

A quick look at...

RETIREMENT PLANS

The following is an overview of conventional retirement plans. All grow tax-deferred. All but the Roth IRA can be tax deductible. This means that if you contribute \$1,000, you pay no income tax on that \$1,000 (it is deducted from your taxable income) and you pay no tax on the annual growth of that \$1,000 (the tax is deferred). You pay tax only when you withdraw money for retirement, and then you only pay tax on the amount withdrawn each year; the rest continues to grow tax-deferred. In the case of the Roth IRA, withdrawals are tax-free. (For all plans, if you withdraw money before retirement, tax and penalties usually apply. These can consume 40 percent of the amount withdrawn.) The Tax Reconciliation Act of 2001 enacted new contribution limits for the next several years. Congress may change the rules again, so verify applicable limits each year.

If you are an employee:

- **IRA** (Individual Retirement Account): An IRA is easy to set up and maintain. You can contribute up to \$3000 annually through 2004, \$4,000 for the years 2005-2007, and \$5,000 from 2008 on. Beginning at age 50 you can even make additional “catch up” annual contributions (\$500 through 2005, \$1,000 thereafter). Your non-employed spouse can also set up a plan. There is no required annual contribution, though there are restrictions if you also contribute to another retirement plan. Everyone should have an IRA.
- **ROTH IRA**: Like a regular IRA but—the bad news—your contribution is not tax-deductible. The good news is you will never again pay any tax on money withdrawn for retirement. You pay tax when you put your money in, but that is it. You pay nothing when you withdraw your original contribution and all of its earnings. Roth IRAs are great for younger workers and a wonderful gift for a grandchild with an after-school job.
- **401(k)/403(b)/457 plans**: With any of these plans you can contribute up to \$11,000 annually if the plan is funded only with your money. (This limit increases \$1,000 annually until 2006 when it reaches a maximum of \$15,000.) Beginning at age 50 you can make additional annual “catch up” contributions (\$1,000 extra in 2002 and increasing \$1,000 each year until it reaches \$5,000 in 2006). In most plans your employer offers several investments, usually mutual funds, and then you choose which ones you put your money into. This is your personal retirement account and it stays with you—even if you do not stay with the company.
- **SIMPLE, SEP, MONEY PURCHASE, and PROFIT SHARING** plans: (See other side for details.) These plans are typically found in small businesses. If your boss has set up one for himself, then by federal law he must offer you the same plan with the same benefits.

If you are a sole proprietor (with few, if any, employees):

- **IRA:** see above
- **SIMPLE** (Savings Incentive Match Plan for Employees): An easy plan to set up, you usually need to submit only one form to the IRS. You can contribute up to \$7000 a year (this limit increases \$1,000 annually until 2005). Your employees can choose to contribute up to \$7,000 from their wages pre-tax. The company must also contribute up to an additional 3% as an employer match contribution. Plus, you and employees can put in another \$500 “catch up” annually if you/they are over 50.
- **SEP** (Self-Employed Pension): Owners can contribute up to 15% of their net earned income (Schedule C net income minus one-half self-employment tax and owner’s retirement contribution; this factors out to 13.04%). The annual limit is \$40,000. A SEP is easy to set up and flexible; you can contribute as little or as much as you want up to the limits in any particular year. The downside: if you have employees, the business must contribute the same percentage of their wages that you contribute for yourself, not as deferrals from their wages.
- **PROFIT SHARING PLAN:** somewhat like a SEP except your employer contributions for you and employees must be “substantial and recurring.” In other words you cannot contribute money one year and then add nothing for the next five years. You can *occasionally* omit an annual contribution if you have had a bad business year. This is a good plan for people in the early stages of self-employment.
- **MONEY PURCHASE PLAN:** with this plan you make employer contributions that are a set percentage of employee income or self-employment business profits (for owners) each and every year—no matter how good or bad a particular year was. You choose the percentage, but after that the same percentage must be used each year. This is a plan for an established business with a dependable cash flow. There is a \$40,000 annual limit.

If you have more than a few employees:

Federal law says you cannot give yourself a good retirement plan and then give your employees an inferior one. The government wants to ensure that employees and employers have comparable plans. Deciding what “comparable” is, however, quickly becomes complicated, especially as your business grows and becomes more complex. And if you make a mistake, the penalties are stiff.

Remember this is only an overview; each plan has its own special rules. Your Cambridge Advisor can help you explore possibilities for saving self-employment income for retirement.

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