




## Retirement Plans Most Appropriate for Self-Employed/Sole Proprietorship/Partnership

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### Introduction

Retirement plans offer a number of benefits. A typical plan provides participating employees the opportunity to systematically save for retirement. From the employer's point of view, having a retirement plan can maximize the business's profitability by helping to attract and retain quality employees, and by boosting employee productivity. In addition, in the case of qualified plans and some nonqualified plans, retirement plans can provide significant tax advantages for both employer and employees.

If you are self-employed or involved with a small business (e.g., a partnership or sole proprietorship), establishing a retirement plan can provide benefits for you, as well as any employees you may have. As you know, however, small businesses and self-employed individuals

have considerations very different from those of large employers. The best retirement plan for a large corporation may not be the best one for a small business with a few employees. Certain types of retirement plans are generally considered more appropriate for small businesses and self-employed individuals.

*Caution: If you have employees and wish to establish a retirement plan for your small business, be aware that you will typically be required to cover some (if not all) of your employees under the plan.*

## Qualified vs. nonqualified plans

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As mentioned, qualified retirement plans (like 401[k], profit-sharing, stock bonus, defined benefit and hybrid plans) offer significant tax advantages to both employers and employees. Employers are generally permitted to deduct their contributions on their federal income tax returns, while participants can benefit from pretax contributions and tax-deferred growth. In return for these tax benefits, a qualified plan must adhere to strict IRC (Internal Revenue Code) and ERISA (Employee Retirement Income Security Act) guidelines regarding participation in the plan, vesting, funding, nondiscrimination, disclosure and fiduciary matters.

In contrast to qualified plans, nonqualified retirement plans are often not subject to the same set of ERISA and IRC guidelines. As you might expect, this freedom from extensive requirements often provides nonqualified plans with greater flexibility for both employers and employees. In addition, nonqualified plans are often less expensive to establish and maintain than qualified plans.

Generally, the main disadvantages of nonqualified plans are (a) they are typically not as beneficial as qualified plans from a tax standpoint, (b) they are generally available only to a select group of employees and (c) plan assets are not protected in the event of the employer's bankruptcy. For these reasons, qualified plans usually appeal to the largest number of employers and employees.

### Specific types of retirement plans

The following types of retirement plans are generally considered most appropriate for self-employed individuals and small businesses:

- **Payroll deduction IRA plan:** A payroll deduction IRA plan is a type of arrangement you can establish to allow your employees to make payroll deduction contributions to IRAs (traditional or Roth). It can be offered to your employees instead of a more conventional retirement plan, such as a 401(k) plan, or to supplement such a plan. Each of your participating employees establishes and maintains a separate IRA, and elects to have a certain amount deducted from their pay on an after-tax basis. That amount is then invested in the participant's designated IRA. Payroll deduction IRAs are generally subject to the same rules that normally apply to IRAs.

- **SEP plan:** A simplified employee pension (SEP) plan is a tax-deferred retirement savings plan that allows contributions to be made to special IRAs, called SEP-IRAs, according to a specific formula. Generally, any employer with one or more employees can establish a SEP plan (although it is best suited for the self-employed, or a sole proprietor or partner with net business income). With this type of plan, you can make tax-deductible employer contributions to SEP-IRAs for yourself and your employees (if any). Except for the ability to accept SEP contributions from employers (allowing more money to be contributed) and certain related rules, SEP-IRAs are virtually identical to traditional IRAs.
- **SIMPLE IRA plan:** A SIMPLE IRA plan is a retirement plan for small businesses (generally those with 100 or fewer employees) and self-employed individuals that is established in the form of employee-owned IRAs. The SIMPLE IRA plan is funded with voluntary employee contributions and mandatory employer contributions. The annual allowable contribution amount is significantly higher than the annual contribution limit for traditional and Roth IRAs. Employer contributions to this type of plan are tax deductible for the employer and are excluded from the employee's current income.
- **SIMPLE 401(k) plan:** A SIMPLE 401(k) plan is a retirement plan for small businesses (generally those with 100 or fewer employees) and self-employed individuals, including sole proprietorships and partnerships. This type of plan is structured as a 401(k) cash or deferred arrangement (CODA), and was devised in an effort to offer self-employed individuals and small businesses a tax-deferred retirement plan that is similar to the traditional 401(k) plan but with less complexity and expense. Employer contributions to this type of plan are tax deductible for the employer, and are excluded from the employee's current income.
- **Keogh plan:** A Keogh plan (sometimes referred to as an HR-10 plan) is a qualified retirement plan for self-employed individuals and their employees. Only a sole proprietor or a partnership may establish a Keogh plan; an employee or an individual partner cannot. Keogh plans may be set up as either defined benefit plans or defined contribution plans.

*Tip: The 401(k) plan has become increasingly popular for sole proprietors and solely owned corporations. With individual 401(k) plans, which are also known as solo 401(k)s, employer-only 401(k)s, single participant 401(k)s, and mini 401(k)s, the business owner is typically the only participant in the plan. The appeal of individual 401(k) plans dramatically increased as a result of the Economic Growth and Tax Relief Reconciliation Act of 2001, which (a) increased the maximum deductible profit-sharing contribution from 15% to 25% and (b) allowed employee 401(k) deferrals to be deducted separately, in addition to the maximum profit-sharing contribution. These changes allow a much larger deductible contribution than was permitted under prior law. As a result, significant dollars can now be contributed, tax deferred, for the benefit of the business owner.*

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