Part VI
Retirement Accounts for Small Businesses and the Self-Employed

While employees of most large companies have access to 401(k) plans or traditional pension plans, those employed by small firms often are not offered company retirement plans of any sort. According to a recent survey sponsored by the American Savings Education Council, of firms with fewer than 100 employees, only 29% of these employees are covered by an employer retirement plan—versus 83 percent of employees at larger companies.

Not all employees of small firms are left out in the cold. There is an entirely different set of retirement plan options that might be available through these companies. These plans also can be used by the self-employed to set up their own tax-deferred retirement plans.

Simple IRAs

This new type of retirement plan, the Savings Incentive Match Plan for Employees (SIMPLE), came into existence on January 1 1997, specifically for companies with 100 or fewer employees (excluding those who earned less than $5,000 in total compensation from the firm during the previous year). This retirement plan is tailor-made for small companies and the self-employed, because, as its acronym implies, it is considerably cheaper and easier to administer than a conventional 401(k) or pension plan.

From an employee's perspective, a SIMPLE IRA or SIMPLE 401(k) works much like traditional 401(k) plan, although not without a few wrinkles. With these accounts, employees can contribute up to $6,500 (this figure will increase in future years to keep pace with inflation), or up to 100 percent of their total compensation each year, whichever is lower. The money is removed from the paycheck on a pretax basis, as is done with a conventional 401(k) plan. But while with 401(k) plans matching employer contributions are entirely optional, the employers are required to provide matching under one of two different approved methods:

- The employer can choose to match employee contributions up to a maximum of 3 percent of the employee's total compensation (topping out at $6,000). In up to two of every five years, the employer may elect to match a percentage of less than 3 percent, perhaps falling to as little as 1 percent.

- The employer can elect to contribute an amount equal to 2 percent of compensation every year, up to a maximum of $3,200, for every eligible employee earning more than $5,000 a year—whether or not that employee contributes to the plan himself.

If one is self-employed, this match isn't as attractive as the company match on a conventional 401 (k), since the employer has to provide the matching funds themselves, but it does increase the amount that can invested on a tax-deferred basis through the SIMPLE plan.

SIMPLE plans have withdrawal restrictions that are quite similar to those of conventional 401(k). In general, withdrawals made prior to age 59 ½ are subject to the same 10 percent early withdrawal penalty faced by 401(k) plan participants, although unlike with 401(k)s, that minimum withdrawal age under no circumstances will fall to 55 for those leaving the company. One additional difference with SIMPLE: the early withdrawal penalty increases to 25 percent if the withdrawal is made within two years of the date one first participated in the plan.

The SIMPLE - IRA is great for:

- Sole proprietorship with no employees or few participants
- Partnership where only one partner participates
- Small family businesses - hire spouse & kids & deduct 100% of W-2 up to $6,000
- Corporations with high turnover & low participation
- Businesses whose 401(k) plan didn't work due to low participation
- Businesses with 100 or less employees

SEP-IRAs

Like the new SIMPLE plans, SEP-IRAs, or Simplified Employee Pension plans, are retirement plans specifically designed for small companies or the self-employed. To qualify, a company must have fewer than 25 eligible employees. Like SIMPLE plans, SEP-IRAs require minimal paperwork, and offer tax-deferred investing. They are appealing to small employers. However, the rules for SEP-IRAs are different from the rules for SIMPLEs.

Simplified Employee Pension **-** SEP's save taxes and build retirement wealth for business owners and professionals. SEP's are becoming the workhorse of small business retirement plans because:

- They are simple & easy to establish

- They can be established after close of business year & after April 15th with extensions
- They offer employee eligibility up to 3 years of service
- They do not require IRS filing or Form 5500 reporting
- There are no administration costs
- Contributions are tax deductible & elective (contributions are not required from year to year)

SEP's are extremely effective for either an individual with a part time business with no employees or any type business or professional practice with many employees. A SEP plan is a business sponsored IRA with higher contribution limits than an individual IRA and can be made to owner/employees over 70-1/2 years old. The maximum contribution to a SEP is the lesser of 15% of employee compensation or $25,500. For an owner of a sole proprietorship or partnership, the maximum contribution is limited to 13.043% of net Schedule C or the K-1 income minus one half of self-employment tax percent.

A SEP Plan for a certain year can be established and funded after April 15th, of the following year by filing a tax return extension. A business can open a SEP Plan and make the contribution with two extensions (4 + 2 months) up to October 15th of the following year and still get a tax deduction for the previous year. If one's business is a corporation the maximum extension is Sept. 15th.

Unfortunately not too many know about this 6 month maximum extension for SEP's and pass up an opportunity to save taxes. This is a useful strategy for last minute tax planning and managing temporary cash flow problems around April 15th. The IRS allows one to take the deduction before he or she actually makes the contribution. This can be an advantage if one owes taxes by April 15th and need to file an extension. The SEP deduction will reduce the taxes one must pay to avoid interest and penalties when they file the extension.

The SEP contribution is an elective decision made by the business owner typically after the close of the business year and when the final financial results are available. There is no requirement for a yearly contribution and the percentages can vary from year to year from none up to 15%.

The typical investment is a mutual fund family with a diversified group of funds. The business owner selects the mutual fund and then uses the mutual fund's SEP documents (no cost). The employees open their own IRA account in the mutual fund group offered by the business. The investment decision, control of the account and IRA fees, if any, are the responsibility of the employee. All the business does is to send a list with the employees' account information and the amount of contributions with one check to the mutual fund. It's that simple and the responsibility transfers from the business to the employee.

Advantages of SEP-IRAs

- One can contribute up to $25,500 per year, twice the maximum possible with SIMPLE plans, and much more than a conventional IRA would allow.
- One can make tax-deferred contributions even if they participate in a traditional 401(k).
- Like SIMPLE plans, SEP-IRAs are inexpensive and easy to run.
- There is a great deal of flexibility with contributions year to year

Disadvantages of SEP-IRAs

- One’s contributions are capped at 15 percent of income.
- If one has employees, they must make contributions for them, too—in the same percentage of compensation that one makes for themselves. These contributions are tax-deductible business expenses

SAR-SEP Plan

This plan is only available if the plan was established by December 31, 1996. It is a worthwhile tax saving plan specifically designed for small business owners, but few have taken advantage of it to:

- Save income taxes every month for the owner
- Build up substantial retirement wealth for the owner
- Give the same benefit to one’s employees at no cost to the business and no administrative cost

It is called a SAR-SEP, a salary deferral payroll savings plan that saves income taxes for both the business owner and employees. It is similar to a 401K plan that larger companies offer, except it is now available to small business owners and professional offices.

After December 31, 1996 the SIMPLE plan (deferral reduced to $6,000 max. plus a required 3% profit sharing contribution) will be introduced and no new SAR-SEP's can be established. All existing SAR-SEP's will be "grandfathered." The SAR-SEP:

- Is simple and easy to establish
- Does not require IRS reporting (no 5500 reports)

- Has no administration cost
- Offers employee eligibility for up to 3 years of service
- Requires no company contribution paid to employees — they defer part of their own wages
- The business owner gets to defer own wages/profits to save taxes

The SAR-SEP was available to businesses with at least one employee but no more than 25 eligible employees. The business can be a sole proprietorship, partnership or corporation ("S", "C" or professional service). Salary deferral plans have been successfully established in medical, CPA and engineering consultant offices as well as an electrical contractor and auto body shop, for example.

Keoghs

The final retirement plan options available to the self-employed and the owners and employees of small businesses fall under the heading of Keogh plans, which are sometimes referred to as HR 10 plans. Like SEP-IRAs and unlike SIMPLEs, employers generally are responsible for all contributions to Keoghs. As a rule, Keoghs tend to be far more expensive and confusing to set up and administer than SEP-IRAs or SIMPLEs. A plus for them is that it might be possible to continue to make tax-deferred contributions to a Keogh past age 70½ , the cutoff point for virtually all other retirement plans. Certain types of Keoghs offer the opportunity to save an even greater percentage of income on a tax-deferred basis than is possible through other means.

Under a Keogh plan, one can invest up to 20% of his or her annual income in stocks, bonds, or just about anything else they like (including cash value life insurance). Contributions to the account also qualify as a tax deduction. Like an IRA, the employee must pay a penalty if the money is drawn out before age 59-1/2. A Keogh plan can net one a fantastic amount of money: if he or she is a small business owner, earning $100,000 a year, and makes the maximum contribution (assuming a 12% rate of return) investment can grow to over $1.5 million by age 65.

In today's world, more and more Americans are self-employed. Planning for one's retirement becomes increasingly difficult without a structured company plan to follow. If one sees themselves in this situation someday, a Keogh plan is for them. A Keogh plan is a self-employment retirement plan.

Keoghs offer many tax advantages for employers, but should be considered carefully before plunging in fully. There are tax deductions and tax-free income that can accumulate from

Keogh plans, but there are many factors to consider. There are several issues that the employer must address before investing in a Keogh.

- They must be aware that they will have to include their employees in the Keogh. These contributions, however, are deductible and can go towards reducing the cost of the contribution.
- The employer must also be aware as to whether or not there will be the available cash to regularly contribute to the Keogh plan.
- They will have to know that they cannot withdraw money out of a Keogh until age 59½ without penalty (with the exception of disability), just like an IRA.

Eligibility

If one has earned self-employment income through performance of personal services, they are eligible to set up a Keogh. As far as these types of accounts are concerned, net profit income is considered (gross income minus deductions). Income earned overseas is not considered self- employment income. If one is an inactive owner in a business (i.e. limited partner or retired partner) they cannot contribute to a Keogh plan.

If one owns more than one business, they must set up a separate Keogh plan for each of them. These plans can be incorporated into one, or remain separate, but it is not permissible for a person to contribute to a Keogh for one business and not another. If one has both self-employment income as well as employment income, they can have a Keogh plan. Being an employee and self-employed does not preclude the opportunity to set up a Keogh.

Defined-Benefit Keogh Plans

Defined-benefit Keoghs provide for a specific retirement benefit fund by contributions on an IRS formula and actuarial assumption. This type of plan allows one to build up retirement benefits equal to a percentage of his earnings. Defined-benefit plans are very similar to other corporate plans. This type of plan may prove to be more costly if one has older employees, because this type of plan requires that one contributes to their plans even if one does not have profits. In such plans, the maximum annual retirement benefit was not allowed to exceed $98,064 in 1989. This number has since been adjusted by an inflationary factor. This number, arrived at by the IRS, assumes retirement at age 65. It must be adjusted for retirement before or after this age.

Defined-Contribution Keogh Plans

Under this type of plan, the retirement benefits will depend on the contributions made to one's account and the accounts of his employees over the years that the plan was in effect. If the contributions were geared towards profits, then the plan is a profit-sharing plan. If they were not based on the profits, then the plan is a money-purchase pension plan. A plan that is set up so that contributions to employees' accounts are based on a percentage of their pay would be a money- purchase pension plan. This sort of plan would require one to make contributions even in years with no profit, just like a defined-benefit Keogh plan.

There are some limitations on defined-contribution plans. For one, the maximum that one can contribute to such a plan is the lower between 25% of earned income or $30,000. Because net earnings must be reduced by the deductible contribution, the maximum contribution for money-sharing pension plans is reduced from 25 to 20% of net earnings. One is allowed to deduct the entire 20%. However, with a profit-sharing plan, one cannot claim this 20% deduction. The maximum deduction for a profit-sharing plan comes out to be 13.0435% of net earnings. One should be especially careful about the deductions he takes on profit-sharing defined-contribution Keoghs, because there is a 10% penalty for exceeding the maximum amount.

Annual Contributions

Like IRAs, a Keogh plan must be established by the end of the year but contributions can be made at any time up until April 15 of the next year. Also like IRAs, it is advantageous to contribute as early in the year as possible to let earnings accumulate tax free, but there are other things to take into consideration. One may be forced to wait until the end of the year to make his contributions because, by that time, he will know his earnings, and the compensation of his employees.

Retirement Benefits

The rules governing Keoghs are very similar to IRAs. If one owns more than 5% of his business, Keogh plan distributions must begin by April 1 following the year in which he reaches age 70 1/2. The penalty for insufficient distributions is hefty. From 1989 onwards, the penalty is 50% of the difference between the amount one received and the amount required. His employees are subject to the same rules. These penalties can add up quickly, so the employer has to be careful to withdraw the right amount at the right time.

A small business owner has a wide variety of investment choices for Keogh plans. When his fund is small, he should invest conservatively. Other than Social Security, the Keogh plan may be his only retirement fund. If he serves as his own trustee, he must assume liability for the total fund should there be losses due to his mismanagement. He can appoint a bank, trust company or company that manages pensions to serve as trustee. Or, he can buy an annuity from an insurance company or use a bank as a custodian to hold certificates of deposit.

If one is self-employed, does freelance or independent contractor work, or has his own business in addition to being employed by someone else, he may set up a tax-deductible Keogh plan (also called HR-10). This type of plan is especially helpful for women who may be out of the mainstream work force but still earning money while working from home.

At retirement, there are two options for distribution. One can take the payout as a lump sum payout. In which case the IRS allows him to income average. He may report 20% of the amount each year for five years. Or he may take monthly payouts. If monthly payouts are selected the monthly payouts are regarded as ordinary income for income tax purposes.

Keogh Plans are intended for self employed individuals and their employees. Self employed means a sole proprietorship or partner in a partnership. If the self employed individual has a Keogh Plan, and he has employees, the employees must be covered under the plan if they work 1,000 hours or more each year, and have worked for the company more than three years. 25% of 'self employment income' or $30,000 is the maximum amount the employer may make to his own account annually. Self employment income may not include dividends, interest, or capital gains from investments. Whatever percentage contribution the employer makes to his own account must also be made to the employees account. Any person taking a distribution from their Keogh Plan before age 59-1/2, is subject to all taxes due and a 10% early distribution fee.