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WestPoint Private client GROUP

 

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Putting the 401(k) Plan on Autopilot

Growing numbers of employers are tackling the persistent problem of low retirement savings rates among American workers by automatically enrolling their employees in 401(k) and other defined contribution plans. The need to boost participation in 401(k) plans is especially acute among companies in the process of phasing out defined benefit pension plans and among companies with large numbers of lower-income workers.

The do-it-yourself approach required by 401(k) plans made more sense when they were first introduced in the early 1980s to supplement employer-provided pensions and profit-sharing plans, a 2005 report on automatic 401(k) features by the Retirement Security Project pointed out. Because participants' basic retirement needs were already met by pensions and Social Security, workers were given a substantial level of discretion over how to manage their 401(k) accounts. But as the 401(k) gradually becomes the primary retirement savings vehicle for most American workers, the presumption that large numbers of employees will take the initiative required to participate successfully in these programs is proving increasingly risky for sponsors, researchers noted.

Automatic enrollment places a percentage of an employee's paycheck in an individual 401(k) account, without requiring the worker to take any action. In addition to automatic enrollment, employers may add other automated features to their retirement plans, including automatic escalation, in which employee contributions automatically increase over time as their earnings rise; automatic

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Is It Time to Incorporate?

Many people associate corporations with big companies whose shares are traded on Wall Street. But a business does not have to be large or public to become a "C" corporation. While you may have started your business as a sole proprietorship or partnership, your firm could benefit from adopting a more complex business structure as it seeks to expand or take on more employees. While a highly regulated business form, the corporation nonetheless offers certain tax and legal advantages that could make it a suitable structure for many growing businesses.

The C corporation is a for-profit, state incorporated business that is

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investment, in which the worker's portfolio is rebalanced on a regular basis to improve diversification and asset allocation; and automatic rollover, in which an employee's 401(k) account funds are automatically rolled over into an IRA when he or she changes jobs.

When workers are forced to take action to avoid participating in a retirement plan, they tend to remain enrolled and are less likely to opt out. Enrollment rates tend to be lower when the onus is on the individual worker to sign up.

A recent study by Hewitt Associates found that 23% of the companies surveyed expect to add automatic enrollment features to their 401(k) plans by the end of 2006, 13% intend to add contribution escalation features, and 20% expect to add automatic rebalancing of 401(k) accounts.

Lori Lucas, director of participant research at Hewitt Associates, said, "Companies that have already implemented automatic features to their 401(k) plans have seen significant results in helping employees save and invest better for retirement. This is creating momentum and prompting other companies to consider them as well."[1]

"Automated features change the equation so that inertia around retirement saving and investing works in employees' favor: If an employee does nothing, it is okay because the 401(k) plan is on autopilot," Lucas added.

The Pension Protection Act signed into law on August 17, 2006 explicitly allows automatic enrollment of workers in 401(k) plans by employers. Employees who have been automatically enrolled in a plan retain the right to opt out, but must take action to do so. In addition, employers are permitted to make default contribution decisions on behalf of 401(k) plan participants who have made no investment choices. For the first time, plan sponsors are, under certain conditions, allowed to provide personalized investment advice to participants.

The new law also makes permanent incentives for qualified retirement savings contained in the Economic Growth and Tax Relief Reconciliation Act (EGTRRA) of 2001. These provisions, many of which were due to expire in 2010, include higher contribution limits and catch-up amounts for IRAs and 401(k) plans, accelerated vesting of employer matching contributions, and higher deductible amounts for employer contributions to employee retirement accounts. By making the newly available Roth 401(k) a permanent part of the tax code, the legislation is expected to encourage 401(k) sponsors to add a Roth option to their plans.

In addition, 401(k) participants are now able to make hardship withdrawals on behalf of any listed beneficiary. The old law limited this option to spouses and dependents.

The Pension Act also permits any beneficiary to roll over his or her interest in a qualified retirement plan, tax-sheltered annuity (TSA), or government plan to an IRA, upon the death of the account owner. Taxes will only be due when normal distributions are taken. Formerly, only spousal beneficiaries were permitted this option.

Beginning in 2008, individuals may roll over funds from a qualified retirement plan, TSA, or government plan directly into a Roth IRA, and the rollover will be treated as a conversion. You must satisfy all conversion requirements, including having income less than $100,000. In 2010, this income restriction will be eliminated.$

[1] *Hewitt Associates, "Hewitt Survey Reveals New Employer Trends in Retirement," press release, January 10, 2006.*

Is It Time to Incorporate?

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considered by law to be a unique entity separate from the individuals who own and run it. A corporation is created when shareholders file articles of incorporation with a secretary of state's office. If a corporation conducts business outside the state in which it was organized, the company may be required by other states to register as a "foreign" corporation.

The organizational structure of a corporation involves three main groups: shareholders, directors, and officers. A corporation is owned by the shareholders, who are usually not directly involved in running the company unless they also serve as officers or directors. Instead, most shareholders influence corporate decisions by electing and removing directors, voting on amendments to the articles of incorporation, and approving or disapproving other major changes. The corporation's officers, who manage the company's day-to-day operations, are appointed by the board of directors. In most corporations, the board has a supervisory role, intervening only in major business decisions.

Corporations, like individuals, are entitled by law to enter into contracts, loan and borrow money, own assets, sue and be sued, hire employees, and pay taxes—all without having to directly involve the shareholders. Corporations offer shareholders liability protection: While shareholders participate in profits in the form of stock appreciation and dividends, their personal assets are shielded from debt liability and lawsuits against the company.

C corporations pay corporate taxes, and the shareholders pay tax on the income they receive as dividends. This double taxation can be a disadvantage, particularly for owners who are not in a position to reinvest a significant portion of profits back into their businesses. On the other hand, corporate federal income tax rates, which start at 15%, may be lower than the shareholders' personal income tax rates. Owners who can afford to do so may leave a portion of earnings in the company for future investment or to reduce their own income tax liability. The amount of corporate tax owed may, in any case, be fairly low after the cost of paying salaries and benefits is deducted.

Of all the business forms, C corporations have the greatest flexibility in raising money through equity financing. There are no restrictions on C corporation shareholder numbers, and owners are not required to be U.S. residents. C corporations may even be owned by other business entities.

Unlike sole proprietorships and partnerships, which often end upon the death or retirement of the owners, C corporations can last in perpetuity. Ownership in a corporation is easily transferable: When shareholders die or sell their interests, the corporation can continue to exist and do business.

The C corporation structure can prove particularly favorable as a company's need to attract and retain employees increases. To a greater extent than other business forms, corporations can deduct the cost of providing employee benefits and perks, including health insurance, retirement plans, and life insurance. This can be personally valuable to shareholders, who, along with employees, enjoy access to tax-deductible medical coverage and retirement plans. Corporations can also offer employee incentive stock plans.

Some businesses may choose to become C corporations for a less tangible reason: image. Because this business structure is used by large public companies, having an "Inc." attached to its name may help a firm to be taken more seriously by potential investors and customers.

The C corporation is not the appropriate structure for every business. While the independent

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Business Owners: Keeping Sight of Personal Priorities

In the rush of day-to-day business activities, many small business owners may lose sight of what they had originally hoped to accomplish from their hard work. Over time, as a business grows, personal objectives that may have been suitable at one stage in life often change.

Do you ever stop to reevaluate and update your personal goals and priorities? The following are some key concerns of many small business owners:

- **Strengthening Personal Finances and Building Wealth.** Many business owners become so engrossed in running their companies that they inadvertently end up putting their personal finances on the back burner. This may occur if most of their liquid assets are tied up in the business. However, to achieve financial independence and build personal wealth, it is important to make personal savings a priority. By conducting regular financial reviews, and taking follow-up action as needed, you can help develop and strengthen *your* personal financial position.
- **Preparing for Retirement.** Many tax-deferred, ***qualified* retirement savings vehicles**, such as **simplified employee pension plans** (**SEPs**) or **401(k) plans**, are available to business owners and their employees. The size of a company, as well as the ages and salaries of its employees, often determines which type of retirement plan is best in a given situation. In addition, ***nonqualified* plans** allow business owners to provide *selective* benefits for themselves, as well as their key employees.
- **Developing an Exit Strategy.** Will your small business be marketable if and when you decide to sell? It is important to develop an "exit" strategy that can help provide cash commensurate with the value of your business in the event you choose—or are forced (due to death or disability)—to divest.
- **Retaining the Company within Your Family.** Your company, like many others, may be a **closely-held business**, operated by more than one family member. If you wish to keep your company in your family, it is important to learn about **transfer tax** issues and develop a **business succession** plan that will help secure your long-term goals and objectives.

Stay Focused

As your company grows and develops, it is important to keep sight of your *personal* priorities, particularly as they change over time. Annual reviews can help ensure your business activities are consistent with your long-term personal goals and objectives. $

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status of the corporation offers many advantages, there are also some potential drawbacks to choosing this structure. C corporation shareholders cannot, for tax purposes, offset the company's losses against their personal income. As profits grow, the company will be faced with corporate tax rates as high as 39%. Because of the organizational complexity and regulatory burdens associated with this structure, the corporation is more expensive to establish and maintain than other business forms.

Each business structure has its advantages and disadvantages. Your choice will affect the taxes you pay and your personal liability risk, so it is important to choose the right entity for your business. For specific guidance, consult your qualified tax professional. $

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