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Quick Guide

This quick guide was prepared by Truebridge.

Quick Guide: Retirement Plans for Self-Employed

Introduction

If you are self-employed and looking for true simplicity, look no further. A Simplified Employee Pension (SEP) is an employer retirement plan that uses IRAs as the funding vehicle. In 2020, you can contribute up to $57,000 ($56,000in 2019), or 25% of compensation, whichever is less. The actual formula limits your contribution to 20% of your net self-employment income. You can even make your regular IRA contribution to your SEP, in addition to your regular SEP contribution.

SUGGESTION: Your contribution can vary from year to year; you can even skip contributions indefinitely. While this is probably not in your best interest, you also don't have to be bothered with complicated plan documents or annual filing requirements.

IMPORTANT NOTE: As in a regular IRA, you can't borrow from a SEP, nor can you use the assets as collateral for a loan. In addition, the rules against putting collectibles in your IRA also apply to SEPs.

Are You Eligible?

Only an employer can establish a SEP arrangement. In order to sponsor a SEP, you can either be in business by yourself or have employees. If you have eligible employees, you must fund the SEP on their behalf; i.e., you must make contributions to the SEP plan for your eligible employees. You, as the employer, are also responsible for establishing and maintaining the plan.

The participation requirements for a SEP are generally broader than those for Keogh plans. An eligible employee for a SEP is one who meets these conditions:

- Is at least 21 years old
- Has performed service for you in at least three of the immediately preceding five years
- Receives a minimum amount of compensation set annually ($600 in 2020 and 2019) by the IRS

IMPORTANT NOTE: Because of the less restrictive participation rules (see above), SEPs are typically less popular for employers than other retirement plans.

Supercharging Your IRA

A SEP is better than an IRA because an IRA allows you to put away only up to $6,000 in 2020($6,000 in 2019). SEPs are IRAs that an employer sets up for its employees as part of a retirement plan. Like a qualified plan, SEPs are subject to overall contribution limitations (similar to a Keogh plan).

Setting Up a SEP

Administrative simplicity is one of the primary advantages of simplified employee pensions (SEPs). SEPs are easy to open and require less paperwork than qualified plans. Unlike Keoghs, SEPs require no plan document other than a standardized IRS form (Form 5305-SEP). If you don't adopt an IRS approved prototype plan, you must prepare and adopt a written plan that satisfies the IRS requirements.

Unlike Keoghs, you have until the due date of your income tax return (including extensions) to both establish and contribute to the SEP. Typically, the employees (including you) can choose how their SEP funds are invested.

Where to Set Up a SEP

Your local bank or credit union can open a SEP for you. All that is required is a simple, one-page document (Form 5305-SEP) to be completed by you, the employer. Setup and annual fees, per plan, may apply.

Reporting Requirements

The reporting and disclosure requirements for SEPs are less cumbersome and costly to employers than those for other retirement plans. All that is required is Form 5305-SEP (Simplified Employee Pension-Individual Retirement Accounts Contribution Agreement), a one-page, easy-to-complete form. This serves as the written plan instrument. The form is not filed with the IRS, but it should be kept in the employer's records to support the legal adoption of the arrangement.

IMPORTANT NOTE: Each employee must be given a copy of the completed Form 5305-SEP. Also, each year, a statement must be given to each employee showing any contributions to the employee's SEP.

SEP vs. Keogh

How do you decide if you should establish a SEP or a Keogh? You must compare both types of plans and determine which retirement plan best fits your needs. Here is a chart summarizing the key features of SEPs and Keoghs:

Key Features of SEPs and Keoghs

Features / Provisions	**SEP**	**Keogh**
Plan document	One-page form can be used: IRS Form 5305-SEP	Full plan document
Maximum contribution	Lesser of $57,000 in 2020 ($56,000in 2019) or 100% of compensation per employee.	
Maximum employer deduction	25% of total eligible compensation of employees covered by the plan.	

Features / Provisions	SEP	Keogh
Loan provisions	Cannot borrow against SEP account	Able to borrow against Keogh account
Eligibility	Less restrictive rules for employee eligibility	More restrictive rules for employee eligibility
When to establish	Have until due date of tax return to establish	Must be established by December 31
Annual reporting requirements	None	Annual reporting requirement on Form 5500

Introduction

What if you're self-employed and you want to place some of your earnings in a tax-deferred retirement account, but you don't want to limit your contribution to $6,000 in an IRA in 2020 ($6,000 in 2019). You'd like to save considerably more. Do you have the same opportunity available to you as employees who are covered by corporate retirement plans? The answer is yes.

Keoghs allow unincorporated, self-employed business owners (sole proprietors and partnerships) to make tax-deductible contributions and receive the same tax advantages as corporations. Unlike IRAs, Keoghs are still tax-deductible if you're covered by an employer plan. Suppose you work as a part-time freelance writer in addition to your regular, full-time job. You can use your freelance writer income to open a Keogh. A Keogh plan lets you accumulate savings in a private retirement plan that supplements your pension and Social Security.

Opening a Keogh is a bit more complicated than opening an IRA. You must have a plan document that is approved by the IRS. The plan document describes the type of Keogh plan it is and how contributions are determined. You can have either a defined benefit or defined contribution (money purchase or profit-sharing) plan. Your maximum contributions will depend upon the type of plan you establish.

IMPORTANT NOTE: If you are covered by a qualified employer retirement plan, the total annual contributions to defined contribution plans in 2020 cannot exceed 100% of your compensation or $57,000 ($56,000 in 2019), whichever is less. If you also have a defined benefit plan, a separate limitation applies; this benefit limitation of $230,000in 2020 ($225,000 as 2019) is the maximum annual benefit that may be paid from the plan. The actual contribution to a defined benefit plan will depend on the benefit provided under the plan, the participant's age and years of service with the employer, and the rate of return earned on plan assets.

Can You Have Both a Keogh Plan and an IRA?

Keogh plans can be established in addition to IRA accounts, but since a Keogh plan is a qualified plan, your contributions to your IRA account may not be fully deductible. Additionally, if you work as an employee and participate in the employer's qualified plan, you can still have a Keogh plan if you have net earnings from self-employment. Your contributions are subject to the overall limitations for defined contribution plans and defined benefit plans.

IMPORTANT NOTE: Keogh plans must be set up by the end of the year to claim a tax deduction for contributions for that year. But you have until the due date of your tax return (including extensions) to actually make your contribution.

IMPORTANT NOTE: If an individual has self-employment income (typically consulting, director's fees, etc.) and is a non-owner employee (or has very little ownership) of another company, he or she could have a separate retirement plan for their self-employment income (but could not double up on 401(k) contributions).

How Keogh Plans Work

If you are self-employed, you can establish a Keogh (a qualified retirement plan) with contributions based on net earnings from self-employment. Contributions to Keogh plans are tax-deductible. The amount of the contribution depends on the type of plan you set up—either "defined contribution" or "defined benefit." No matter what type of plan you select, you must fund the Keogh of your eligible employees; i.e., you must make contributions to the Keogh plan for your eligible employees.{$CSA_XREF 1058 START} For the employee eligibility rules, see the section Establishing a Keogh Plan.{$CSA_XREF 1058 END} An overview of Keogh plan rules follows.

Defined Contribution Plans

Defined contribution plans are the most common type of Keogh plan, and include money-purchase pension plans and profit-sharing plans. There are overall contribution and deduction limitations to a Keogh plan.

For both types of plans, contributions in 2020 are generally limited to the lesser of $57,000 ($56,000 in 2019) or 25% of your self-employment income, after the retirement contribution is subtracted.

As the self-employed owner, you may be able to deduct up to 25% of the combined compensation of all eligible employees.

The contribution and the deduction for the contribution to your own Keogh are computed after you subtract your retirement plan contribution from your net earnings. This means that you can't actually put 25% of your self-employment income into your retirement plan. Effectively, you can put only 20% of your self-employment income into your plan. For example, if your self-employed income is $30,000 (net of ½ of the self-employment tax), you can contribute $6,000 ($30,000−$6,000 = $24,000 x 25% = $6,000; or $30,000 x 20% = $6,000) to your retirement plan.

Defined Benefit Plans

A defined benefit plan provides individuals with specified benefits at retirement, typically in the form of a monthly retirement benefit and typically based on levels of compensation and years of service. If you set up a defined benefit plan, you will need an actuary to calculate the amount necessary to fund the plan.

General Types of Keogh Plans[1]

Type	Maximum Contribution[2]	Factors to Consider
Money-Purchase	$57,000 in 2020 ($56,000 in 2019) or 25% of the earned income[2] from the business, whichever is less	Contributions are required. You are locked into a specified percentage each year.
Profit-Sharing	$57,000 in 2020 ($56,000in 2019) or 25% of the earned income[3] from the business, whichever is less	Your contributions are flexible, up to the maximum percentage you initially set.
Defined Benefit	The plan funds for a fixed annual income at retirement.[4]	Allows older workers to put away substantially more money, but younger workers may not be able to put away as much as in a money purchase or profit-sharing plan. Also, there are higher administrative costs with a defined benefit plan. (Rewards older, longer-service employees over younger, short-term employees.)

[1] Assumes you are an owner-employee.

[2] The employer must make a contribution to each eligible employee’s account. This contribution is not currently taxable to the employee, but is taxed upon withdrawal.

[3] Your earned income equals your income minus the retirement contribution and minus ½ of the self-employment tax.

[4] The maximum defined-benefit you can fund is set annually by the IRS.

SUGGESTION: Your Keogh contributions are deductible on your individual income tax return. Deduct the contributions for your employees on Schedule C (or Schedule F if applicable) on your Form 1040. Take the deduction for contributions for yourself on page 1 of Form 1040 under the section *Adjusted Gross Income*.

Defined Contribution or Defined Benefit?

You need to consider these factors when selecting the right type of Keogh:

- How much money you need to accumulate
- Your age
- Your cash flow—i.e., whether you can put money into the plan every year (for employees, too)
- The administrative cost of the different plans

A **defined benefit plan** is attractive to older self-employed individuals who are just starting a plan because it allows greater contributions for older plan participants. Keep in mind, you will need an actuary to calculate the amount necessary to contribute to the plan. The cost of continuing professional assistance must be factored into the decision. Also, you may have to make quarterly installments of required contributions if certain participant notification requirements are not met.

Generally, if you are young, a **defined contribution plan** allows you to make a greater contribution to your Keogh plan than does a defined benefit plan. Of the defined contribution plans, a money purchase pension plan requires you to contribute (contributions must be made for you and your employees) to the plan each and every year, regardless of how good or bad your business is doing. So, you need to have sufficient cash flow to support the contributions each year.

On the other hand, a **profit-sharing plan** is more flexible. Contributions can be any amount up to 25% of the total eligible payroll of plan participants. Plan contributions can be omitted entirely in a bad year. But the IRS does require that contributions be "substantial and recurring" so that the plan is not terminated.

Establishing a Keogh Plan

If you are self-employed, you can establish a Keogh plan for yourself. If you have employees, you must make contributions to the plan for them if they meet the minimum participation requirements (or the requirements of your plan, if more lenient). As the employer, you are responsible for establishing and maintaining the plan.

Written Plan Requirement

A written plan instrument is required for a qualified Keogh plan. All provisions of the plan must be expressly stated in the document. Most plans follow a standard master or prototype plan already approved by the IRS. You can adopt such a plan as offered at most financial institutions, including banks, insurance companies, and mutual fund companies. An individually designed plan can also be established, but IRS approval will be required.

Minimum Participation Requirements

An employee must be allowed to participate in your plan if he or she meets these conditions:

- Has reached age 21

- Has at least one year of service (two years if the plan provides that the employee has an immediate, fully vested (non-forfeitable) right to all of his or her benefit under the plan)

Setting up a Keogh

Financial institutions have prototype plan documents that can easily be completed. A trustee must generally be designated and holds title to plan assets, and is responsible for managing them unless this responsibility has been delegated to an investment manager. Where you decide to go should be based on the type of investments you want.

Investment concepts for Keoghs are similar to those for IRAs.{$CSA_XREF 1048 START} See the section "Investment Considerations for Your IRA".{$CSA_XREF 1048 END} Speak with your financial professional to select the investments that are right for you.

Tax Reporting Requirements

An annual filing must be made with the IRS for Keogh plans. The annual report for a plan is generally made on a Form 5500 (Annual Return/Report of Employee Benefit Plan). Reports are generally due seven months after the end of the plan year (July 31 for calendar year plans).

SUGGESTION: If your Keogh plan covers only you, or you and your spouse if you jointly own a business, you can file Form 5500-EZ, Annual Return of One Participant (Owners and Their Spouses) Retirement Plan.