Small Business Retirement Plans

[Editor's Note: This is a guest post from Kayla Sloan, a writer for ListenMoneyMatters.com. I've written on this subject before, here and here, but it has been 3-5 years and I thought it was perhaps time to address it again. I have no financial relationship with the author or the linked site.]

Being your own boss sounds great, doesn't it? You get to set your own hours and decide how much you will work, where you work, what you do, and more. Although it sounds like a dream job, keep in mind there are drawbacks as well. There's no employer withholding your taxes, nor do you have the benefits of vacation and sick days, health insurance, and a retirement plan paid by your employer.

Even though you're on your own, there are ways to save for your future retirement. Here are three popular investing options for small business owners.

 # 1 Simplified Employee Pension (SEP IRA)

The IRS allows you to contribute up to 25% of your earnings net of the employer portion of self-employment taxes and the contribution itself [basically 18-19% of gross income for most docs-ed], with a maximum of $53,000, into a SEP-IRA. These are pretax earnings, just like a retirement account through an employer would be. You can establish an account through your bank or through another financial institution of your choice *[like Vanguard-ed.]* Then, fill out an IRS Form 5305-SEP-Simplified Employee Pension—Individual Retirement Accounts Contribution Agreement.

One of the really nice things about this type of account is you can wait right up until you are going to file your taxes to set it up, allowing you to take advantage of knowing exactly how much your tax bill is for the year. If your tax bill is high, you can increase your SEP contribution and reduce the amount of taxes you have to pay.

There are drawbacks to this type of retirement plan if you have employees, however. You must establish SEP-IRAs for them if they are over 21 and have performed services for you in at least 3 of the immediately preceding 5 years. You don't have to contribute every year, but if you contribute to one employee you must contribute to all, and employees can't contribute to this type of account themselves.

[Editor's Note: A SEP-IRA is an acceptable option for a doc with no employees who has no interest in a Backdoor Roth IRA or who is willing to convert the entire SEP-IRA every year to allow for a Backdoor Roth IRA. It is also a useful one-year "band-aid" if you failed to open a 401(k) in time since you can establish it in April for last year, whereas an individual 401(k) is required to be open by the end of the calendar year.]

 # 2 Savings Incentive Match Plan for Employees (Simple IRA)

If you have fewer than 100 employees, a good retirement option would be a Simple IRA. Like a SEP-IRA, your contributions to these accounts are tax-deferred until the funds are withdrawn. The maximum amount of money you can invest in one of these accounts is $12,500 for 2016, but if you are over 50 you can add another $3,000 to this figure. If you choose this option you must also contribute either a 3% matching contribution or a 2% fixed contribution to the employee. To get started, fill out the IRS Form 5305-Simple-Savings Incentive Match Plan for Employees of Small Employers (SIMPLE)—for Use with a Designated Financial Institution. If you plan to allow your employees to choose the financial institution, however, the form to fill out would be Form 5304-Simple-Savings Incentive Match Plan for Employees of Small Employers (SIMPLE)—Not for Use with a Designated Financial Institution. Then open a Simple IRA account through a bank or other financial institution.

One drawback to this plan is that you must wait two years to withdraw funds or be subject to a 25% penalty. Instead of withdrawing funds, you could roll them over into another IRA without incurring any penalty. Another downside comes into play if you have a second job and contribute to a 401K plan. Any contributions to your Simple IRA are counted against your 401K plan.

[Editor’s Note: The main problem with a SIMPLE IRA is the low contribution limit. For this reason, it’s a lousy option for a doc without employees. It also counts against you when it comes to the pro-rata calculation on the Backdoor Roth. However, if you have employees AND really want to offer them retirement benefits, it’s not the worst thing in the world. But chances are you’re going to spend a lot of money on matching funds in order to defer your $12,500. I mean, assume you get a $5K tax deduction for your contribution but have to contribution 3% for your 5 employees whose salaries total $200K. You just paid $6K in order to defer $5K in taxes. Not exactly a winning formula unless providing for your employees’ retirement is more important to you than providing for your own.]

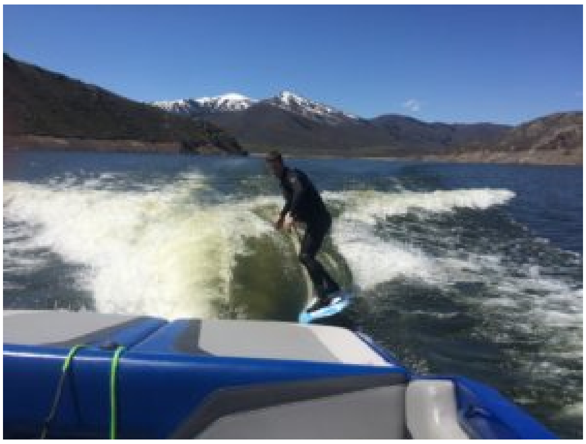
 # 3 Individual (Solo) 401K

Business owners and their spouses may choose this option because of the higher contribution limit of $18,000 per year for 2015 and 2016. If you are over 50 you can add another $6,000 in contributions. Again, these are pretax dollars. You can add an additional 25% of your net earnings *[Same as the SEP-IRA, ~ 18-19% of gross self-employment income-ed]* if you are self-employed, up to a maximum contribution of $53,000. There’s no minimum amount which allows you to control how much of your salary you have available as disposable income for the year and how much to allocate toward investing. If you have another IRA account that was a rollover from a previous employer’s 401k, you can roll them into this account as well *[a great way to avoid pro-rata issues with a backdoor Roth IRA.-ed]*

You may be able to borrow against this account in times of need. *[50% of the balance up to $50K total, but be sure your plan document allows for loans, many don’t.-ed]* Restrictions may apply, such as a limit on how much you can borrow and how long you can take to pay it back. A disadvantage is that this is not an option if you have employees. You can only set up this type of investment account for yourself and a spouse.

[Editor's Note: I prefer this account over the SEP-IRA for the self-employed physician without employees because it allows for higher contributions for those with income below ~$285K than a SEP-IRA and allows you to do a Backdoor Roth IRA. Setting it up is slightly more hassle than a SEP-IRA, and fees at Vanguard are slightly higher (because you can only use the higher-priced investor shares where you can do admiral shares in a SEP-IRA) but I think it is worth it. There are other options for individual 401(k)s and you can even have one in addition to your employer's 401(k), so long as you have self-employed income.]

Being self-employed does have some disadvantages, but the inability to invest doesn't have to be one of them. By choosing one of the 3 investing options for small business owners, you can add investing to your list of advantages for self-employment.



Wakesurfing…almost as fun as finding out you're eligible for another retirement account

[Editor's Note: This is where the submitted guest post ended. But I think it ought to be extended a bit because there are at least three other good options. The remainder of the post is

written by me.]

4. A Formal 401(k)

If you have no employees, the individual 401(k) is almost a no-brainer. However, if you have employees, things get a lot more complicated, especially if your goal is to maximize your own tax-deferral while minimizing how much you're spending on the employees. In fact, it can get so complicated that it is a good idea to hire a pro to do an analysis of your business and goals to determine the best way to proceed. But suffice to say that one commonly chosen option is to simply start a 401(k) like any employer may offer. This will probably allow you a higher contribution than a SIMPLE, while allowing you to spend less on your employees than using SEP-IRAs. There is a dramatic difference in how much you can spend on this, so look for low fees and experience with small practices.

5. Defined Benefit/Cash Balance Plans

Another retirement account you may use is a defined benefit or cash balance plan. This can be stacked on top of your 401(k). If you have employees, you're probably going to need/want professional help setting this up. If you don't, a personal defined benefit plan is an option. Schwab is one of the bigger names offering these. Fees are definitely higher than an individual 401(k), however. For instance, Schwab charges a set-up fee of $1500 plus $1500 a year. But for a highly compensated physician, especially an older one who is behind on his retirement savings, this can be a great option despite the higher fees.

6. Personal Savings

Another option that many self-employed with employees choose is to simply avoid a plan all together. You don't have to offer anything to your employees if you do all of your savings in a personal Backdoor Roth IRA ($5500 a year, $6500 if over 50), a spousal Backdoor Roth IRA (another $5500-6500), and a taxable account (unlimited contributions.) However, before deciding to do this I would hire a professional to see just how much it is likely to cost you to implement a 401(k), it may be less than you think and you might even be able to reduce salaries or other benefits somewhat to help make up the difference in your cost.

What do you think? If you are self-employed, which of these plans do you use? Have you considered changing? Why or why not?