How Business Owners Can Reduce Tax Burdens Using a 401(k) Plan

A guide for business owners to help reduce business and personal tax burdens.

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Often Overlooked Tax Benefits of
A 401(K) PLAN

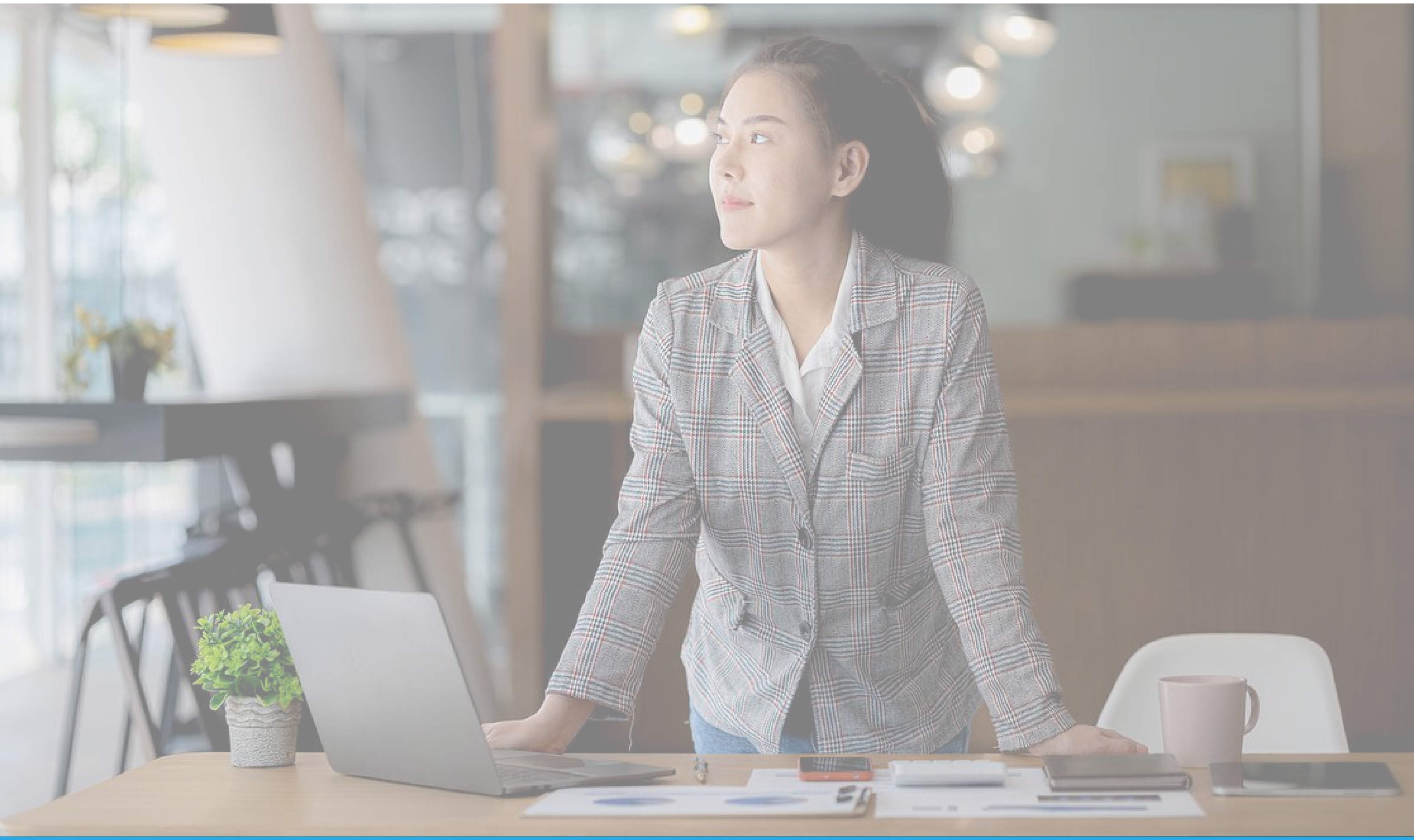
Whether you are just starting or have been in business for decades, a 401(k) may be an excellent addition to your business.

That's because a 401(k) comes with various benefits, from tax deductions and credits to increased employee retention and satisfaction.

In this paper, we'll explore how a 401(k) can reduce taxes both for businesses and for their owners.

Personal Benefits
FOR BUSINESS OWNERS AND EMPLOYEES

One of the best advantages of a 401(k) is it allows both owners and employees to easily save for retirement. Retirement accounts like 401(k)s come with some unique tax advantages that separate them from a regular investment accounts.



Let's explore three primary tax-saving contribution options with a 401(k).

1 Pre-tax contributions

A traditional 401(k) means all contributions happen *before* taxes.

This allows both owners and employees to contribute to their 401(k) without paying federal or state income taxes on those contributions. That can create significant tax savings now by lowering their taxable income.[1] Then, traditional 401(k) funds grow tax-free until retirement, and distributions are taxed as ordinary income during retirement.

It's important to know that there are annual contribution limits for participants and employers, with special catch-up provisions for employees and owners over age 50. Be sure to check the latest guidance from the IRS, as these contribution limits change over time.

TOTAL INCOME

401(k) contributions	taxable income

CONTRIBUTION LIMIT **$23,000***

$7,000* **CATCH-UP PROVISION**

[1] Investopedia. "401(k) Plan: The Complete Guide". December 5, 2021

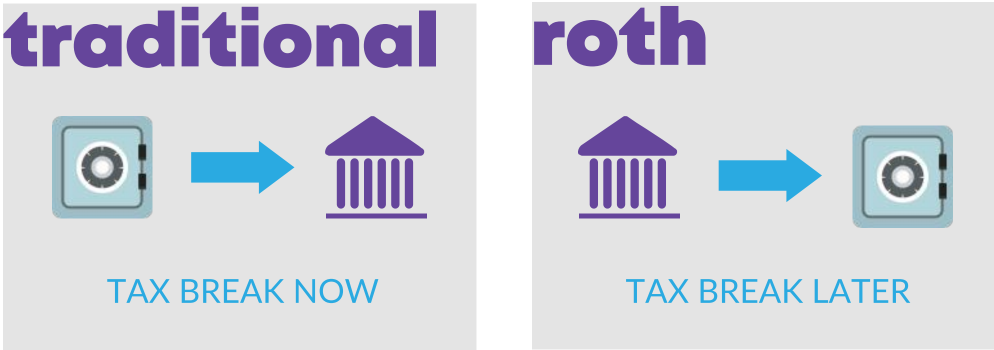
*for 2024

Pre-tax contributions lower your taxable income.

2 Roth (after-tax) contributions

With a Roth 401(k), all contributions are made *after* taxes.

This means that instead of creating a tax reduction now, participants pay taxes today in exchange for tax-free growth and tax-free distributions in retirement.[2] This can be very appealing for participants or owners who anticipate being in a higher tax bracket during retirement and want to lock in their favorable tax rate now.



While this does not reduce taxable income like a traditional 401(k), it can be a great way to diversify tax treatment. In addition, just like traditional 401(k)s, Roth 401(k)s have annual contribution limits for the participant and employer, with special catch-up provisions for participants age 50 or over.

Remember to check the annual contribution limits directly on the IRS website.

Additionally, with SECURE 2.0 legislation that passed at the end of 2022, employees are able to choose to have their employer contributions treated as Roth. This is good news for workers who expect to have a higher income after retirement than they do currently, because it allows them to pay taxes on the matching funds now, and avoid paying taxes on them later. See our full discussion of this on page 10.

[2] Bank Rate. "Roth 401(k) vs. 401(k): Which one is better for you?" March 30, 2022.

After-tax contributions provide tax-free distributions in retirement.

3

Profit-sharing (non-elective) contributions

In addition to the typical matching contributions, businesses can choose to offer profit-sharing contributions to their participants. These contributions are tax-deductible for the *previous* tax year. This means businesses have time to determine how much they can afford to provide, and they can even elect to make no contribution for a year.[3]

Participants tend to prefer this type of benefit,[4] because it doesn't increase their taxable income, often making it more valuable than a bonus payment. It also doesn't count toward the IRS deferral limit, making it particularly helpful for highly compensated employees who may have their 401(k) contributions maxed.

integrated
Based on social security tax levels

age-weighted
Older employees receive more

pro-rata
Equal percentage of salary

new comparability
Based on unique benefit groups

While there are several different profit sharing methods available, business owners can benefit from using the new comparability calculation. It typically provides more compensation for those who are older and make more money, which can give owners the ability to maximize the contributions to their own accounts.

[3] Employee Benefits Security Administration. "Profit Sharing Plans for Small Businesses".

{4} Glassdoor. "4 in 5 Employees Want Benefits or Perks More Than a Pay Raise; Glassdoor Employment Confidence Survey (Q3 2015)". October 2, 2015.

Profit-sharing benefits can be more valuable than a bonus payment.

Business Benefits
TAX SAVINGS FOR BUSINESS ENTITIES

In addition to the tax savings and advantages as a participant, there are substantial business tax savings opportunities to consider.

The tax savings provided by a retirement benefit is often the biggest reason businesses choose to offer it.

Let's explore three primary tax-saving channels for businesses.

Deductible expenses

administration

recordkeeping

auditing

consulting

Since a 401(k) is an employee benefit, the costs associated are deductible expenses.[5]

This includes contributions you make to employee accounts and any administrative costs that come with establishing and maintaining your 401(k) plan.

For example, many 401(k) plans include fees for:

- third-party administration
- recordkeeping
- auditing
- hiring outside consultants

These deductible expenses are a great way to save money at tax time while offering a high-quality benefit to your employees.

[5] IRS. "Publication 535 (2021), Business Expenses".

Deductible expenses help businesses save money at tax time.

2 Compensation offset

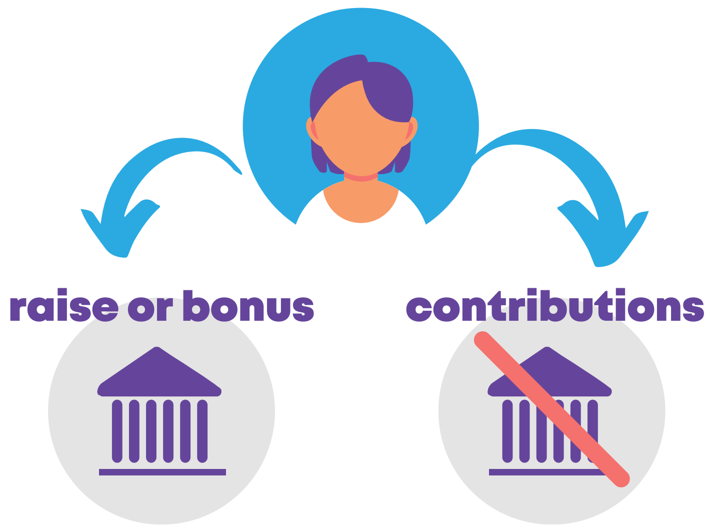
Another unique way that 401(k)s can reduce business taxes is by offsetting compensation.

When creating compensation packages, employers must value the benefits and compensation offered. Often, this means when employers provide a 401(k) with matching contributions, they can either reduce or forego an upcoming raise as their employee is receiving additional compensation through the 401(k) plan.

This offers unique tax savings for employers because of the way matching contributions are taxed.

Most employer matching contributions to 401(k) plans are pre-tax, meaning they reduce the amount of wages that are subject to Federal Income Tax, Social Security, Medicare, or other payroll taxes.

This means that if employers offset payroll wages for 401(k) contributions, they can save the additional amount they would have paid in payroll taxes while creating a deductible expense.



FICA withholding taxes	EMPLOYER	EMPLOYEE
Social Security	6.2%	6.2%
Medicare	1.45%	1.45%
Medicare over $200k	0.0%	0.09%

Source: The Balance SMB

401(k) contributions are not subject to payroll taxes.

Understanding Roth Employer Contributions

One of the SECURE Act 2.0 updates allows fully-vested employer contributions to be designated as Roth for tax purposes. Previously, all employer contributions were made pre-tax.

This provision is a welcome one for employees that are already benefitting from their own Roth contributions, but the practical details have yet to be ironed out, making it advisable to wait before adding this feature to your plan.

401(k) contributions can be taxed before they enter the retirement account (traditional) or when they leave the account (Roth), but it must be one or the other. Employer Roth contributions are complicated because we don't yet have guidance on how the tax reporting will be managed.

Industry experts have speculated on a couple of likely options. [6]

option 1:

The Roth employer contributions may listed as income on the employee's W-2, making the employee responsible for the taxes on their annual report.

However, functionality to allow for these taxes to be paid with each payroll doesn't yet exist, forcing employees to cover those costs in one lump sum when their tax forms are filed each year.

option 2:

The contributions may be reported on a separate 1099R form at year end.

This option would make the reporting process much easier, but would still leave the employee with the same tax problem as with the W-2 reporting option.

[6]: ASPPA: SECURE 2.0—So, About that Employer Roth Contribution...

Roth employer matching contributions are complicated.

3 Tax credits

Lastly, specific tax credits are available to businesses to help offset the costs of establishing a retirement plan like a 401(k).

It's important to note that you can either claim the tax credit or deduct the startup expenses, but you cannot do both. SECURE 2.0 created some new and expanded tax credits to make retirement plans more affordable for small businesses. Be aware of three credits.

AUTO-ENROLLMENT CREDIT

The credit is available for new plans that include an auto-enrollment feature,

$500 *per year*

for:

3 years

Be sure to work with your accountant or tax professional to verify eligibility and visit the IRS website for additional details.

Employers may qualify for tax credits of $500 x 3 years for auto-enrollment.

Tax credits through SECURE 2.0

SECURE Act 2.0 have expanded tax credits for small businesses that start a new 401(k).

Some key highlights of the bill include the expansion of the previous tax credit to cover 100% of start-up costs (up to $5,000) and creating a new tax credit that offers employers a credit for a percentage of plan contributions made for the first five years, up to a per-employee cap of $1,000 (with some restrictions).

ADMINISTRATIVE CREDITS:

100%

of start-up costs, up to $5000

for 3 years

For companies with fewer than 50 employees.

OR

50%

of start-up costs, up to $5000

For companies with 51-100 employees.

The maximum credit is reduced for very small companies. Those with fewer than 20 employees should use this calculation:

$250 x no. of NHCEs = max credit

NHCE = non-highly-compensated employee, exact definition here: https://www.irs.gov/retirement-plans/plan-participant-employee/definitions

SECURE 2.0 expands business tax benefits for small employers.

More tax credits through SECURE 2.0

The contribution credit is particularly valuable for companies, helping to reduce the burden of providing employee contributions for 5 years.

CONTRIBUTION CREDITS:

up to **$1000** per eligible employee* per year for **5 years**

For businesses with 50 or fewer employees. Credits are available on a diminishing scale, reduced by 25% per year starting year 3.

Tax credit schedule

Year 1:	100%
Year 2:	100%
Year 3:	75%
Year 4:	50%
Year 5:	25%

*Eligible employees are those that are paid no more than $100,000 (in 2024).

Businesses with 51 - 100 employees

A sliding scale is used to calculate the tax credit for businesses with 51-100 employees. The percentage is reduced by 2 points for every employee over 50. The 5-year tax credit schedule is still applied.

EXAMPLE: A business has 70 employees

number over 50= 20
20 x 2 points = 40% reduction
(or 60% total)

Year 1:	100% x 60%
Year 2:	100% x 60%
Year 3:	75% x 60%
Year 4:	50% x 60%
Year 5:	25% x 60%

Business + Personal Benefits
FOR THE SELF-EMPLOYED

If a business employs just one owner (and spouse, if applicable), a solo 401(k) plan is a great option. In addition to providing a vehicle for retirement savings for business owners, it also offers other tax and business benefits.

For businesses with just one owner, a solo 401(k) plan is a great option.

1 Solo-k benefits

large contributions

Plans allow up to $69,000/yr in contributions (in 2024) without restriction (+ $7500 in catch-up for those 50 and older).

easy administration

Plans are not subject to most qualification requirements or annual nondiscrimination testing. 401GO provides automation that manages many day-to-day tasks.

low fees

Because they cover few employees and require little administration, fees for solo plans are typically very affordable. Spouse accounts are often included at no extra charge.

plan options

You can choose your tax advantage: traditional plans reduce taxable income now, while Roth plans allow for tax-free distributions in retirement.

Solo 401(k) plans allow large annual contributions

HERE TO HELP

With so many considerations associated with retirement planning, one cut-and-dried answer for everyone does not exist. It's important to think through these details carefully to ensure the best long-term benefits.

At 401GO, we provide small business 401(k) plans powered by an easy-to-use platform. Our streamlined approach allows you to get up and running in just minutes with simple and affordable pricing to fit your unique business.

401go.com