributions and investment gains are not taxed until distributed. Contributions are easy to make through payroll deductions. Interest accrues over time, which allows small, regular contributions to grow to significant retirement savings. Retirement assets can be carried from one employer to another. The saver's credit may be available to some employees. Employees can improve financial security in retirement.

What are the common practices of employee retirement plans?

There are different types of retirement plans for instance Rockwood (2018) states that Individual Retirement Accounts (IRAs) are the most basic type of employee retirement plan. There are three types of IRAs an employer can help their employees set up and fund:

1. Payroll deduction. An employer is responsible for arranging contributions from an employee’s pay to their IRA. All employees are eligible to participate, but there is no requirement for employee contribution. There are no annual filing requirements for employers in payroll deduction plans. There is a limit to how much an employee can contribute — a maximum of $5,500 per year (those 50 and older in 2018 can make an additional catch-up contribution of $1,000, for a total annual IRA contribution of $6,500). This plan can either be a

- Traditional IRA, where contributions may be tax-deductible and the portion of the contribution that was tax-deductible also does not get taxed until distributed, or

- Roth IRA, where contributions are not tax-deductible, but the distributions, including Roth IRA earnings, are not included in income.

1. Simplified Employee Pension (SEP). The SEP allows just an employer to make contributions to employees and their SEP-IRA accounts. Those contributions are capped at 25% of each employee’s pay. Under this plan, all employees of the business must receive equal contributions but the annual amount an employer must contribute is not fixed. This gives smaller businesses some flexibility. A SEP does not have the same operating or set up costs as a conventional retirement plan.
2. SIMPLE IRA. This plan is available to small businesses with 100 or fewer employees. Both the employee and employer make contributions to a SIMPLE IRA. Employers are required to match 3% of the employee's contribution or contribute at least 2% of an employee's total compensation if the employee opts to not participate. SIMPLE IRAs also have yearly employee contribution caps.

Kagan (2019) states that there are two main types of pension plans the defined-benefit and the defined-contribution plans.

1. Defined contribution plans

Defined contribution plans are employer-established plans that do not promise a specific benefit at retirement. Instead, employees or their employer (or both) contribute to employees’ accounts under the plan. At retirement, the employee receives the total contributions plus earnings (or minus losses) on the invested contributions. According to the 2018 Retirement Confidence Survey put out by the Employee Benefit Research Institute, 76% of workers with a defined contribution plan are confident in having enough funds to retire comfortably versus 46% who do not have one.

The following four options have different specifics, but each option, if chosen by the employer, must be offered to all employees who are at least 21 years old and who have worked at least 1,000 hours in the previous year (Rockwood, 2018).

- Profit-sharing. Profit-sharing is one of the most flexible types of retirement plans from an employer. Only the employer can contribute to these plans, but it allows a business to make large contributions to its employee retirement funds if they have good years. However, there is no required annual employer contribution. There is, however, some paperwork involved in these plans. Each employee must get a separate account and employers must document how the profits for each employee have been determined.
- Traditional 401(k). In a traditional 401(k) plan, employees defer part of their salary to a retirement fund pre-tax, but some plans allow for them to be made on a post-tax basis. Contributions made by an employer to a traditional 401(k) plan are also not taxed by the federal government and most state governments. Employer contributions may vest over time depending on plan terms. There is a yearly maximum employer/employee combined contribution. These plans require annual nondiscrimination testing. Compliance testing is nondiscrimination tests that check to make sure a company isn’t offering 401(k) plans to only their highly compensated

employees and often require work on the part of an employer to perform. This is required because there is no mandatory minimum contribution on the part of the employer.

- Safe harbor 401(k). A safe harbor 401(k) plan eliminates the need for the IRS compliance tests of a traditional 401(k) plan. Employees can contribute a percentage of their salary each paycheck and there are mandatory employer contributions of at least 3% of employee contributions. There are maximum annual combined employer/ employee contributions.
- Automatic enrollment 401(k). Automatic enrollment will help an employer increase retirement plan participation, but an employee can still opt-out. There are a maximum annual combined employer and employee contribution. However since it is automatic enrollment, the contribution rates are all set to default. Employer contributions may vest over time depending on plan terms. These plans may require annual nondiscrimination testing.

1. Defined benefit plan

In a defined benefit plan, an employer is allowed to contribute more, and thus deduct more on taxes, compared to a defined contribution plan. Unlike a defined contribution plan, these plans are primarily funded by employer contributions. There are two types of defined benefit plans: pensions and cash-balance plans.

- Pension benefits at retirement time are based on a formula using the length of time an employee worked at the company and his or her average salary.
- Cash-balance plans refer to a set percentage of an employee’s salary each year plus a set interest rate applied to his or her balance.

These plans may vest over time according to plan terms which means an employee might need to work at the company for a set number of years to receive the full amount. The employer is required to make an annual contribution based on plan terms. They must be offered to all employees at least 21 years old who worked at least 1,000 hours in the previous year. These plans tend to be more complex than traditional retirement funds so they might be more expensive to set up and maintain.

It is essential for employees with the help of their employers to plan for retirement. A highlighted above there are several things to consider when *planning for retirement*, however, need to ensure that a viable retirement plan is put in place that will be of benefit to both the employer and the employee at the end of the day.

References

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