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RETIREMENT PLANNING

Set up your own pension as a self-employed business

BY MATT KEELING, CFP

Joe left corporate America to become a consultant in the health-care field, leaving behind the bureaucracy, deadlines and inflexible work schedules. But Joe also discovered he had left behind 401K matching, a corporate pension and stock options as he zoomed past age 50. While the financial and emotional rewards of his new venture were even better than he envisioned, in the back of his mind he wondered how he could possibly save enough for the day when he didn't want to work anymore.

What Joe didn't know was that the government was on his side. The major tax overhaul in 2001 did more than just lower tax rates; it created a spate of new retirement plans directed specifically at small business owners and the self-employed. These new plans allow the self-employed to make extremely large yearly retirement plan contributions without IRS private letter rulings or scrutiny

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RETIREMENT PLANNING

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by the federal Pension Benefit Guarantee Corporation.

Since Joe is self-employed, he was able to set up an employer-sponsored defined benefit pension plan.

The yearly contributions are based on a formula taking into account Joe's age, his retirement date and the percentage of his current salary he'd like to start receiving on that date. Portfolio management and risk are entirely under the control of his company. There are restrictions on when and how Joe can withdraw funds without penalties. And there are administrative costs as well.

But those costs can be offset by the amount of tax-deductible contributions Joe can make every year. In his case, based on age and income, that contribution is substantial – $130,000. And since the plan is considered a pension, he also can make employee contributions to an individual 401K plan for both himself and his wife of $20,000 each in 2006, as his wife is on the payroll. The 401(k) limit is normally $15,000, but because Joe and his wife are over age 50 they are eligible to make an additional $5,000 catch-up contribution. In total, Joe will contribute approximately $170,000 per year in tax-deductible contributions for 10 years.

Based on conservative growth rates assumed on his investments, Joe could have more than $2 million by the time he is 60, which will allow him to maintain his current lifestyle.

By working with a financial consultant and a nimble pension administration firm, Joe can maintain full control over his investments, and have some flexibility regarding yearly contributions. Joe still has his professional independence, while retaining the corporate retirement package he left behind.

> The major tax overhaul in 2001 did more than just lower tax rates; it created a spate of new retirement plans directed specifically at small business owners and the self-employed.

There are three parties involved in establishing and maintaining a defined benefits plan: the business owner, the Third Party Administrator and the financial consultant. The TPA sets up the plan and does the annual administration. A typical company charges about $2,000 a year. A financial consultant is not necessary, but often very valuable – especially if you are so busy running your company that you don't have time to stay abreast of the economy.

As with IRAs, there are some restrictions on how your plan can invest. You can't own personal property or a boat within the plan, for example.

The money in Joe's plan either will be used as a pension – withdrawn on a schedule – or it can be rolled into a traditional IRA; this option can be beneficial, especially if Joe continues to work past his original retirement date.

A defined benefit pension plan is a less attractive alternative for a business that employs many workers. If you set up a pension plan that pays you 80 percent of your salary, you must also set up a plan for all your employees. A spouse who works in the company is not subject to these requirements.

Now, hypothetically, if you are 55 years old and make $250,000 a year and you have a 28-year-old assistant who earns $30,000, the amount you may have to allocate to her pension may be so small – about $1,400 annually – it still may be worth setting up a plan. But if your assistant is 50 years old and makes $45,000 a year, you would have to fund roughly $50,000 a year for that pension.

Ironically, as more large corporations abandon their pension plans, small business owners are finding the very same plans a useful tool for their retirement planning. ■

NECESSARY DISCLOSURE
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