

HOW RETIREMENT PLAN TAX DEFERRAL PAYS

Twenty years ago, Dave began making a \$250 pretax contribution to a tax-deferred retirement account at the beginning of each month. At the same time, his brother Ron began investing for retirement in a taxable account. Ron is in a 28% tax bracket, so his monthly after-tax investment is \$180. Dave and Ron's accounts earn an average annual return of 7%. Ron's after-tax return is 5.04%.

As you can see from the table, Dave's tax-deferred account is now worth \$130,991 and Ron's taxable account only \$74,641. If Dave and Ron continue to invest the same amounts in their accounts for 20 more years, Dave could have \$660,031 in his account – versus \$278,734 for Ron. Even after paying 28% income tax on his balance, Dave would still have \$475,222 – \$196,488 more than Ron.

Years	5	10	15	20	25	30	35	40
Dave's Tax-deferred Account	\$18,003	\$43,524	\$79,703	\$130,991	\$203,699	\$306,772	\$452,890	\$660,031
Ron's Taxable Account	\$12,305	\$28,128	\$48,476	\$74,641	\$108,287	\$151,553	\$207,190	\$278,734

This graph is for illustrative purposes only. Rates of return are hypothetical and do not represent the rate of return for any particular investment. Your returns and account balance would be different. All amounts withdrawn from the tax-deferred account would be taxed as ordinary income in the year they are received and not as capital gain and may be subject to a 10% early withdrawal penalty if taken before age 59½. Source: NPI

COMPARING RETIREMENT PLANS

You can use the following table to see how adding a retirement plan or changing the type of plan you offer could help in your business tax planning.

	Profit Sharing	Defined Benefit	401(k)	Simplified Employee Pension (SEP)	SIMPLE IRA
When To Establish Plan	By the end of the tax year	By the end of the tax year	By the end of the tax year	Due date of tax return (including extensions)	Existing business: Any time between 1/1 and 10/1
Maximum Contribution	Smaller of \$40,000 or 100% of participant's compensation	Amount needed to provide an annual benefit no larger than the smaller of \$160,000 or 100% of average compensation for highest three consecutive years	Employee: Defer up to \$12,000; \$14,000 if age 50 or older. Employer: May contribute total employee and employer contributions not to exceed smaller of \$40,000 or 100% of participant's compensation	Employer: Smaller of \$40,000 or 25% of participant's compensation For SAR-SEPs established before 1997, employees may defer up to \$12,000; \$14,000 if age 50 or older	Employee: Defer up to \$8,000; \$9,000 if age 50 or older Employer: Match employee contributions up to 3% of compensation or fixed 2% nonelective contributions
Maximum Deduction	25% of all participants' compensation	Based on actuarial assumptions and calculations	25% of all participants' compensation	25% of all participants' compensation	Same as maximum contribution

Notes: Compensation is generally limited to \$200,000 in 2003. Calculating the contribution limit for a self-employed individual's profit-sharing contribution involves a special computation. SIMPLE IRAs are available only to small employers. Sources: IRS Publication 560 and NPI.