

Choosing the Right Retirement Plan for a Self-Employed Individual

by Randy Gardner, LL.M., CPA, CFP®; Julie Welch, CPA, CFP®; and Brooke Grechus, CPA

Self-employed business owners, including sole proprietors, partners in partnerships, and members of limited liability companies treated as partnerships, are often confronted with the dilemma of which retirement plan is best for them as owners and best for their employees. Most owners choose from a savings incentive match plan for employees (SIMPLE), a simplified employee pension (SEP) plan, or a profit-sharing (Keogh) plan. Table 1 summarizes the major differences of these plans.

	SIMPLE	SEP	Profit Sharing (Keogh)
Contributions	Deductible up to \$9,000 (\$10,500 if age 50+). Requires employer match for most employees.	Deductible up to the lesser of \$41,000 or about 25% (20% for owner) of earnings. Discrimination rules apply.	Deductible up to the lesser of \$41,000 or about 25% (20% for owner) of earnings. Discrimination rules apply.
Date to set up a new plan	Generally by 10/1 of the year before the start of the plan.	By due date of tax return (including extensions).	By year end (generally 12/31).
Coverage requirements	At least \$5,000 of earnings in any two prior years and expected to earn at least \$5,000 in the current year.	Attained age 21, performed services for the employer during at least 3 out of the immediately preceding 5 years, and received at least \$450 in compensation from the employer for the year.	Generally age 21 and 1 year of service (1,000 hours). Other qualified plan rules apply.
Date that contributions are due	Due date of tax return, including extensions; elective deferrals by participants due 30 days after the last day of the month for which contributions are made.	Due date of tax return, including extensions.	Due date of tax return, including extensions.
Ability to customize plan	Minimal	Minimal	Yes
Integration with Social Security?	No	Yes	Yes
Age weighting/cross-testing permitted?	No	No	Yes
IRS annual filing requirements	IRA: None, but some employee notifications required. 401(k): Must file Form 5500 annually.	None	Must file Form 5500 annually.
Vesting	Full and immediate	Full and immediate	Five-year cliff or three-to seven-year graded (three-year cliff or two-to six-year graded if top heavy)
Participant loans	IRA: No 401(k): Yes	No	Yes
Participant withdrawals	Can occur any time after contribution is made, but 25% penalty if withdrawal occurs during two-year period beginning on first day of participation.	Can occur any time after contribution is made.	Subject to plan restrictions.
Distributions	Taxable. May be subject to 25%/10% penalty.	Taxable. May be subject to 10% penalty.	Taxable. May be subject to 10% penalty.

SIMPLE IRA

SIMPLE plans are usually set up as individual retirement accounts (IRAs), but they may be set up as a 401(k). SIMPLE plans are established with the completion of a Form 5305-SIMPLE that is submitted to a financial institution rather than the Internal Revenue Service. They must be set up on a calendar-year basis and are available to employers with no other retirement plans and 100 or fewer employees. Employees are eligible if they earn at least \$5,000 in any two prior years and are expected to earn at least \$5,000 in the current year, meaning that employees are not necessarily required to be covered once they turn age 21 and have one year of service, the participation level for qualified plans. All employees, even those who are highly compensated, can defer up to \$9,000 annually. In addition, a \$1,500 catch-up contribution is available to individuals age 50 and over.

Employer contributions are flexible under a SIMPLE IRA plan. The employer can either (1) match dollar for dollar up to three percent of compensation (no statutory compensation limit) for those employees who made contributions or (2) choose to make a two percent (up to \$205,000 of compensation) nonelective contribution for each eligible employee, whether or not they make any contributions of their own. In other words, employees contribute most of the funding through a salary deferral approach. All employee and employer contributions are immediately and fully vested.

Example. ABC Company has three employees, all under age 50 (their earnings and deferrals are listed in Table 2). If ABC uses the three percent matching approach, retirement contributions are as shown in Table 2. Jane is able to defer \$18,000 for herself while putting away \$1,500 toward Jake's retirement, a sharing ratio of 7.6 percent ($\$1,500/(\$18,000 + 1,500)$).

TABLE 2

ABC Company: Retirement Contributions with Three Percent Matching

	Jane (the owner) \$300,000 (after deducting half of the self-employment tax)	Jake \$50,000	Robin \$30,000
Employee/Earnings			
Employee Deferral	\$9,000	\$2,000	\$0
Employer Match	\$9,000	\$1,500 (3% of \$50,000)	\$0 (No deferral to match)
Total Retirement Contribution	\$18,000	\$3,500	\$0

If ABC Company uses the two percent nonelective contribution approach, contributions are as shown in Table 3. Jane is able to defer \$13,100 for herself, with a sharing ratio of 10.8 percent ($(\$1,000 + 600)/(\$13,100 + 1,000 + 600)$). Because of the higher sharing ratio (10.8 percent compared with 7.6 percent) and the higher contribution amount for employees (\$1,600 compared with \$1,500), many employers choose the three percent approach rather than the two percent approach.

TABLE 3

ABC Company: Retirement Contributions with Two Percent Nonelective Approach

	Jane (the owner) \$300,000 (after deducting half of the self-employment tax)	Jake \$50,000	Robin \$30,000
Employee/Earnings			
Employee Deferral	\$9,000	\$2,000	\$0
Employer Match	\$4,100 (2% of \$205,000)	\$1,000 (2% of \$50,000)	\$600 (2% of \$30,000)
Total Retirement Contribution	\$13,100	\$3,000	\$600

From a planning point of view, SIMPLE plans are useful for self-employed individuals who do not want the complexity of a qualified plan or the funding burden of a SEP. Because 100 percent of earnings can be contributed to a SIMPLE plan, SIMPLEs are well suited to employed individuals with side businesses who want to contribute as much of their self-employment earnings as possible toward retirement. Although the sharing ratio

of a SIMPLE is favorable to the owner, the disadvantages are that the contribution amounts are lower and the owner's deferrals count toward the owner's \$13,000 total deferral limit. In other words, if the owner participates in a 401(k) plan of an employer, the sum of the SIMPLE and 401(k) deferrals cannot exceed \$13,000. If the owner is already contributing \$13,000 to a 401(k) plan, then the owner should consider either a SEP or a profit-sharing (Keogh) plan, rather than a SIMPLE, to defer the maximum.

Simplified Employee Pension Plans

A simplified employee pension plan (SEP) is a "super IRA." The owner funds his or her own IRA as well as the IRAs of all eligible employees on a nondiscriminatory basis. An eligible employee is an employee who (a) has attained age 21, (b) has performed service for the employer during at least three out of the immediately preceding five years and (c) received at least \$450 in compensation from the employer for that year. Similar to a SIMPLE plan, if the owner wishes to limit the number of plan participants, SEPs allow the owner to keep employees out of the plan for longer than the age-21-and-one-year-of-service standard of qualified plans.

Adopting a SEP simply requires completing Form 5305-SEP and keeping it in the company records. Plan establishment can be done after year-end, as late as the extended due date of the income tax return for the year contributions are made. The employee account can be a SEP-IRA or a traditional IRA, but not a Roth IRA or a SIMPLE IRA. Since SEPs cannot discriminate in favor of highly compensated employees, contributions must bear a uniform relationship to includible compensation. The maximum contribution to a SEP is limited to the lesser of 25 percent of the employee's compensation (\$205,000 maximum compensation can be considered), or \$41,000. Similar to SIMPLE plans, SEP contributions are immediately vested and are therefore 100 percent portable.

Example. If Jane, from our earlier ABC example, wishes to maximize her contributions toward retirement, she must also contribute toward her employees' retirements (see Table 4).

TABLE 4

ABC Company: Owner Contributions to Employee Plans

	Jane (the owner) \$300,000 (after deducting half of the self-employment tax)	Jake \$50,000	Robin \$30,000
Employee/Earnings			
Employee Deferral	\$0	\$0	\$0
Employer Contribution	\$41,000 (20% x \$205,000 compensation limit*)	\$12,500 (25% x \$50,000*)	\$7,500 (25% x \$30,000*)
Total Retirement Contribution	\$41,000	\$12,500	\$7,500

*The contribution rate for the employee is 20%. For Jane the contribution rate is 20% (25% (1 + .25)) if she were the only contributor at a lower rate for her own retirement, but in the given scenario, Jane is contributing at the same 25% rate as her employees (\$41,000 = (25% (\$300,000 - 41,000)).

Jane is able to defer the maximum \$41,000 for herself, but she must also contribute \$20,000 for Jake and Robin, a sharing ratio of 32.7 percent $((\$12,500 + 7,500)/(\$41,000 + 12,500 + 7,500))$.

From a planning point of view, the advantages of a SEP are (1) they are easy to establish and administer, (2) they can be set up after year end and (3) the contribution amounts are higher. Although SEPs can be integrated with Social Security, the main disadvantage of a SEP is that the owner must make nondiscriminatory contributions to the accounts of all eligible employees and those contributions are immediately 100 percent vested.

Profit-Sharing (Keogh) Plan

The rules for setting up and administering a profit-sharing plan for a sole proprietorship or partnership are essentially the same as for a corporation. Keogh plans have the administrative costs and complexities (such as minimum coverage requirements and top-heavy rules) of a qualified retirement plan and do not have the last-minute planning potential of a SEP because the plan itself must be in place by the end of the taxable year. The contribution levels and sharing ratio are the same as the SEP above. However, unlike SEPs and SIMPLEs, custom-designed Keogh plans can encourage longevity with a vesting schedule and favor older employees with age-weighting formulas.

Different Plans for Different Discretionary Incomes

Owners can contribute 100 percent of their self-employment income to a SIMPLE plan, but only 20 percent of their self-employment income (after deducting half of the self-employment tax) to a SEP or profit-sharing plan. Consequently, as the calculations in Table 5 illustrate, \$57,740 is the break-even level of income at which the amount that can be contributed to a SIMPLE plan with a three percent employer match for an individual under age 50 is the same that can be contributed to a SEP or Keogh. Below this level of income, the amount that can be contributed to a SIMPLE is greater. Above this level of income, the amount that can be contributed to a SEP or profit-sharing plan is greater. For someone who is 50 years old or more, the break-even level of income is \$67,364 and the break-even contribution amount is \$12,521.

TABLE 5
Comparison of SIMPLE and SEP or Keogh Plans

Plan	SIMPLE	SEP or Profit Sharing
Self-Employment Earnings	\$57,740	\$57,740
Owner Contribution	\$9,000	\$0
Employer Contribution	\$1,732 (3% of \$57,740)	\$10,732*
Total Retirement Contribution	\$10,732	\$10,732

*Self-employment tax deduction on \$1,732 is \$4,679 [(1.52)(303)(1.152) (\$1,732)]. The maximum SEP and Keogh contribution is \$10,732 (\$1,732 + \$9,000).

Example. A 42-year-old self-employed individual is trying to decide between a SEP, a profit-sharing plan, or a SIMPLE IRA (assuming a three percent match). The individual's goal is to put as much money away for retirement as possible. The owner would also like to consider which plan is most beneficial as the discretionary income level increases to the following levels: \$25,000, \$50,000, \$100,000, \$200,000, and \$300,000 (see Table 6).

TABLE 6
Contribution Levels for 2004

Income	SIMPLE	SEP or Profit Sharing*
\$25,000	\$9,750	\$4,294
\$50,000	\$10,500	\$9,294
\$100,000	\$12,000	\$18,638
\$200,000	\$15,000	\$36,741
\$300,000	\$18,000	\$41,000 (20% x \$205,000)

*90% of income after deducting one-half of the self-employment tax.

Self-employed owners wishing to maximize their retirement contributions have numerous factors to consider as they select which retirement plan to use. Until their income level reaches \$57,740, they might be well advised to use a SIMPLE because the amount they can contribute to their own retirement is larger, employees fund their

own retirements, and SIMPLEs are easy to set up and administer. As their discretionary income level increases, many owners choose either a SEP or profit-sharing plan so they can contribute more to their own retirements. However, with these larger contribution amounts comes the burden of funding their employees' retirements.

Randy Gardner, LL.M., CPA, CFP®, directs and teaches in the Certificate in Financial Planning Program at the University of Missouri-Kansas City, Kansas City, Missouri.

Julie Welch, CPA, CFP®, is a shareholder and the director of tax services at Meara, King, and Company in Kansas City, Missouri.

Brooke Grechus, CPA, works in the tax department of an international accounting firm in Kansas City, Missouri.