

Self-Employed Retirement Plans

Your goal should be to put away as much income as you can, deferring taxes until retirement, when presumably, you'll be in a much lower tax bracket. In 2009 you can contribute a maximum of \$5,000 to an individual retirement account (IRA) or \$6,000 if you are age 50 by year end. If held jointly with a nonworking spouse, the limit is \$12,000. The limit can be up to 100% of your earned income.

If you know you will be making an IRA contribution for 2009, consider getting the money into whatever investment you plan as early in the year as possible.

Beginning in 1987, the law restricts the deduction for contributions to IRA's for individuals who participate in an employer's plan. There are no changes in the rules that govern the amount of the deduction for an individual who is not an active participant in an employer plan. If married and the spouse is covered by a pension plan, an individual is subject to the income restrictions even if they aren't covered by a retirement plan themselves.

Future contributions that are deductible are limited to those covered by a qualified plan or a Keogh or 401(K) and have a restricted taxable income. A full contribution can still be made if adjusted gross income is \$85,000 or less on a joint return or \$53,000 or less on a single return. The amount deductible is reduced from the maximum by \$1 for every \$5 over the threshold.

Therefore, no deductible contribution is allowed if adjusted gross income is \$95,000 or more on a joint return or \$63,000 or more on a single return.

The AGI phase-out ranges for making deductible contributions to IRA's by taxpayers who are active participants in an employer-sponsored retirement plan will increase under the law. The phaseout ranges increase each year after 1997 until they level out in 2005 and later years at \$50,000 to \$60,000 for single taxpayers (up to from \$25,000 to \$35,000 under pre-Act law), and in 2009 and thereafter at \$80,000 to \$100,000 for joint filers (up to \$40,000 to \$50,000 under pre-Act law). In 2004, the phaseout range was \$45,000 to \$53,000 for single taxpayers, and \$65,000 to \$75,000 for joint filers. (The phaseout range for joint filers increases to \$20,000 from \$10,000 after 2006).

In 2001 through 2002, the dollar level at which AGI phaseout range begins for single taxpayers and joint filers will increase by \$1,000 each year. Thereafter, the increases accelerate (e.g., in 2009, the phaseout range begins at \$53,000 for single taxpayers, and at \$85,000 for joint filers).

Contributions into an IRA can be made even if income levels do not permit you to take the deduction. Making nondeductible IRA contributions means withdrawals will consist partly of earlier nondeductible contributions. So, some of the withdrawal will not be taxable. A taxpayer may designate IRA contributions as nondeductible even if they could be deducted. How? First, don't deduct the contribution on Form 1040. Second, file IRS Form 8606 with your return. The Form 8606 is needed because your IRA trustee will not keep records of nondeductible contributions. You must have this form to keep a record of nondeductible contributions.

There is no minimum age required to have an IRA. If your children under 18 work in your business, you can pay them \$10,700 in 2009 before they would be subject to paying any tax (\$5,700 standard deduction and \$5,000 into an IRA). A youngster who starts an IRA early in life will have an extra big nest egg by the time he or she retires. That's because the impact of interest compounded over 50 years or so is tremendous.

If a person starts at age 26 putting away \$4,000 in an account earning a 10% return, and contributes another \$4,000 annually for the next 40 years, the account will grow to \$1,570,534 when the saver is 65. Total Contribution: \$160,000.

Alternatively, if a saver puts aside just \$15,000 in five annual installments between the ages of 14 and 18, the account will be worth \$1.77 million at age 65. In both cases, well over half of the total buildup comes in the last 10 years of the savings program. That's the way compounding works, getting stronger the longer it has to operate.

A skeptic can point out that inflation erodes the value of those savings - and also compounds - over time. Certainly \$1 million will have a lot less purchasing power 30 or 40 years from now.

But of course, inflation will raise living costs for everybody, whether they save or not. Doing nothing about inflation is hardly a strategy for coping with it.

Only people who are self-employed qualify for Keogh plans. There are two basic kinds:

Under a defined contribution plan, you make a tax-deductible contribution of a set amount each year. The maximum amount that you can deposit annually in a defined contribution Keogh in the form of a money purchase pension or target benefit plan is 25% of self-employment income, or \$49,000, whichever is less.

However, the actual computation of your contribution is more complex, because it's based on your self-employment income minus your Keogh contribution. As a result, you first subtract your proposed Keogh contribution from your self-employment income, and then take 25% of the total to determine whether you're within the limits. This works out to 20% of your self-employment income, the rule-of-thumb system for doing the figuring.

Defined contribution Keogh plans that are profit-sharing plans will not work for someone who is 50-plus because the most you can put away each year is 20% of self-employment income, up to \$49,000. This is enough for people who have many years to save before retiring, but not for people who are closer to retirement.

For such an individual, the solution is a Defined Benefit Keogh Plan. With defined benefit Keoghs you can put away a much bigger percentage of your income. That's because you are funding an account that is designed to pay you a fixed monthly amount when you retire. So the older you are, the more you can contribute to the plan each year. They're perfect for someone who has 10 to 15 years to go before retirement.

Under a defined benefit plan, you decide how much you want to receive yearly when you retire and key your contributions to that amount. Thus, you must determine how much you'll need to deposit each year until retirement to arrive at that defined benefit. There's a maximum on the amount you can choose. If you retire at the Social Security retirement age, your maximum allowable benefit per year is currently \$185,000, or 100% of the average of your three best earning years in a row, whichever is less.

Your Social Security retirement age depends on the year you were born. If you were born before 1938, it's 65; if you were born between 1938 and 1954, it's 66, and it's 67 if you were born in 1955 or later.

Tax rules are much stricter for defined benefit plans than for defined contribution plans. You must make minimum contributions every year or face a 10% under-funding penalty. The defined benefit plan must be custom-made for you by a pension specialist. Expect to pay between \$1,000 and \$1,500 a year to administer the plan.

A 15% limit applies if your Keogh is a profit-sharing plan. Most companies are of this type.

In calculating earned income, you have to reduce income for the contribution itself. Therefore, the maximum deduction for a contribution to a profit-sharing plan is 25% divided by 1.25, or 20 percent. You must also reduce earned income for the self-employment tax deduction, even though it doesn't show up on your Schedule C or F, before you apply the limits.

If you decide to establish a Keogh plan, you must act before the end of the calendar year. However, you need not contribute to your established Keogh(s) until you file your tax return.

Like other qualified plans, you are eligible to start withdrawing money from a Keogh at age 59 ½. If you do so earlier, you are subject to a 10 percent withdrawal penalty, except in cases of death or disability. If you elect to take a lump-sum distribution, you can use ten-year averaging, which can reduce your tax bill. Under this provision, your income is taxed as if it were paid out over ten years. For example, if you receive \$100,000 in a lump-sum distribution, you will be taxed as if you received \$10,000 a year for ten years. (The lower marginal rates for this income level account for the tax benefit). Alternatively, you could continue to defer tax on your funds by rolling over your lump-sum distribution into an IRA. Or you might want to receive your funds in the form of periodic payments, which would subject you to tax rules on annuities.

But by no later than April 1 of the year in which you reach 70 ½, you must start receiving distributions from your Keogh.

All Keogh plans are required to file an annual return. You have to file a Form 5500-C in the year you start a Keogh and every third year after that. In each of the intervening years, you may file Form 5500EZ if the plan covers only an individual or an individual and spouse if they wholly own a business. Employers who have: (1) a one-participant plan with \$100,000 or less in assets at the end of the plan year, or (2) two or more one-participant plans that aggregate \$100,000 or less in assets at the end of the plan year are not required to file Form 5500EZ.

Failure to file, when required, can result in a penalty of \$25 per day, up to a maximum of \$15,000. The filing deadline is July 31 for a plan in a calendar year.

Deductions for Keogh contributions will be eyed by Revenue Agents. The Service has issued guidelines directing agents to check Keogh payins by self-employed under audit to see whether they paid too much into plans. Agents have been told to make sure that contributions are based on net self-employment income less half of the self-employment tax paid.

As a general rule, defined contribution plans benefit business owners who are age 40 or under, while those over age 50 get more money from defined benefit plans.

A Simplified Employee Pension (SEP) plan is another way for the self-employed to put dollars into a tax-deferred retirement fund.

Referred to as a SEP-IRA, this plan is a simple, low-cost retirement plan that is easy to set up and administer. It is an easy way to set aside tax deductible funds for retirement and defer tax on the earnings until they're withdrawn at retirement. You can contribute up to the lesser of 25% of earned income or \$46,000 each year.

However, there is a major drawback to such a plan if you have employees, especially a lot of part time help. With a SEP-IRA, contributions must be made for all employees who have performed services in any three of the last five years, are at least 21 years old, and have received at least \$450 in compensation from you for the year. Under a qualified retirement plan, such as a Keogh plan, you do not have to include part-time help.

The percent you can put into your own account under a SEP-IRA plan is dependent on the percentage you contribute to your employees' accounts. Contributions are not mandatory each year. You can vary the amount you contribute from year to year as business conditions warrant. Though you may contribute to a SEP-IRA, you can also put money into an IRA.

A Simplified Employee Pension (SEP) plan eliminates IRS administration, reporting, and the fiduciary responsibilities associated with qualified plans such as the Keogh retirement plan. You have until tax filing time to establish a SEP. This gives you an extra, last-minute tax planning tool.

Comparing Retirement Plans

To help you decide which small business retirement plan is right for you, here's a side-by-side comparison of the main features of these four options. The figures are based on the limits for the 2009 tax year.

	SEP	SIMPLE	Keogh*	Solo 401(k)*
Size	No limit.	100 or fewer employees.	Not applicable.	Not applicable.
Eligibility	All employees age 21 and older who have worked for a company three of the previous five years and earned at least \$450 annually.	All employees paid at least \$5,000 in compensation for any two previous years at the company (and who expect to earn at least \$5,000 in the current year.	Limited to self-employed individuals (and any employees),.	Limited to self-employed individuals (and any employees).
Employee contributions	Not allowable.	Limited to \$11,500.	Not allowable.	Elective deferrals limited to \$15,500.
Catch-up contributions	Not allowable.	Limited to \$2,500.	Not allowable.	Limited to \$5,000.
Deductible employer contributions	Maximum of the lesser of 25 percent of compensation or \$49,000.	Required match of 3 percent of compensation (or 1 percent in no more than two out of five years) or 2 percent of participant's compensation	Maximum of the lesser of 20 percent of self-employment income or \$49,000.	No required match; maximum combined employer and employee contribution of \$44,000.
Distributions	Required after age 70 ½ ; 10 percent penalty for withdrawals before 59 ½ .	Required after age 70 ½ ; 10 percent penalty for withdrawals before age 59 ½ . (25 percent in first two years).	Required after age 70 ½ ; 10 percent penalty for withdrawals before age 59 ½ .	Required after age 70 ½ ; 10 percent penalty for withdrawals before age 59 ½ .
Deadline to establish plan	Tax return due date (plus extensions).	October 1 of the current year.	Last day of the tax year.	Last day of the tax year.
* Assumes sole proprietor				

