# There's a Better Way: How Small-Business Owners and the Self-Employed Can Save More for Retirement

**By Reed Smith and Matthew Senger**

Albert Einstein is attributed the famous quote describing compound interest as the eighth wonder of the world. Unfortunately, he was not around long enough to benefit from the proliferation of retirement vehicles allowed to invest in marketable securities, which enabled that compounding to occur in a tax-deferred, or even tax-free, environment. Through the early 1960s, employees were mostly covered by the defined benefit pensions of large corporations, many of which were famously underfunded, Studebaker being the prime example and legislative tipping point. Change arrived in 1962, when the Keogh Act made qualified pension plans available to self-employed persons, unincorporated small businesses, farmers, professionals and their employees. Twelve years later, the Employee Retirement Income Security Act of 1974 (ERISA) established individual retirement accounts (IRAs). As thankful as we all are for the creation of this ninth wonder – tax-free compound interest – the increase in retirement account types has led to an abundance of options, creating confusion for small companies and self-employed individuals who lack the resources and time required to identify the best option. We have you covered.

Defined benefit plans, most often known as a pension, and defined contribution plans, such as a 401(k) or 403(b), are well known because of media coverage and the sheer number of participants in each. Pensions, usually preceded by an adjective describing how adequately funded they are, are often the subject of news stories, and 401(k) plans are common at larger firms that have abandoned pensions. However, outside of those two plan types exists an oft-overlooked subset of the retirement investment spectrum offering benefits that are uniquely advantageous to sole proprietors and small-business owners. These plans are often much easier to create and administer and can have large contribution limits, which can be attractive to a small, under-resourced organization or retired executive who has some consulting income and wants to contribute a significantly larger amount to a retirement vehicle than the $5,500 ($6,500 for those over 50) allowed for traditional IRAs.

Whether it is a small-business owner, a retired professional receiving consulting income or an employed individual with a small side business, many successful professionals generate self-employed 1099 income, requiring them to pay both the employer and employee tax portion. These taxes include Social Security, Medicare and federal income tax. Three retirement plan types that are most suitable to these professionals exist: the Savings Incentive Match Plan for Employees (SIMPLE), the Solo 401(k), often referred to as an Individual 401(k), and the Simplified Employee Pension (SEP) plan. All three plans offer certain tax advantages – namely, tax-deferred growth and the corporate tax deduction of employer contributions. That is where the similarities end, though, as they differ in how they are set up and how much they can be funded with. Understanding these differences is important, as each small-business owner or self-employed professional may have different needs when it comes to funding his or her retirement.

### Savings Incentive Match Plan for Employees

A SIMPLE IRA is ideal for small-business owners with 100 employees or fewer who do not have any other type of retirement plan and who are looking for their employees to participate in the funding of their own retirement. These plans are funded by both the employer and employee through salary reductions and, importantly, a mandatory employer contribution every year. As the name suggests, they are easy to set up and administer, and all contributions immediately vest.

There are two big disadvantages to SIMPLE IRAs. The first is their relatively low contribution limits of $12,500 per year. This contribution limit increases to $15,500 when an individual turns 50 years old in a calendar year through what is called a catch-up contribution. The second disadvantage is that employers have an obligation to contribute to these plans each year either through a match or a nonelective contribution of up to 2% of compensation for eligible employees. Eligible employees include anybody who has made $5,000 in compensation during any of the two years preceding the current calendar year and is reasonably expected to receive at least $5,000 in compensation during the current calendar year. For businesses in growth mode, or for those with less predictable cash flow, a mandatory annual contribution for each employee may not be feasible.

SIMPLE IRAs follow the same distribution rules as traditional IRAs in that individuals can begin receiving funds at 59 ½ years old with no 10% penalty and must start receiving funds by April 1 of the following year in which they turn 70 ½. No matter one's age, though, when a SIMPLE IRA is established, funds must be held in that plan for at least two years. If funds are transferred or withdrawn before the two-year participation rule, the penalty is more severe at 25%. All funds distributed from a SIMPLE IRA are included in an individual's ordinary income.

### Solo or Individual 401(k)

A Solo or Individual 401(k) plan is most ideal for sole proprietors and business owners with no employees, other than a spouse, and no future plans to add any. These plans can be funded with much higher contribution limits than SIMPLE IRAs. The business owner (individual) in these plans is considered the employer and employee, and therefore can make both a salary reduction contribution of up to $18,500 and a profit sharing contribution of up to 25% of compensation (not to exceed $55,000) when combined with the salary reduction contribution. A Solo 401(k), similar to a SIMPLE IRA, also allows for an annual catch-up contribution of an extra $6,000 when a participant turns 50 years old. These limits are similar to the types of 401(k) profit sharing plans seen at big corporations; however, like SIMPLE IRAs, Solo 401(k) plans are easy to set up and vest immediately. Another advantage to Solo 401(k) plans is the flexibility they can offer by permitting an owner to allow the plan to include loans.

Unlike SIMPLE IRAs, the major drawback of Solo 401(k) plans is that they involve more administrative work to remain in compliance. As such, these plans require a plan administrator, who will be responsible for periodic plan amendments resulting from any legislative changes, as well as annual IRS tax filings through IRS Form 5500 once plan assets reach $250,000.

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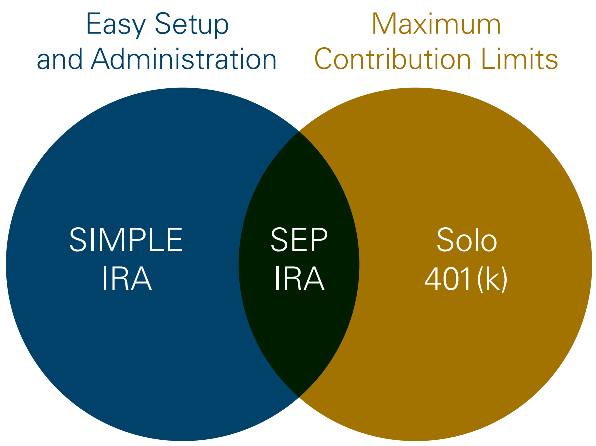
**Retirement Strategies for the Small-Business Owner and Self-Employed**




## Simplified Employee Pension Plan

If it seems like we have painted two incomplete pictures of the perfect retirement planning solution for small-business owners and sole proprietors, it is because we have. Fear not, however, as the ideal combination of easy setup and administration and high contribution limits does exist. The answer? SEP IRAs. Similar to SIMPLE IRAs, SEPs are easy to set up and administer – almost as easy, in fact, as a traditional IRA. In order to establish a SEP, a small-business owner or self-employed professional would simply need to execute and keep a record of a 5305-SEP document (found on the Internal Revenue Service's website). This document does not need to be reported to any regulatory agency and can simply be held on file by an IRA custodian or personally.

Unlike a SIMPLE or traditional IRA, the contribution limit for a SEP IRA is very generous. An employer can fund the plan with the lesser of 25% of compensation or $55,000 (for 2018) – 10 times a traditional IRA's contribution limit. In addition, all contributions are tax deductible to the business. A major advantage to a SEP contribution is that there are no age restrictions on when a professional must stop making contributions, compared with the limit of 70 ½ years old for traditional IRA contributions. As long as the business owner has eligible compensation, he or she can continue making employer contributions after age 70 ½. A SEP is then managed exactly like a traditional IRA and can even be rolled into a Roth IRA. While there are tax implications for doing the latter, those taxes are essentially a wash due to the initial contribution's tax deductibility. In fact, the SEP IRA contribution and subsequent rollover to a Roth IRA can be a highly advantaged strategy so long as there is 1099 income. In a traditional backdoor Roth, a participant can get around income limits by contributing to a traditional IRA first and then rolling it into a Roth. However the amounts, as discussed, are capped at $5,500 ($6,500 for those over 50 years old) annually. With a SEP, those contributions can be up to 10 times as large, allowing for a $55,000 backdoor Roth. Therefore, the simplicity of establishing and administering a SEP combined with generous contribution limits to the business owner or self-employed professional create a very favorable solution for those with active income who do not want the administrative hassle. SEP IRA plans also follow the same rules as traditional IRAs when it comes to withdrawing money. Once an individual reaches age 59 ½, he or she can begin withdrawing the funds with no 10% penalty and, as in SIMPLE IRAs, an individual must start withdrawing the funds by April 1 of the following year in which he or she turns 70 ½. That is, of course, unless the plan has been rolled into a Roth IRA, at which point there are no mandatory distributions. All funds withdrawn are subject to an individual's ordinary income rate.

As a trusted advisor to business owners and executives, Brown Brothers Harriman's goal is to find efficiencies for our entrepreneurial clients. Taking advantage of a SEP IRA is a wonderful, efficient way to maximize retirement contributions and allow for years of tax-deferred, or tax-free, compounding – a strategy that we are confident would garner Einstein's approval.

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