Tax Tips You Can Use Aug 2007

Financing Retirement Part 3

By Kathleen Crawford, EA

This article is the third in the series about retirement savings. In June, 401K plans for employees were discussed and in July, traditional and Roth IRA's were outlined. This article discusses special plans to assist the self-employed in saving for retirement.

The most common type of special retirement savings plan for the self-employed is the SEP or Simplified Employee Pension plan. It can be thought of as a hybrid plan. It has rules for contributions and withdrawals similar to an IRA, but the contribution limits are more in line with a 401k. Retirement savings plans for the self-employed are complicated if the self employed person also has employees. In most cases, the plan for the owner of the business must be duplicated for the employees. If the owner of a sole proprietor business, a partnership or a single member LLC has employees there are several plans available to the business and several complications to be aware of. This article will only address a plan for the self-employed person with no employees.

A SEP account is set up similar to an IRA account. Contributions are allowed up to 25% of the net income from self-employment, with a maximum contribution of $45000.00 in 2007. The net self-employment income must be reduced by the contribution and the SE tax deduction before the 25% is calculated. As an example, if Susan nets $80,000.00 on her schedule C and wants to contribute the maximum to her SEP account, her contribution could be $14870.00. If that sounds confusing, it is. Tax preparers have tables to help with this calculation. Once the money is in the account, it is subject to rules similar to IRA's. That is, withdrawals taken before age 59 and 1/2 are subject to a 10% penalty unless one of the very limited exceptions applies. Money must be withdrawn starting at age 70 and 1/2. All of the money comes out of the account as ordinary income and is taxed at ordinary rates just like pensions, interest or wages.

The SEP account is a good deal for the self-employed, allowing for the possibility of large amounts of retirement savings. The taxpayer must remember, however, that the SEP deduction is not a business expense. The deduction is taken on the income tax form. The amount used to calculate the self employment tax is taken from the net business income on schedule C, E or F- before the amount moves to the final tax form. Contributions to a SEP will lower the taxpayers income tax, but will have no effect on the taxpayer's self employment tax. Also, an individual cannot use a SEP and an IRA in the same year.

Two last comments about retirement and retirement savings. First, some people have the misconception that once a person begins receiving social security, they no longer are required to pay into social security. This is not true. If a person's wages or income is subject to social security withholding, it does not matter what their age is. Some types of accounts allow for contributions past the age of 70 and 1/2. A person with income could be in a position to contribute to their retirement fund and be forced to take distributions in the same year.

The fine print is that this article is for information only. Please call Kathy or a tax professional for questions about your individual tax situation. The Jacksonville Tax Lady can be reached at 541-899-7926 or at 610 North Fifth Street.