Strategies for maximizing tax reduction and deferral

For business owners and the self-employed, frustration with annual tax liabilities is a cornerstone of every spring season; as constant and repetitive as April showers. But perhaps it doesn't have to be? It's never too soon to plan for your next tax season.

At Mesirow, we work with business owners like you to help maximize retirement savings, minimize taxes, and maintain the flexibility required to productively run your business by implementing custom retirement plan strategies.

Qualified retirement plans have been around for decades, but many business owners don't realize just how effective they can be for delivering large tax deductions that can:

- significantly reduce your taxable income
- greatly enhance your annual savings
- provide for wealth accumulation through tax-deferred compounding, and
- shift expense from a large tax liability to a more reasonable benefit allocated to your employees

Generally, the strategy is to reallocate the business owners' income/profit into the plan as contributions to both the owners and employees. While providing a valuable retirement contribution to all (including yourself) and sheltering that money away from tax, owners can often save significant dollars relative to taking the money home and paying current income tax.

There are two primary approaches to qualified retirement plans: defined contribution plans and defined benefit plans.

Defined contribution plans—more commonly known in the marketplace as profit sharing and 401(k) plans—are ideal for business owners seeking flexibility and annual discretion. These plans provide the ability in profitable years to shelter up to an annual 2024 individual limit of $69,000.00, (or $76,000 if age 50 or older).[1] The appeal of a defined contribution program is that the fixed annual commitment is often very manageable, and yet the potential to scale up remains available in years when business is good.

Defined benefit plans, on the other hand, offer the appeal of considerably larger contributions and deductions. Depending on the demographics of the shareholders and employees—age, compensation, etc.—it is not at all uncommon to obtain six-figure tax deductions annually in a defined benefit plan. However, in exchange for the larger tax and savings vehicle, as a business owner you must be comfortable with a less flexible commitment; the contributions are not as discretionary and flexible on an annual basis as they are in defined contribution plans. However, the larger contribution levels in defined benefit plans have the same benefits of tax reduction and deferral, thus providing a tremendous tax and wealth accumulation strategy for businesses with consistent revenue, such as small medical practices, closely-held law firms, etc.

One defined benefit program that is increasingly common in the market today is a cash balance plan—a specific type of defined benefit plan that is communicated and packaged to employees more like a defined contribution plan. While the mechanics on the back end are very much a traditional defined benefit plan, the contributions are delivered more like profit sharing contributions so that the employees can more easily digest what they are receiving and what they take with them if they terminate employment.

One of the misconceptions about qualified retirement plans is that your business must be formally incorporated to take advantage. In most cases, you only need net earnings from self-employment in order to be eligible to sponsor a qualified plan.

Smaller companies are often ideal candidates for these programs because the contributions are not diluted by the number of employees. As an example, professionals who have outside income from consulting or outside contract work can shelter significant income with these plans. In short, these tax-advantaged programs are available to most types of businesses, from sole proprietors to partnerships, corporations, and LLCs.

Evaluating whether a program like this would be financially beneficial is very straightforward, and the mechanics can be crystallized by exploring your customized tax objectives and employee demographics.

There is never a bad time to begin planning for tax season, but there are clear deadlines to establishing these types of retirement plans for the upcoming year. As your wealth advisor, we are here to help discuss the retirement plan options that make the most sense for you and your business.

Published February 2024

1 https://www.irs.gov/retirement-plans/plan-participant-employee/retirement-topics-401k-and-profit-sharing-plan-contribution-limits

2 https://www.mesirow.com/sites/default/files/PDFs/Wealth/2024-Contribution-Limits.pdf

Source: Mesirow

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