

5 Tax Reasons to Start a 401(k)

Make tax time more rewarding

Most people get that 401(k)s are designed with big advantages over traditional IRAs when it comes to retirement savings. Yet, few small business owners realize 401(k) plans also offer tax advantages ranging from tax credits and deductions for their business to protecting more of their individual hard earned money from taxes within their own account. During these times, it has never been more cool or necessary to spend less, save more, and build up reserves for when it's needed down the road.

1. Tax savings are 3.5 times greater than plan costs

In 2010, you can contribute up to \$16,500 tax-deferred into a 401(k) plan (\$22,000 if you are over 50). So let's suppose you are 45 years old, you contribute \$16,500 into your 401(k) and you employ 6 workers. If you are in the 25% tax bracket, you just paid \$4,125 less in taxes by contributing the maximum. With low-cost providers, the on-going cost to have a 401(k) plan is no more than \$1,200 for a company with 2-10 employees. If you subtract the cost of the plan from the tax advantages, that's a \$2,925 advantage in your favor. Plus, you just put \$16,500 (plus any match) to work for your future. That's more than a pennywise business move for most. Compared to a traditional IRA, it's a no-brainer.

401(k) advantages over traditional IRAs

	401(k)	IRA
2010 Contribution Limit	\$16,500	\$5,000
Age 50+ Catch-Up Amount	\$5,500	\$1,000
Roth Income Limit	None	\$120K*
Penalty-free access if needed	Yes, loan	No

* Beginning at \$105K, the amount you are allowed to contribute begins to decrease, hitting \$0 at \$120K.

2. The solo 401(k) bracket buster

Solo 401(k) buyers have it even better as the plan costs are much, much lower. Solo plans are for those companies that have no employees, just owners and spouses. \$15 a month is a common price (\$180 a year) and it's easy to shelter up to \$49,000 (\$54,500 if over 50) from taxes in a solo 401(k).

In addition to your \$16,500 personal contribution, if you are a sole proprietor (also some LLCs) or a partnership, you can contribute up to 20% of your net Schedule C—another exciting IRS tax form—into a solo 401(k) plan up to the limits for 2010. It's 25% of wages if your company is a corporation. That's a great shelter that might even drop you a tax bracket!

Note that those companies with employees could put in up to the \$49K limit too, but matching and profit-sharing to these amounts would be quite a feat. Also, it can be tough for some employees to contribute near the \$16,500 maximum.

3. First time buyers receive \$1,500 in tax credits

If you start a 401(k), and it's the first for your company, you can qualify for a \$500 tax credit for each of the first three years of your plan. That's \$1,500 over the first three years to offset setup and administration charges for the maintenance of your plan. Here's how it works. Your business must have at least one employee, besides you as the owner, who earns less than \$106,000 a year to qualify for a tax credit. The tax credit is equal to 50% of administration and setup charges for your 401(k) with a cap of \$500. It's that simple. Thank you Uncle Sam!

4. A deductible match made in heaven

Giving an employee a 401(k) match is tax deductible for your business. It's another nice way businesses are provided breaks to offer a plan and help keep your costs low. While matching is optional, most small business owners with a fairly stable revenue stream choose to do so for three reasons:

1. a "safe harbor" ensures any employee including you the owner can give the maximum to the plan;
2. by matching, you the owner benefit as well, since you are also an employee and you receive the match tax-deferred;
3. avoids the hassles of government discrimination testing.

401(k) regulations ensure that plans serve employees beyond owners and highly compensated employees. By offering a small match that meets the "safe harbor" requirements, everyone is served well and it's deductible.

5. Retire tax-free: a Roth without limits!

If tax protection this year is not your primary concern or you are predicting steep tax increases in the years to come, the Roth 401(k) option is something

to consider as a way to retire tax-free. Unlike its popular cousin the Roth IRA, there is no income limitation. Anyone in your 401(k) program can put some, part, or all of their contributions into a Roth 401(k) after-tax. Simply put your Roth contributions are not taxed again.

One thing to know is that any and all company matching and profit-sharing is done on a tax-deferred basis only. Company monies can not be given via Roth 401(k).

As you look for new ways to build reserves and keep taxes in check, starting a 401(k) plan can help you along the way. To ensure maximum tax benefits, it pays to get started sooner rather than later. The savings benefits might just last you a lifetime.

And remember, it's always wise to check with your tax advisor.

Want to learn more?

Read our guide, [Lower Your Taxes with a 401\(k\)](#).

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401(k) plans are: Not FDIC insured · Not bank guaranteed · May lose value