



Employee Benefits: How to Handle Them

Many companies offer a variety of employee benefits to their staff in order to keep them satisfied. The types of benefits include, but are not limited to, health insurance, retirement plans, vacation and sick leave. This Financial Guide provides an overview of the types of benefits that businesses provide for employees and what's involved in offering them.

Employee benefits play an increasingly important role in the lives of employees and their families, and have a significant financial and administrative impact on a business. Most companies operate in an environment in which an educated work force has come to expect a comprehensive benefits program. Indeed, the absence of a program or an inadequate program can seriously hinder a company's ability to attract and keep good personnel. Employers must be aware of these issues and be ready to make informed decisions when they select employee benefits.

Designing the right benefit plan for your employees is a complex task. There are many issues to consider, including tax and legal aspects, funding, and finding the right vendors or administrators.

This Financial Guide describes the basics of an employee benefits program.

Tip: You may want to contact your insurance carrier, broker, or benefits consultant for assistance in designing and implementing your benefit plan.

What Is An Employee Benefit Plan?

An employee benefit plan protects employees and their families from economic hardship brought about by sickness, disability, death or unemployment. It also provides retirement income to employees and their families. And it provides a system of leave or time off from work.

Mandated Benefits

The employer must pay in whole or in part for certain legally mandated benefits and insurance coverage:

- Social Security.
- Unemployment insurance.
- Workers' compensation.

Funding for the Social Security program comes from payments by employers, employees and self-employed persons into an insurance fund that provides income during retirement years. Full retirement benefits normally become available at age 65. For younger individuals the date for maximum benefits is being adjusted to age 67. (These benefits are discussed in more detail in the Retirement Benefit Plans section of this Financial Guide.) Other aspects of Social Security deal with survivor, dependent and disability benefits, Medicare, Supplemental Security Income and Medicaid.

Related Guide: For a detailed discussion of these benefits, please see the Financial Guide [SOCIAL SECURITY BENEFITS: How To Get The Maximum Amount.](#)



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Unemployment insurance benefits are payable under the laws of individual states from the Federal-State Unemployment Compensation Program. Employers contribute to the program based on total payroll.

Workers' compensation provides benefits to workers disabled by occupational illness or injury. Each state mandates coverage and provides benefits. In most states, private insurance or an employer self-insurance arrangement provides the coverage. Some states mandate short-term disability benefits as well.

Optional Benefits

A comprehensive benefit plan can include the following elements:

- Health insurance.
- Disability insurance.
- Life insurance.
- A retirement plan.
- Flexible compensation (cafeteria plans).
- Leave.

A benefit plan can also include bonuses, service awards, reimbursement of employee educational expenses and prerequisites appropriate to employee responsibility.

Why Offer Your Employees Benefits?

Here are some of the reasons employers offer benefits:

- To attract and hold capable people.
- To keep up with competition.
- To foster good morale.
- To keep employment channels open by providing opportunities for advancement and promotion as older workers retire.

A combination of benefits programs is the most effective and efficient means of meeting economic security needs. For many employers, a benefit plan is an integral part of total compensation, because employers either pay the entire cost of a benefit plan or have employees contribute a small portion of premium costs for their coverage.

Health, Disability, And Life Insurance Plans

Employers might offer medical and dental plans, disability benefits, and life insurance.



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Medical and Dental Plans

A serious illness or injury can be devastating to an employee and his or her family. It can threaten their emotional and economic well-being. Thus, adequate health insurance is important to employees and is part of a solid group plan.

Group health plans help attract and keep employees who can make your business a success. They relieve your employees of the anxiety of health care costs by providing the care they need before illness becomes disabling, thus helping you avoid costly employee sick days.

Group health plans usually cost less than purchasing several individual policies with comparable coverage. Moreover, there are tax advantages to offering health care benefits: your contribution as an employer may be deductible and the insurance is not taxable income to your employees.

As an employer, you can choose either an insured (also known as an indemnity or fee-for-service plan) or a pre-paid plan (also known as a health maintenance organization).

Traditional Indemnity Plans. An indemnity plan allows the employee to choose his or her own physician. The employee typically pays for the medical care and then files a claim form with the insurance company for reimbursement. These plans use deductibles and coinsurance as well. A deductible is a fixed amount of medical expenses an employee pays before the insurance plan reimburses any more expenses. The deductible can range from \$100 to \$1,000 a year. Coinsurance is a percentage of medical expenses the employee pays, with the plan paying the remaining portion. A typical coinsurance amount is 20%, with the plan paying 80% of approved medical expenses. Listed below are the most common types of insurance arrangements (indemnity plans) providing health care to groups of employees.

- A basic health insurance plan, covering hospitalization, surgery and physicians' care in the hospital.
- A major medical insurance plan, usually supplementing a basic plan by reimbursing charges not paid by that plan.
- A comprehensive plan, covering both hospital and medical care with one common deductible and coinsurance feature.

Health Maintenance Organizations. Health maintenance organizations (HMOs) provide health care for their members through a network of hospitals and physicians. Comprehensive benefits typically include preventive care, such as physical examinations, well baby care and immunizations, and stop-smoking and weight control programs.

The main characteristics of HMOs are as follows:

- The choice of primary care providers is limited to one physician within a network; however, there is frequently a wide choice for the primary care physician.
- There is no coverage outside the HMO network of hospitals and physicians.
- Costs are lower, due to limited choice. Physicians are encouraged to keep patients healthy; accordingly, they often are paid on a per capita basis, regardless of how much care the patient needs.
- The employer prepays HMO premiums on a fixed, per-employee basis.



- Employees do not have to apply for reimbursement of charges, but they may have small co-payments for medical services.

Preferred Provider Organizations. Preferred provider organizations (PPOs) fall between the conventional insurance and health maintenance organizations, and are offered by conventional insurance underwriters. A PPO is a network of physicians and/or hospitals that contracts with a health insurer or employer to provide health care to employees at predetermined discounted rates.

Some of the key elements of a PPO are:

- It offers a broad choice of health care providers. Because of the broader choice of providers, PPOs are more expensive than HMOs.
- It may have less comprehensive benefits than HMOs, but the benefits usually can meet almost any need.
- PPO providers usually collect payments directly from insurers.

Although there is no requirement for employees to use the PPO providers, there are strong financial reasons to do so.

Dental Benefits. Medical insurance frequently includes dental plans. Most plans cover all or portions of the cost for the following services:

- Cleaning, x-rays and oral examinations.
- Fillings.
- Crowns and dentures.
- Root canals.
- Oral surgery.
- Orthodontia (these portion of the cost covered here are generally quite limited, if at all)

Health Savings Accounts. The HSA allows employees to deduct contributions to the HSA even if they do not itemize deductions. The HSA plan allows employees who are covered by a high-deductible health plan to contribute pre-tax amounts that will be used to cover medical expenses or used later for retirement. Qualified amounts contributed to an employee's HSA by an employer can be excluded by the employee. Distributions from the HSA are not taxable as long as they are used for medical expenses.

Disability Benefits

A disability plan provides income replacement for the employee who cannot work due to illness or accident. These plans are either short-term or long-term. They can be distinct from workers' compensation because they pay benefits for non-work-related illness or injury.

- **Short-Term Disability.** A short-term disability is usually defined as an employee's inability to perform the duties of his or her normal occupation. Benefits may begin on the first or the eighth day of disability and are usually paid for a maximum of 26 weeks. The employee's salary determines the benefit level, ranging from 60 to 80% of pay. You, as an employer, may specify a number of days of sick leave paid at 100% of salary. The employee can use these before short-term disability begins.



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- **Long-Term Disability.** Long-term disability (LTD) benefits usually begin after short-term benefits conclude. LTD benefits continue for the length of the disability or until normal retirement. Again, benefit levels are a percentage of the employee's pay, usually between 60 and 80%. Social Security disability frequently offsets employer-provided LTD benefits. Thus, if an employee qualifies for Social Security disability benefits, these are deducted from benefits paid by the employer.

Life Insurance

Traditionally, life insurance pays death benefits to beneficiaries of employees who die during their working years. There are two main types of life insurance:

- Survivor income plans, which make regular payments to survivors.
- Group life insurance plans, which normally make lump-sum payments to specified beneficiaries.

Protection provided by one-year, renewable, group term life insurance, with no cash surrender value or paid-up insurance benefit, is very popular. Frequently, health insurance programs offer this coverage.

You should use the same principles for selecting a life insurance program as you do for selecting health insurance. Finding a benefit plan that meets your budget constraints and fills the needs of your employees is crucial. Among the sources to check are:

- Your local chamber of commerce.
- Independent insurance agents.
- Trade associations of your business.
- State departments (or commissions) of insurance.
- Community business leaders.
- Benefit consultants or actuaries.
- Service Corps of Retired Executives (SCORE) (affiliated with the U.S. Small Business Administration).

Tip: To reduce risk, select insurance underwriters with top ratings from Best's (Best Insurance Reports: Property-Casualty Ed. and Life-Health Ed. Published annually by A.M. Best Company, Oldwick, N.J.). HMOs and Blue Cross/Blue Shield are not rated by Best, but are regulated by state governments. Please refer to Standard & Poor's Financial Strength Ratings, in order to select the right insurance underwriter.

Tip: Check with other users and state regulators on the history of the particular plan you are considering.

Self-Insurance

Rising costs are prompting small business owners to take a look at a form of health care coverage previously considered an option only for big business: self-insurance. With self-insurance, the business predetermines and then pays a portion or all of the medical expenses of employees in a manner similar to that of traditional health care providers. Funding comes through establishment of a trust or



a simple reserve account. As with other health care plans, the employee may pay a portion of the cost in premiums. Catastrophic coverage is usually provided through a "stop loss" policy, a type of coinsurance purchased by the company.

The plan may be administered directly by the company or through an administrative services contract.

The advantages of self-insurance are listed below:

- Programs can be flexible. They are designed to reflect employee needs, including medical and dental care, prescriptions and so on.
- Mandated benefit laws and state insurance premium taxes do not affect these plans.
- The employer retains control over the timing and amount of funds paid into the plan and can manage costs more directly.
- Administration of these plans can be more efficient.
- Over time, these plans can save money.

The drawbacks to self-insurance include the following:

- Health care is costly and heavy claims years may prove extraordinarily expensive.
- Commitment for the long haul is necessary to achieve significant savings.

Caution: While insurance can be a viable option for small businesses, it should be undertaken only after careful study.

Balancing Cost, Quality And Accessibility

In summary, when deciding on a health, disability, or life insurance plan, consider what you and your workers want in a plan. Determine all costs associated with the plan. Investigate the quality of potential insurance carriers.

Examine the quality of each plan, including the benefits and restrictions:

- Hospital coverage (inpatient care).
- Outpatient services.
- Physical coverage.
- Substance abuse treatment.
- Prescriptions.

Check on underwriting and other restrictions that may exclude you from the health plan:

- Employee medical histories.
- Minimum employer contribution.
- Minimum participation by eligible employees and dependents.
- Waiting periods.
- Proof of employee status.
- Purchase of other benefits.
- Other limitations — what isn't covered.



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Check on the extent to which your company can control costs. This might include prior review of hospital admissions to determine necessity of hospitalization. Or it could mean concurrent review of hospital stays to confirm continuing need of hospitalization.

Management programs for catastrophic cases might be used. These programs arrange for the most cost-effective care.

Questions To Ask Before Signing a Benefits Contract

- Who is the insurance company?
- Is it committed to small business?
- How solvent is it? What is its rating?
- What is the carrier's reputation for customer service?
- What is the choice of doctors and hospitals?
- How does the company manage health care costs?
- Who administers the plan?
- What information must the employer provide?
- How are the employees enrolled?

When Problems Arise

From time to time problems arise with benefit delivery. Patience on the part of the provider, the employer and the employee usually brings a resolution.

Occasionally, unusually prolonged and difficult problems develop that do not yield to resolution. Such instances should be brought to the attention of your state's insurance department or commission, which is responsible for regulating insurance companies.

Retirement Benefit Plans

A financially secure retirement is a goal of all Americans. Since many of us will spend one-fourth to one-fifth of our lives in retirement, it is more essential than ever to begin preparations at an early age. Many financial planners report that an individual requires about 75% of his or her pre-retirement income to maintain the same standard of living enjoyed during one's working years.

Social Security, employer-sponsored retirement programs and personal savings are the three sources of post-retirement income.

Social Security Benefits

Social Security provides retirement benefits for most persons employed or self-employed for a set period of time (currently 40 quarters; about 10 years). Benefits paid at retirement, traditionally age 65, are based on a person's earnings history. The age at which you can retire at full benefits increases depending upon your current age. For younger individuals full benefits begin at about age 67. Payments may begin at age 62 at a reduced rate or, if delayed beyond full retirement age, at an increased rate.



For a person with earnings equal to the U.S. average, the benefit will be about 40% of pay. For someone with maximum earnings, the benefit would be about 25% of the portion of pay subject to Social Security tax.

Tip: Every worker should understand Social Security retirement benefits. By completing Form SSA-7004, "Request for Social Security Earnings and Benefit Estimate Statement," you can receive a projection of benefits. Forms can be obtained through Social Security Online, local Social Security offices or by calling .

Planning Aid: To obtain an immediate copy of this form, please click on Request for Social Security Earnings and Benefit Estimate Statement.

Employer-Sponsored Retirement Plans

A retirement plan makes good sense and can attract and reward employees. The benefits and tax advantages of supplementing Social Security with a qualified retirement plan are significant.

A qualified plan is one meeting IRS specifications. Currently, such contributions are tax-deductible and earnings accumulate on a tax-deferred basis. In addition, benefits earned are not part of the participant's taxable income until received, and certain distributions are eligible for special tax treatment.

Whether you are a sole proprietorship, a partnership or a corporation (employing many people or only yourself as the owner/employee), there are a wide range of options available. These can range from simple plans, which you establish and maintain, to complex versions, which require an actuary, attorney or employee benefits consultant. If you are active in the business, you can be included as a plan participant. Accountants, banks, insurance and investment professionals, as well as other financial institutions, can provide information on retirement plan products.

Tip: Several provisions of the tax law encourage employers to involve professionals on plan issues. Specifically, the law:

- Subsidizes the paperwork costs for small businesses setting up a plan. It grants a tax credit for half the cost up to a credit of \$500 a year for each of the first 3 years. Since such costs are already deductible, the deduction (less valuable than a credit) will be for the amount of the expenses less the credit.
- Waives (for 5 years) the fees IRS charges for issuing determination letters (rulings) to plan sponsors on the tax status of their plans.
- Makes employer-provided retirement planning advice a tax-favored fringe benefit (tax-free to employee and spouse, deductible by employer).

Depending on whether you are a sole proprietor, a partnership or a small corporation, the following plans are available:

- Defined benefit — A retirement plan favoring older, more highly paid employees.
- Profit-sharing — A flexible plan based on profits and contributions that can be discretionary from year to year.
- Money purchase — A method that often favors younger workers. Steady plan contributions are required.



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- Individual retirement accounts (IRAs) — A simple plan; allowing modest contributions.
- Simplified employee pension (SEP) — A plan for small businesses combining features of IRA and profit-sharing plans, offering flexibility and easy self-administration.
- 401(k) — The most popular plan today for businesses with employees, providing employees with the ability to save for their retirement with pre-tax dollars. Can be at low cost to employers.
- SIMPLE Plans – A new type of plan which combines IRA and 401(k) features.
- Stock bonus — Benefits in the form of company stock.
- Employee Stock Ownership Plan (ESOP) — Another plan based on company stock.

Designing the Right Corporate Plan

Selecting the right pension plan for a corporation results from a process of identifying business needs and expectations, including

- Need for flexibility.
- Current age of key employees.
- Current number of employees and plans for growth.
- Maximization of retirement benefits.

Although there are many different types of retirement plan options available to corporations, they fall into two general categories: defined benefit plans and defined contribution plans:

Defined Benefit Plans. With this plan, the benefits an employee will receive are predetermined by a specific formula — typically tied to the employee's earnings and length of service. The law allows a pension of up to \$160,000 a year. This figure is indexed for inflation; the 2007 amount is \$180,000. The employer is responsible for making sure that the funds are available when needed (the employer bears funding and investment risks of the plan).

Such a plan can generally provide larger benefits faster (through tax-deductible contributions) than other plans. The price of providing a higher degree of tax savings and being able to rapidly shelter larger sums of retirement capital is having to meet additional reporting requirements. Defined benefit plans typically cost more to administer, requiring certifications by enrolled actuaries, and insurance payments to the Pension Benefit Guaranty Corporation (PBGC), which may review plan terminations.

Defined Contribution Plans. Also known as individual account plans, defined contribution plans specify the amount of funds placed in a participant's account (for example, 10% of salary). The amount of funds accumulated and the investment gains or losses solely determine the benefit received at retirement. The employer bears no responsibility for investment returns, although the employer does bear a fiduciary responsibility to select or offer a choice of sound investment options.

Tip: Defined benefit plans are typically better for older employees (usually age 45+). For example, these plans can provide the ability to fund for years of employment before the inception of the plan. While some contribution flexibility is available, factors determining the cost of promised benefits (e.g., number and ages of employees, rates of return on investments) will mandate the level of required deposits to the plan.



There are several basic types of defined contribution plans, including (1) simplified employee pension plans (SEPs), (2) profit-sharing plans, (3) money purchase plans, (4) 401(k) plans, (5) stock bonus plans, (6) employee stock ownership plans, and (7) SIMPLE plans.

1. ***Simplified Employee Pension Plans.*** A simplified employee pension (SEP) suits many small corporations. It requires no IRS approval, no initial filings and no annual reporting to the government. Although SEPs are called "pensions," they are actually IRAs, except that contributions to them aren't subject to the IRA dollar limits. The total deferral per employee each year can be up to \$40,000 (indexed; the 2007 amount is \$45,000) or 25% of his or her annual earnings, whichever is less. There is also a limit on how much of an employee's earnings may be included in the percentage computation.

Contributions must be made on a nondiscriminatory basis to all employees who are at least age 21 and who have worked for any part of three of the past five years earning a minimal amount. Contributions can vary from year to year — you may even skip entire years. To be deductible for a year, contribution must be paid no later than the due date of an employer's income tax return for the year, including extensions. Once made, the entire contribution is owned by the employee.

Tip: Complete specifications for the plan can be found in IRS Form 5305. The form itself serves as the plan document, requiring only the insertion of business name, the checking of three boxes and a signature. The form is not filed with the IRS, but rather copied for all employees and then placed in the firm's files. Many employers instead use plan documents provided by financial institutions.

2. ***Profit-Sharing Plans.*** Similar to a SEP, a profit-sharing plan offers the flexibility of making contributions — up to the lesser of \$40,000 (indexed; the 2007 amount is \$45,000) or 25% of compensation.

Tip: Alternatively, rather than selecting a percentage, a flat amount (for example, \$100,000) could be allocated among eligible employees, generally proportionate to compensation. Historically, contributions could only be paid out of profits; this is no longer required.

Profit-sharing plans differ from SEPs in several distinct ways. An employer can apply a vesting schedule to the company's contributions, based on an employee's length of service with the company after the contribution is made. If an employee is terminated before becoming "fully vested," his or her funds will revert to the plan (reducing future contributions) or be reallocated among the remaining participants. In addition, profit-sharing plans permit the exclusion of part-time employees, and can allow participants to borrow from the plan.

Profit-sharing plans, as all other qualified retirement plans, require the preparation of formal master documents as well as annual tax filings. A standardized master or prototype plan will often satisfy requirements and will typically be less expensive and simpler to set up and operate than an individually designed plan.

3. ***Money-Purchase Plans.*** With a money purchase plan, the employer is usually committed to making annual contributions equal to a designated percentage of each employee's compensation. This percentage may not exceed 25% of compensation, with a maximum contribution per employee of \$40,000 a year (indexed; the 2007 amount is \$45,000). Contributions must be made even in years in which there are no profits.



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4. **401(k) Plans.** These tax-deferred savings plans have become highly popular in recent years. The basic idea of a 401(k) is simple: it is a profit-sharing plan adopted by an employer that permits employees to set aside a portion of their compensation through payroll deduction for retirement savings. The amounts set aside are not taxed to the employee and are a tax deductible business expense for the employer. Set-asides (called "elective deferrals") for any employee can't exceed \$15,000 (indexed; the 2007 amount is \$15,500). Elective deferrals don't count in figuring the employer's deduction limits. Thus, the employer's contribution up to the profit-sharing deduction limit, plus the elective deferral, are tax-sheltered.

An employer's discretionary matching contribution can provide incentive for employee participation as well as serve as an employee benefit. Employer contributions can be capped, to limit costs, and a vesting schedule can be applied to employer deposits (employees are always 100% vested in their own contributions).

For employees, the opportunity to reduce federal — and often state and local — taxes through participation in a 401(k) plan offers significant benefits. While savings are intended for retirement, certain types of loans can provide employees with access to their funds — employees repay borrowed principal plus interest to their own account.

Caution: Special non-discrimination tests apply to 401(k) plans, which may limit the amount of deferrals that highly compensated employees are allowed to make. To avoid these limits, some employer contribution on behalf of lower-paid employees may be required.

Some employers automatically enroll employees in the 401(k), giving them the right to opt out. After 2007, automatic enrollment arrangements (with right to opt out) can escape the nondiscrimination tests, if certain prescribed minimum employer contributions are made and certain prescribed investment types are available.

401(k)s can allow employee deferrals to go into a Roth account (based on a Roth IRA concept). Withdrawals from an account maintained 5 years or more can be tax-free after age 59 ½. The amount deferred into the Roth 401(k) is currently taxable (unlike amounts deferred into the regular 401(k)).

Tip: Tax professionals consider that the Roth 401(k) favors high-income individuals. If that describes you, consult your tax adviser on deferring into a Roth 401(k), where this is offered.

5. **Stock Bonus Plans.** This is similar to a profit-sharing plan. The plan invests in employer stock, which is generally distributed to participants at retirement.

6. **Employee Stock Ownership Plans.** A special breed of qualified plan, an employee stock ownership plan (ESOP), provides retirement benefits for employees. In addition, an ESOP can be used as a market for company stock, for financing the company's growth, to increase the company's cash flow or as an estate planning tool.

ESOP funds must be primarily invested in employer securities. ESOPs are stock bonus plans or stock bonus combined with money purchase plans. Tax deductible contributions to the plan are used to buy stock for eligible employees. On retirement, the employee may take the shares or redeem them for cash. Complicated rules must be adhered to in the establishment and maintenance of an ESOP plan. Expert advice should be sought.



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7. **SIMPLE Plans.** Employers with 100 or fewer employees can establish "Simple" retirement plans. The Simple combines the features of an IRA and a 401(k). Employees can contribute to the Simple, pre-tax, and the employer must make either a matching contribution for employees who contribute or a contribution for each eligible employee. The limit on the employee's contribution \$10,000 (indexed, the 2007 amount is \$10,500). The penalties for withdrawing money from the Simple before age 59-1/2 can be higher than with other plans.

Plans Available to Non-Corporate Employers

Non-corporate employers can adopt any of the plans listed above that corporate employers can, except, of course, those based on stock in the employer corporation (stock bonus and ESOP plans). Defined benefit, profit-sharing, money purchase and 401(k) plans sponsored by non-corporate employers — that is, self-employed persons — who participate in the plans are often called "Keogh" plans.

Contribution limits for unincorporated businesses are the same as for corporate plans of the same type, except for contributions on behalf of the self-employed owner — sole proprietor, partner or LLC member, who for this purpose is treated as an employee. Contributions for a self-employed owner are based on the owner's self-employment net earnings. The contribution ceiling for money purchase, profit-sharing and SEP plans are the same: in effect, 20% of earnings (technically, 25% of earnings reduced by the contribution) up to a maximum contribution of \$40,000 (indexed; the 2007 amount is \$45,000). For defined benefit plans, a self-employed owner's benefit is based on self-employment net earnings less deductible contributions.

In plans such as 401(k)s or SIMPLEs where employees defer part of their salary, self-employed owners are deferring part of their self-employment earnings. For employees, deferred salary is excluded from taxable pay; for self-employed owners, deferred self-employment earnings are deducted.

Keogh plans, like comparable corporate plans, must be established by the end of the year for which you are making the contribution. Once established, you have until your tax return filing date - including extensions - to make the contribution.

SIMPLEs generally must be established by October 1 of the year they go into effect.

A SEP may be established by the tax return due date, including extensions, for the year it goes into effect. Thus, a plan effective for 2007 can be created in 2008; contributions to that plan in 2008 will be deductible on the 2007 return if designated as for 2007 and made by the 2007 return due date including extensions.

Employee contributions. These are important elements of many employer plans, allowing employees to make their own tax-sheltered investments within the company plan.

In many cases such contributions are "pre-tax"—that is, from salary (reducing taxable pay), as in the case of 401(k)s, SIMPLEs, and certain SEPs, called SARSEPs, formed before 1997. Pre-tax "employee" contributions can also be made by self-employed owners, in which case they reduce taxable self-employment earnings. The ceilings on such contributions are discussed above (SARSEP and 401(k) ceilings are the same).

Additional pre-tax contributions are allowed for participants age 50 or over. The ceiling amount of such contributions, called "catch up" contributions (misleadingly, since the amount or lack of prior



contributions is irrelevant), for 401(k)s and SARSEPs is \$5,000 (for 2006 and 2007). For SIMPLEs, the amount is halved (\$2,500)

Employee contributions may also be after-tax. That is, they are not excludable (where made by employees) or deductible (where by self-employed owners) but still grow tax-free once invested, until withdrawn. The contributions come back tax-free; only the earnings are taxed.

Employee after-tax contributions may be attached to a plan, such as a 401(k), or be to a standalone plan (maybe called a savings plan) for employees' contributions alone, or with some employer match.

Credit for low-income participants. "Lower-bracket" taxpayers age 18 and over are allowed a tax credit for their contributions to a plan or IRA. Credit is allowed on joint returns of couples with (modified) adjusted gross income (AGI) below \$50,000. Credit is a percentage (10%, 20%, 50%) of the contribution, up to a contribution total (considering all contributions to all plans and IRAs) of \$2,000. The lower the AGI, the higher the credit percentage: the maximum credit is \$1,000 (50% of \$2,000). Head-of-household filers get 75% of the credit allowed on a joint return; singles get 50%. The \$50,000 amount and the AGI credit percentage ranges are indexed for inflation starting in 2007.

Credit is allowed whether the contribution is pre-tax (credit is in addition to a deduction or exclusion) or after-tax.

Review plan decisions. There have been a number of recent law changes, especially in the already popular 401(k).

Those lacking tax-favored retirement plans should give plan adoption a new look. Those with such plans already should review the options, and what's required to take advantage of them. Professional guidance is essential and, as pointed out above, encouraged by the law.

Individual Retirement Accounts. An employer may establish IRAs for its employees to which the employees contribute, though this is not usual. An employer may establish IRAs for employees within an employer plan. But virtually all IRAs are set up by the individual worker, employed or self-employed (occasionally for the worker's spouse) without involvement of any employer.

An IRA is a tax-favored savings plan that allows workers to make contributions with pre-tax dollars (where deduction is allowed, see below) and defer taxation on earnings until retirement.

There are several limitations to IRAs:

- Contributions for 2006 and 2007 cannot exceed the lesser of \$4,000 per year or 100% of compensation (\$8,000 for a couple), rising to \$5,000 (couples \$10,000) for 2008 and after. Additional "catch-up" contributions are allowed persons age 50 or over, of \$1,000 (2006 and after).
- Contributions may be made only up to age 70 1/2.
- The account holder may not use funds to purchase life insurance or collectibles (except gold or silver coins issued by the U.S. Government).
- IRA contributions up to the ceiling are deductible if neither the taxpayer nor his or her spouse is covered by a corporate or unincorporated retirement plan. Deduction is limited (phases out) at prescribed income levels (which increase each year) where the taxpayer is covered by a plan or where (using higher levels) the taxpayer's spouse is covered though taxpayer is not. Nondeductible contribution is allowed in other cases, and nondeductible contribution is allowed



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to Roth IRAs (Subject to income limits). Also, low-income taxpayers are allowed the up-to-\$1,000 tax credit described above (under Employee Contributions) for IRA contributions.

Related Guide: For details on Roth IRAs and how they compare to other retirement IRAs (called traditional IRAs), see the Financial Guide: [ROTH IRAS: How They Work And How To Use Them.](#)

Where To Get Pension Information

The variety of plans and related regulations are numerous. You should consult with your professional advisors regarding which options are available to you and which one best first your company's needs.

Questions To Ask Before Finalizing a Pension Plan

1. Does the plan require a given level of contribution each year?
2. Do the plan provisions (eligibility, hours of service and vesting of employer contributions) meet current and future needs?
3. What are the costs of establishing and administering a plan and trust, including providing annual employee reports?
4. What are the investment options offered?
5. Are there any loads (charges) associated with deposits (front-end charges) or surrenders (rear-end charges) from the plan?
6. Can — and should — employees make individual investment selections? What types of reports do participants receive?

Leave

The old concept of "two weeks with pay" has given way to a wide variety of paid and unpaid leave plans for all businesses. Among the typical options are

- Annual leave.
- Holidays (national and state).
- Sick leave.
- Personal leave (birthday, other reason of choice).
- Emergency leave.
- Compassionate leave (funeral, family illness).
- Religious observance.
- Community service (voting, jury duty, court witness, National Guard, Civil Air Patrol, volunteer fire department).
- Education/training.
- Leave without pay.
- Leave of absence (paid or unpaid).
- Parental (formerly maternity) leave.

In a strict sense, paying people for not working is a costly, unprofitable concept. However, time off from the grind is a tradition of the American workplace, and rightly so. Benefits can far outweigh costs. Among the many benefits for the employee are rest, relaxation, a new perspective, travel, pursuit of hobbies and release from daily tensions. The employer also benefits — the employee returns



refreshed from the break in daily routine, possibly with new ideas and renewed energy for doing a better job. Employers also can observe the performance of employees in new situations, as they fill in for their vacationing coworkers, potentially leading to better allocation of work force talents.

Eligibility for Leave

In determining employee eligibility for leave, an employer must find answers to many questions, including the following.

- How much paid leave time can the company afford per year?
- How many categories of leave should there be?
- Can employees carry over unused leave from one year to the next? If so, how much?
- Are there leave rights during probation?
- Who gets first choice of dates in scheduling annual leave? How are conflicts resolved? By seniority?
- Can employees borrow leave in advance?
- At what point does extended/borrowed paid leave become unpaid leave and extended/borrowed unpaid leave become unemployment?
- Are employees eligible for more leave after a certain number of years with the company?

Employers must determine when eligibility for leave begins: immediately? after the first year? Many employers establish a paid annual leave schedule by declaring employees eligible for so many hours leave after they have worked a specified number of hours; for example, two hours leave for every 80 hours worked or one day for so many weeks worked.

Tip: Limits on sick and other leave are vital. You should restrict sick leave to illness or medical examinations and treatment. It must not become an extension of annual leave. Accordingly, it is wise to reserve the right to require physician certification of an illness.

Although the vast majority of employees will not abuse time allowed for compassionate, emergency or other leave categories, clear policies should be established on requesting such leave and on its duration.

Budget Considerations

Granting paid or unpaid leave is a costly benefit. Depending on the nature of an employee's work, you may need to require overtime from other employees or hire temporary employees to cover the absence. Extended leave situations pose special problems.

Questions To Ask Before Finalizing a Leave Plan

1. Is the business open on all holidays? If not, on which ones?
2. If the business is open on holidays, do you work with full or limited staff, paying them double time as may be required by law?
3. How many hours/days are allowed as leave for voting, jury duty, religious observance, funerals, etc?
4. How are insured benefits handled during unpaid leave?
5. Which state laws affect leave?



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Prerequisites

While all employees are usually eligible for benefits such as health and other insurance, retirement plans and leave, key employees have come to expect certain additional benefits related to their increased levels of responsibility. Among the perquisites (perks) employers may want to consider for top performers and key, or even all, employees are:

- Company automobile.
- Extra vacation.
- Special parking privileges.
- Personal expense accounts.
- Spouse travel on company business.
- Sabbaticals (with pay).
- Professional memberships.
- Professional publications.
- Loans/mortgages.
- Estate planning.
- Legal services.
- Medical expense reimbursement.
- Physical examinations/health screening.
- Physical exercise facilities.
- Executive dining room.
- Matched donations to universities, colleges and/or charities.
- Tuition programs.
- Dependent day care (on- or off-site).
- Merchandise discounts.
- Holiday gifts.
- Employee assistance programs (EAPs) (substance abuse, debt, interpersonal relationships, psychological, financial, other types of counseling).
- Service awards.
- Credit unions.

Like basic benefits, perquisites help attract and keep good employees. You can balance the far higher cost of providing some perquisites with expectations of increased production from the employees who benefit.

Key employees responsible for generating contacts for new business should receive consideration for company automobiles, personal expense accounts, professional memberships and publications, club memberships, spouse travel on company business, credit cards, home entertainment allowances, end-of-year bonuses and sabbaticals.

Sales staff responsible for keeping current customers satisfied should receive consideration for company automobiles (if needed for their duties), credit cards, personal expense accounts, professional memberships and publications, sales commissions, spouse travel on company business and end-of-year bonuses.

All employees should receive consideration for EAPs, physical exercise facilities (if you have them), parking, tuition programs, dependent day care, holiday gifts, service awards, credit unions, matched



donations to universities, colleges and/or charities, physical examinations or health screenings when offered and merchandise discounts.

Tip: Offer legal services and loans and mortgages on a case-by-case basis. Some perquisites, such as extra vacation, should be given only as a reward for extraordinary service to your company.

You may want to consider employer-employee cost sharing of such pre-requisites as physical exercise facilities, dependent day care, parking and, perhaps, some health screening services.

Before beginning any program of perquisites, check current tax law for treatment of each item:

- Can you, as the employer, deduct it as a business expense?
- Will it become taxable income for your employee?

Flexible Compensation or "Cafeteria" Plans

To accommodate today's many variations in family relationships, life-styles and values, flexible compensation or "cafeteria" benefit plans have emerged. In addition to helping meet employee needs, cafeteria plans also help employers control overall benefit costs.

The idea behind cafeteria plans is that amounts which would otherwise be taken as taxable salary are applied, usually tax-free, for needed services like health or child care.

Example: Employee John earning \$60,000 allocates \$4,000 of salary to cover health care costs through a cafeteria plan. John is taxed on \$56,000; the \$4,000 is tax-free. Had John taken the full \$60,000 and paid \$4,000 of health care costs directly, he would have paid tax on the full \$60,000, probably with no offsetting medical expense deduction.

Besides saving employee income and social security taxes, salary diverted to cafeteria plan benefits isn't subject to social security tax on the employer. With a cafeteria plan, employees can choose from several levels of supplemental coverage or different benefit packages. These can be selected to help employees achieve personal goals or meet differing needs, such as health coverage (family, dental, vision), retirement income (401(k) plans) or specialized services (dependent care, adoption assistance, legal services (legal services amounts are taxable)).

Careful planning and communication are the keys to the success of flexible compensation. Employees must fully understand their options to make choices of greatest benefit to them and their families. Both employers and employees must fully understand the tax consequences of the various options.

Keeping Current On Benefit Plans

The government has certain requirements for qualified pension or profit-sharing plans, as well as for most health and welfare plans. It is essential for you to stay current on developments that may affect your plan. Even small changes in tax laws can have a significant impact on your plan's ability to help you and your employees achieve your goals. Information on these requirements is available from the IRS and from qualified accountants and financial advisors.



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Communications

Once you've implemented a benefits program, you'll want to tell your employees about it. Good communication is important in enabling employees to use the plan effectively and to appreciate the role of benefits in their total compensation.

Benefits orientation should be part of the orientation of a new employee. You can use newsletters, staff memos or employee meetings with audiovisuals to announce plan changes or answer employees' questions.

Planning Pointers

Before you implement any benefit plan, you should ask yourself some questions:

- How much are you willing to pay for this coverage?
- What kinds of benefits interest your employees? Do you want employee input?
- What do you think a benefits plan should accomplish? Do you think it is more important to protect your employees from economic hardship now or in the future?
- Is a good medical plan more important than a retirement plan?
- Do you want to administer the benefits plan, or do you want the administration done by an insurance carrier?
- What is your employee group like today? Can you project what it might look like in the future?

You now have some basic benefits information as well as the basic questions that need answers before you go benefit shopping for your employees.

Tip: If you are serious about offering your employees a satisfactory benefit plan, the next step may be to contact an insurance broker or carrier, the local chamber of commerce or trade associations. There may be off the shelf products that will suit your needs. A benefit consultant or actuary can help you design a specialized benefit program.

An adequate benefit program has become essential to today's successful business, large or small. With careful planning you and your employees can enjoy good health and retirement protection at a cost your business can afford.

Recommended Books

- Stephan R. Leimberg and John J. McFadden, *The Tools and Techniques of Employee Benefit and Retirement Planning*, (National Underwriter Company, 1995), ISBN 0872181154.