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Time for small businesses to get with 401(k)s

There's no reason why small-business owners shouldn't take advantage of a tax-advantaged retirement savings plan; here are some tips to get started.

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NEW YORK (CNNMoney.com) -- It's hard for small companies to retain good employees, since bigger fish often can lure them away with more attractive pay packages.

But one proven retention tool -- tax-qualified retirement plans -- are becoming less expensive and easier for small businesses to set up.

There's been significant growth in the number of plans among companies with fewer than 100 employees, according to David Wray, president of the 401(k)/Profit-Sharing Council of America.

But many small business owners still believe retirement plans are too costly and complicated for them.

As of the end of 2005, only 15 percent of the nearly 6 million small firms with fewer than 100 workers offered a defined contribution plan, such as a 401(k), according to the Spectrem Group. Ninety-seven percent of large companies do.

Part of the problem is that much of the 401(k) plan industry is geared towards corporations and large businesses, said Chad Parks, founder and CEO of San Francisco-based retirement-plan management company The Online 401(k).

Since the financial institution that provides the plan, such as a bank, mutual fund firm or insurance company, makes more money when there are more assets under management, there is more incentive for them to cater to the deep pockets of big businesses with thousands of employees.

Then there's the matter of small-business owners often operating on a shoestring budget. So for many, the question of setting up a 401(k) plan comes down to a cost-benefit analysis.

"If they're a very small business they may be debating between that and putting an ad in the yellow pages," said Bob Guillocheau, president of BISYS Retirement Services, a division of The BISYS Group.

But the cost and the process of setting up a retirement plan for small businesses has gotten more manageable over the past few years thanks in part to increased competition among retirement-plan management companies.

The Online 401(k), for example, doesn't charge commissions based on the assets invested in the plan, but instead charges a monthly fee to cover all the logistics.

The Online 401(k)'s fees start with a one-time $495 set-up fee plus $145 flat monthly fee for companies with 10 or fewer employees, $185 for firms with 11 to 30 employees and $235 for companies with 31 to 50 workers. That covers administration, record keeping, investments, education, advice and service.

Fidelity, the largest 401(k) provider, also offers fairly low-cost plans for small business owners. "On average, the pricing is about $3000 a year, including the per participant fee," said Edmund Murphy, executive vice president of Fidelity's emerging corporate market.

All company costs related to the plan are tax-deductible.

Pick a plan

Of the three basic 401(k) plans, a traditional is the most popular plan and offers the most flexibility.

In a traditional 401(k), small-business owners can decide whether to make contributions on behalf of all participants, match employees' deferrals, do both or do neither. In addition, any contributions they do make can be subject to a vesting schedule that they set. The vesting schedule provides that an employee's right to employer contributions becomes nonforfeitable only after a period of time.

And a traditional 401(k) allows participants to make pre-tax contributions through payroll deductions, and that can reduce their tax bill in the current year.

The second basic type of plan is a safe-harbor 401(k). It is similar to a traditional 401(k) plan, but among the differences is that any employer match must be fully vested when the contribution is made.

However, the safe-harbor 401(k) is not subject to many of the complex rules associated with a traditional 401(k) plan, including having to make sure that highly paid employees don't benefit from the plan more than lesser paid employees do.

Both traditional and safe-harbor 401(k) plans can come with a profit-sharing plan if an employer wishes to distribute some of the company's profits to employees.

The third type of plan is a SIMPLE 401(k), which is like a safe-harbor plan in that employer contributions must be fully vested when made. But a SIMPLE is only available to employers with 100 or fewer employees who earned at least $5,000 in compensation from the company in the prior year. Employees can only contribute up to $10,000 and an employer match is required.

This is generally a less popular option since it is typically less flexible than the other 401(k) options.

There are also Simplified Employee Pension plans (SEPs), which allow employers to set aside money in retirement accounts for themselves and their employees. Under a SEP, an employer makes tax-deductible contributions to traditional individual retirement accounts (SEP-IRAs) for all employees (including the employer).

This type of plan allows for a contribution of up to 25 percent of each employee's pay and employee contributions are not allowed. The SEP-IRA is a good option for businesses with just a handful of employees since setting it up and administering it can be cheap (e.g., $10 a year per employee) - and in some cases free - and there is no requirement to make contributions every year.

In addition, the IRS has made more 401(k) information available to help small business owners better understand their responsibilities in establishing and operating their plans. (Read Publication 4222, 401(k) Plans for Small Businesses.)