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eady or not

Best scenario: stay young forever. Second-best: prepare for retirement. We won't even mention the third scenario… but we will help you understand what your retirement-planning options are as an independent professional.

by Jan Zobel

Forget the gold watch. The farewell speech. The retirement party at the swankiest steakhouse in town. When you go to hang up … er … take down your shingle, you'll do so entirely on your own — without the help of a benefits department or 30 years of employer-matched contributions. Which is to say, if you don't want to spend your golden years eating Alpo from a can, you'd better find a retirement plan while you're still hard at work.

But aren't those retirement plans complicated? After all, you're an independent professional, and your IP specialty may not be financial analysis. Retirement plans mean weird acronyms, difficult calculations, and all sorts of arcane rules and regulations. How will an IP like you hack through those thick fiscal forests?

The good news is you don't have to: I've already been there, done that. Read on as I translate all of that financial mumbo-jumbo into plain English.

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Family Resemblance

The first thing you should know is that all the retirement plans available to IPs share a certain family resemblance, sort of like a weak chin or male-pattern baldness (but more attractive than these, and better for your pocketbook). A quick glance shows that there are four distinct features that all plans share. To a plan, they're all:

- Tax-deferred, meaning that the income contributed to them and the earnings on that money are not taxed until the money is withdrawn at retirement. For an example of what this can mean, let's say you're in the 28 percent federal tax bracket. Deferring tax on current income will save you $280 (more when state taxes are added in) for each $1,000 contributed to a retirement plan.
- Available to anyone who has a profit from self-employment or independent contracting work, even if you do that work only part-time and are covered by a retirement plan at your full-time job.
- Offered as an option by most brokerages, mutual fund companies, and banks.
- Not appropriate if you expect to withdraw your contributions before age 59½. Early withdrawal penalties, combined with federal and state taxes, can gobble up nearly 50 percent of the amount you withdraw.

The most important feature is, of course, the tax-deferred nature of the plans. Here's the idea: you'll be withdrawing money from the account when you're retired or working part-time — and therefore, in all likelihood, in a lower tax bracket than you were in when you invested the money. In other words, the taxes you save when you put the money in are usually greater than the taxes you pay when you take the money out. (However, there's a limit to the government's generosity: while the current income tax savings can be significant, contributions to a retirement account are not treated as business deductions and do not reduce your self-employment tax.)

Independent professionals have a number of retirement options. Hint: Any of them is better than doing nothing.

Now let's examine the individual quirks of the various plans. Before you pick a retirement package, you should weigh the pros and cons of each. *Any* plan is usually better than none, and it *is* possible to change your mind later and transfer your funds from one plan to another, so don't let the decision-making process slow you down too much. Still, it does pay to shop around.

A SEP in the Right Direction

The Simplified Employee Pension Individual Retirement Account (sep-ira) is, on the menu of retirement plans, a piece of cake. That is, it's the easiest plan to set up, and the rewards are sweet. You can contribute up to 15 percent of your net self-employment income (the amount left after deducting business expenses) to a sep-ira, up to a maximum of $24,000 per year.

You may vary the percentage you contribute each year to your sep-ira, and you may sometimes choose to contribute, as they say in the vernacular, zilch. You can open a sep and make contributions up until the due date of your tax return. And if you're short of cash on April 15, consider filing an extension for your tax return, which gives you until August 15 to dig up the funds for your sep-ira. (If money's *really* tight, you can file a second extension, giving you an October 15 deadline; your IP tax preparer will no doubt appreciate the extra work.)

A lifetime as an independent professional behind you. A hard-earned, well-planned, and comfortable retirement.

Short Story from our Paranoid Zone:

The sep-ira's 15 percent contribution figure is, in fact, just a reference point. Your actual contribution percentage is 13.043 percent. Essentially, calculating your contribution is a three-step process: (1) figure out your net income (your income after deducting expenses); (2) subtract half of your self-employment tax from your net income; and (3) multiply the outcome of this deduction by 13.043 percent. Why do they give you two different percentages? All I can say is that the irs works in mysterious ways. This may seem confusing, but as the following example shows, it's as clear as Crystal Pepsi:

John Q. Freelancer has an IP net income (after deducting expenses) of $60,000. To compute the maximum he can contribute to his sep-ira, he calculates 50 percent of his self-employment tax ($4,239) and subtracts that amount from $60,000. He then multiplies the balance ($55,761) by 13.043 percent, resulting in a maximum sep-ira contribution of $7,273.

The Keogh to Your Success

Then there are the Keogh — rhymes with "Leo" — plans. While slightly more complex to administer than sep-iras, some Keoghs allow you to make bigger contributions. As with sep-iras, you have until April 15 (or later, if you get an extension) to make a Keogh contribution. However, unlike sep-iras, a Keogh account must have been opened by December 31 of the year for which the contribution is being made. In addition, a Form 5500 must be filed annually with the irs for Keogh accounts having balances of $100,000 or more.

Keoghs come in two flavors: the *defined-benefit plan* and the *defined-contribution plan.*

Defined-benefit Keoghs are most often opened by workers who are closing in on retirement and who need to accumulate a predetermined amount of retirement assets asap. Annual contributions are then calculated backwards from this final goal. This is way too complex to explore in our brief introduction — you need to use an actuarial table to figure out the contribution amount and typically will do this with the help of a financial professional — so let's focus instead on the other type of Keogh, the defined-contribution plan.

There are two kinds of defined-contribution Keoghs — *profit-sharing* and *money-purchase* plans — and each has different features.

Profit-sharing plans resemble sep-iras in a number of ways. Let me count them:

- The smaller of 15 percent of net self-employment income or $24,000 can be contributed each year.

For more information, go to 1099.com/retirement

Hot Tip

Hmm ... your stocks are up today. That's nice. Wait a minute ... stocks? What do you know about stocks? You never bought any sto ...

Reality Attack! Are you a prosperous retiree imagining the poverty you've avoided, or an old derelict fantasizing about the retirement you'll never have?

- The actual maximum percentage is 13.043 percent of net profit after it's reduced by 50 percent of the self-employment tax but before you calculate your retirement contribution.
- The percentage you contribute can vary from year to year (and you can choose not to contribute at all).
- If you don't have a profit from your business, you can't make a contribution.
- Early withdrawal (before age 59½) of your retirement money results in a 10 percent federal penalty plus possible state penalties, plus you'll pay federal and state taxes on the amount you withdraw.

Now if 15 percent is too puny a contribution for a high-roller like you, you'll want to open a Keogh money-purchase plan instead of, or in addition to, a profit-sharing plan. Money-purchase plans allow you to sock away up to 25 percent of your net profit. When setting up one of these plans you must commit, for as long as you have this plan, to contribute a set percentage (1 to 25 percent) of your self-employment profit each year to the account. (The IP who fears commitment will probably not be happy with a money-purchase plan.)

Keogh plans, which are specially designed for self-employed people, come in a few different flavors. Your choice depends on balancing contribution limits against risk.

The most flexible option is to open both a money-purchase and a profit-sharing plan (financial folks call this a paired plan). You can dump 10 percent into your money-purchase plan each year. In the years you want to contribute more, you can also put up to 15 percent into your profit-sharing plan, for a total of 25 percent of your net profit or $30,000, whichever is less. If you have a lousy year, you can just make the 10 percent contribution.

If you have both a profit-sharing Keogh and a sep-ira, the maximum contribution for the two combined is 15 percent of your self-employment profit. The money-purchase Keogh can be combined with either of these plans, allowing for the additional 10 percent contribution.

As with the sep-ira and the Keogh profit-sharing plan, the 25 percent allowed for a money-purchase or a paired plan is reduced by the amount of your retirement contribution, meaning that the actual maximum allowed is 20 percent of your self-employment profit.

If you happen to be evolving from IP-hood into entrepreneurship, this may affect you: whichever type of Keogh you choose, if you have employees who are over 21 and have worked for you at least 1,000 hours during the year, you *must* contribute to their retirement plans when you contribute to your own. Sorry, boss, that's just the way it is.

Keep it SIMPLE, Stupid

The simple (Savings Incentive Match Plan for Employees) was designed especially for small businesses with employees but it can also be used effectively by IPs. Unlike sep-iras and Keoghs, which allow only employer contributions, simple plans let employees set aside money for retirement. Employers must either match employee contributions dollar-for-dollar up to 3 percent of compensation (to a maximum of $6,000) or contribute 2 percent of compensation (not to exceed $3,200 per employee) to the accounts of all employees who have earned at least $5,000.

But, I can hear you cry, I'm an IP — I don't have any employees! If this is the case, don't panic. If you're self-employed and have a simple ira, you're treated as both employer and employee. As an "employee," you can contribute up to 100 percent of net self-employment earnings (not to exceed $6,000) to your simple. As the "employer," you'll match your contribution in the same way you would for other employees. Being able to defer as much as 100 percent of earnings makes the simple a good plan for the IP who has only a small profit and who wants to contribute the maximum to retirement. The following tale demonstrates the potential value of a simple.

Darva G. has a full-time wage-slave job. She also does some independent computer consulting on the side. The net income from her IP work is $5,500 for the year. She wants to save as much as possible for retirement. If she opens a sep-ira, she can put aside $667 ($5,500 minus $389, which is 50 percent of her

self-employment tax, times the sep-ira percentage of 13.043 percent). If she opens a paired money-purchase and profit-sharing Keogh, she can put aside $1,022 ($5,500 minus $389, times the paired Keogh percentage of 20 percent). If Darva opens a simple, she can contribute $5,500 (100 percent of her net profit) plus the "employer" match of 3 percent of her net profit ($165) for a total retirement contribution of $5,665.

Warning: simple iras have more complex administrative requirements than sep-iras or Keoghs. For example, employees — if you have them — must receive notification at least two months before the plan becomes available to them. This generally means the simple must be set up by October 1 if you want to contribute in the current year. If you have another kind of retirement plan, that plan must be closed before a simple can be opened. You cannot contribute to a simple in the same year you contribute to a Keogh or sep-ira.

Plan carefully before opening a simple ira. Money withdrawn within two years of the contribution date is subject to a 25 percent, rather than the normal 10 percent, early withdrawal penalty. (By the way, I hope you're not withdrawing early from this article — there's a severe early withdrawal penalty that you don't want to know about.)

IRAs: Tradition vs. The Grapes of Roth

Traditional iras are available to any slob with earned income — either wages or IP income. (Actually, snobs with earned income can get them, too.) The maximum allowable contribution to an ira is the lesser of your compensation or $2,000 per year. If you're single and have a loss from your business and no other earned income for the year, since your compensation amount is less than zero, you're ineligible for an ira. (You are, however, eligible for a pep talk from mom.) A married couple can put up to $2,000 per spouse into an ira, even if only one spouse has earnings.

Being able to put money into a traditional ira doesn't necessarily mean that you'll be able to deduct the contribution. This depends on your total income (including your spouse's income if you're married) and whether you and/or the spouse have a retirement plan at work. Singles who have a retirement plan at work will not be able to deduct an ira once their adjusted gross income (agi) exceeds $42,000. Married folks who have a retirement plan at work and agi over $62,000 can't deduct an ira contribution. For more information about the deductibility of iras, including restrictions for married people who *don't* have a retirement account but whose spouses do, see irs Publication 590. (It also makes for great bedtime reading for your kids.) Note that the phrase "having a retirement plan at work" refers not only to wage-slave retirement plans, but also to having a sep-ira, Keogh, or simple to which you've made contributions during the year.

But maybe the traditional ira isn't your style. Instead you may choose to contribute up to $2,000 a year to a Roth ira. Your allowable Roth contribution will be less when your income exceeds $95,000 if single or $150,000 if married. No contribution can be made by single people whose income exceeds $110,000 or married people whose income is more than $160,000. A Roth contribution is not deductible; its advantage is that earnings (interest or dividends) and increases in market value are not taxed on a yearly basis, nor when the money is withdrawn from the account.

The total that can be contributed to any combination of traditional ira and Roth ira is $2,000 per person. As long as you meet the income restrictions, you can have a Roth ira in addition to an employee retirement plan contribution and/or a self-employed retirement plan such as a sep-ira or Keogh. And the good news just keeps coming: if you have some work as an employee and participate in your employer's 401(k)

or 403(b) retirement plan based on that income, you can still contribute to a SEP-IRA, Keogh, or SIMPLE plan based on your IP earnings.

A Few Words Before Investing

There are many factors to consider when deciding which retirement plan is best for you. It's essential that you review carefully all the rules and regulations that apply to the various plans. You may also want to consult with a financial or tax advisor to consider the advantages and disadvantages of each one. (Though I appreciate you reading all the way to the end, I have to admit that this article is just an introduction, and isn't — or shouldn't be — everything you always wanted to know about retirement plans.)

If you decide to open a retirement account on your own, you can do that through a bank, a brokerage house (e.g., Charles Schwab, TD Waterhouse, E*Trade, etc.), or with a mutual fund company (e.g., Vanguard, Fidelity, Janus, etc.). Hint: If you're doing this on your own and need more information before investing, be sure to talk directly with the retirement department, because the customer service representatives at banks, brokerages, and mutual fund companies are sometimes unfamiliar with the plans available to self-employed people.

Wherever you decide to open your account and whichever retirement plan you choose, the most important thing is to start contributing immediately, even if you begin with just a small amount each year. Remember, as an IP, there's no one else out there doing it for you! Plan now, so you won't have to eat Alpo later. 1099

The Web has lots of valuable retirement-planning information. There are financial companies that can set up a retirement plan for you; general reference sites; and government-sponsored sites. We've done some of the legwork for you and collected some of the best links for IPs. You'll find them at **1099.com/retirement**.