Retirement Plans for the Self-Employed

While the tax code provides several provisions to encourage self-employed individuals and small business owners to save for retirement, selecting the right type of plan can be a complicated process. The good news is that the correct plan can help you save a significant amount of money toward your retirement and provide generous tax advantages as well.

Set forth below is a summary of the various retirement plan options, including a description of who will most benefit from them. For purposes of this article, the terms "self-employed" and "business owner" will be used interchangeably. All of these plans apply to both incorporated and unincorporated businesses.

1. **IRA/Roth IRA**.

Overview: While not limited to the self-employed, all owners of profitable businesses are eligible to contribute up to $5,500 ($6,500 if over 50) to either a traditional, a non-deductible, or a Roth IRA. These contributions can be made in addition to any of the plans outlined below and allow your investments to grow tax-free while in the retirement account.

Who it's for: Everyone. While income restrictions may limit which type of IRA you are eligible to utilize, even high income business owners can contribute to a non-deductible IRA account. Contributions can be made up until April 15th of the next calendar year.

2. **Solo 401(k)**.

Overview: The Solo 401(k) has been generally available for only the past few years and so it may not be familiar to many people. A Solo 401(k) plan allows a self-employed person to contribute up to the first $18,000 of net income ($24,000 if over 50) to the plan on a pre-tax basis. Also, an additional 20% of net profits can be sheltered as well, up to a total contribution of $53,000 per year ($59,000 if over 50).

The Solo 401(k) is available both in traditional and Roth versions (no income limitations apply to the Roth option). Also, business owners have complete flexibility to contribute as much or as little as they desire from year to year. A Solo 401(k) plan can be established up until the last day of the applicable tax year for the business.

Who it's for: Self-employed individuals or business owners with no employees other than their spouse and part-time workers (less than 1,000 hours per year). The business need not be owned by a single person—partnerships that have no employees other than spouses of the partners and part-time workers are eligible as well. As 100% of the first $18,000 in salary or net income ($24,000 if over 50) may be contributed to the plan on a pre-tax basis, the Solo 401(k) is an excellent choice for side or part-time business activities, freelance work, corporate director's fees, etc.

However, if you plan to hire any full time employees in the future, a Solo 401(k) may not be a good fit as the administrative burdens and maintenance costs will then increase significantly as will the restrictions upon treating plan participants differently. Also, if you own and control multiple businesses, a Solo 401(k) would not be available if you employ full time workers in any of your other business ventures. Finally, if you contribute to a 401(k) plan at another employer, the maximum limit will be reduced by the amount of such contributions.

3. **SIMPLE IRA**.

Overview: As the name implies, a savings incentive match plan for employees (SIMPLE) allows businesses with employees to provide a retirement savings plan without costly administrative requirements. Contribution limits are $12,500 per year ($15,500 if over 50) plus the employer matching contribution. Contributions are made directly to an IRA established for the business owner and each eligible employee. There is no Roth IRA alternative.

Like a traditional 401(k) plan, employees have the option to make pre-tax contributions to the SIMPLE plan from their salary and need not contribute at all. If the employees do contribute, the employer must provide a dollar for dollar matching contribution up to a maximum of 3% of compensation (which can be reduced to 1% for two of every five years). Alternatively, in lieu of matching contributions, in any year the employer can elect to contribute 2% of each employee's salary to the plan.

Business owners can also exclude from participation in a SIMPLE plan those employees who earn less than $5,000 per year as well as those who have worked for the business less than two years. A SIMPLE plan must be established by October 31st of the applicable tax year.

Who it's for: Business owners with 100 or fewer employees who do not currently maintain any other retirement plan. Businesses with a large percentage of high turnover or seasonal employees may benefit as most of these employees could be excluded from the SIMPLE plan contribution matching requirements. Also, if a side or part-time business has one or more full time employees, a SIMPLE plan may be a good fit as 100% of the first $12,500 in salary or net income ($15,500 if over 50) may be contributed. If the business does not have (or plan to have) any full time employees, then a Solo 401(k) should be utilized instead as the contribution limits are higher.

4. **SEP-IRA**.

Overview: Unlike a SIMPLE IRA, contributions to a simplified employee pension (SEP) are funded solely by employer contributions. Contribution limits for a SEP may be higher than a SIMPLE plan—25% of compensation (20% of precontribution income for business owners) up to a maximum of $53,000 per year. Similar to a SIMPLE IRA, there is no Roth IRA alternative and SEP plans are easy to establish. Contributions are made directly to an IRA account established for the business owner and each eligible employee. The IRA is owned and controlled by the employee without any additional administrative burdens upon the business owner.

An employer can limit eligibility for a SEP plan to only those employees over 21 years of age who have worked for the business a minimum of three years.

Business owners have the flexibility to vary contributions from year to year but the contribution percentage for the business owner and all employees must be the same. SEP plans can be established at any time before the due date of the tax return for the business (including all extensions).

Who it's for: Self-employed individuals and business owners who wish to provide generous retirement benefits to themselves and a few key employees. To the extent the business owner's compensation is significantly greater than that paid to the employees, or if the workforce experiences a high level of turnover, a SEP plan may be an attractive alternative.

5. **Keogh Plans**.

Overview: Keogh plans are subject to the qualified retirement plan rules and thus are much more complex and expensive than the other alternatives discussed above. However, there are advantages to Keogh plans such as increased flexibility in designing the plan to more closely match the specific needs of the business and increased contribution limits for highly compensated business owners. Keogh plans may be established by sole proprietors, partnerships, and corporations.

There are two basic types of Keogh plans—defined contribution plans and defined benefit plans. The maximum annual contribution limitation for a defined contribution plan is $53,000. The defined benefit plan contribution is based upon actuarial calculations and can be quite large for older, highly compensated employees and business owners. Defined contribution plans can be established as profit sharing plans and thus allow for flexibility in pension contribution amounts from year to year.

A business can adopt defined benefit and profit sharing plans simultaneously and thus maximize contributions in good years and maintain some degree of flexibility with respect to mandatory contributions in lean years. A Keogh plan can be established at any time up until the last day of the applicable tax year for the business.

Who it's for: Highly compensated business owners with full time employees who wish to contribute more to their retirement plan and are willing to incur significantly increased costs and administrative burdens in order to do so.