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White paper

Retirement planning for the self-employed business owner

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The way in which a business is structured, the way that federal taxes are levied on the entity and its owners, and the number of employees the business has will all have a significant impact on how business owners plan to save for retirement. In addition, with baby boomers retiring in ever-increasing numbers, coupled with advances in medicine that keep us all living longer, it is becoming more important than ever to reduce the risk that we will outlive our income.

A recent brief from the American Academy of Actuaries[1] states that lifetime income planning is not just an "investment issue." In addition to planning for the accumulation phase, business owners should also be aware of the need for long-term care insurance and fixed annuities as ways to meet future needs due to:

- Longer life expectancy
- Poor or declining health
- Inflation
- Lower than expected investment returns
- Increasing tax rates

This paper will focus on sole proprietors, working partners in a partnership (including a limited liability partnership or LLP) and working members in a limited liability company (LLC). Each of these business owners will have "earned income" from the business that is subject to self-employment tax (Social Security/Medicare) and that "passes through" the business directly onto the owners' personal income tax returns.[2] Further, this paper will deal primarily with small business owners who have few, if any, employees.

Tax-deferred plans

The Internal Revenue Code (the "Code") and the Employee Retirement Income Security Act ("ERISA") have provisions that allow self-employed individuals to save for retirement on a tax-deferred basis and in some cases with only minimal government reporting.

Before exploring other options for retirement savings, self-employed individuals should consider setting up one of the plans described below. Each provides for tax deductible contributions, tax-deferred growth and taxable distributions. Some of these options provide flexibility in the timing and amount of contributions; however, all generally require that all employees employed by the business and who meet the minimum eligibility requirements be given the opportunity to participate in the plan.

Selecting an appropriate plan will depend on:

- Whether the business owner has employees other than a spouse
- What the owner's earned income is from the business
- Whether the business's earnings are consistent from year to year
- Whether the business owner believes the company will grow and there will be additional employees in the future

Here is a brief summary of the available tax-deferred plans from which a self-employed individual may choose.

Type of plan	2019 limit on deductible contributions and major features of plan	2019 catch-up deferral for those age 50 or older	Suitability
Traditional IRA[3]	Lesser of 100% of earned income or $6,000	$1,000	• Self-employed individual • Neither the self-employed individual nor his/her spouse can be a participant in some other employer's qualified plan.[4]
SEP (SEP-IRA) (Simplified Employee Pension)	• All employees are eligible[5] and own their own accounts • Per person contribution cannot exceed the lesser of 25% of compensation or $56,000[6] • Cannot discriminate in favor of highly compensated; subject to top-heavy testing if there are employees besides owner and spouse • No employee deferrals • Easy to implement; no reporting to IRS	n/a	• Self-employed with no employees • Self-employed with only a few employees
SIMPLE IRA	• Employees who had compensation of at least $5,000 in any prior 2 years and reasonably expect to earn at least $5,000 in current year must be included • Employees may elect to defer up to the lesser of 100% of compensation or $13,000 • Requires employer to either (i) contribute 2% of compensation to all eligible employees or (ii) match 100% of employee's deferrals up to 3% of compensation	$3,000	• Not best choice for self-employed with no employees • Only for employers with 100 or fewer employees • Requires commitment by employer to contribute annually to employees' accounts • Can have no other qualified plan
SIMPLE 401(k) (Hybrid of the SIMPLE IRA and safe harbor 401(k) plan)	• Has all the reporting, disclosure and document rules of 401(k) plans with the lower contribution limits of the SIMPLE IRA • Employees may elect to defer up to $13,000 per year • Employer must either (i) contribute 2% of compensation to all eligible employees or (ii) match 100% of deferrals up to 3% of compensation	$3,000	• Not used by many employers • Not best choice for self-employed with no employees • For employers with 100 or fewer employees • Deferral limits less than "regular" 401(k) plan and employer must commit to making annual contribution to employees • Can have no other qualified plan
Code sec. 401(a) defined contribution plans (profit sharing, 401(k))	• Total employer plus employee contributions to defined contribution plans cannot exceed the lesser of 100% of compensation or $56,000 • Employees can defer up to $19,000 of compensation • Employees can borrow from account • If plan permits, employees can make after-tax Roth contributions	$6,000	• Self-employed with no employees[7] • Self-employed with employees • Provides opportunity to save and deduct larger amount • Cannot discriminate in favor of highly compensated; subject to top-heavy testing if there are employees besides owner and spouse

Type of plan	2019 limit on deductible contributions and major features of plan	2019 catch-up deferral for those age 50 or older	Suitability
Code sec. 401(a) defined benefit plan Cash balance (hybrid)	• Defined benefit contribution is based on actuarial factors • The maximum contribution is the amount needed to fund an annual annuity at normal retirement age that does not exceed the lesser of $225,000 or 100% of average compensation for the highest 3 consecutive calendar years	n/a	• High earning self-employed individual • Can also be combined with 401(a) defined contribution plan for maximum savings and deduction • May be costly to provide to other employees

Other methods of savings for retirement

Taxable investments

Of course, the easiest way to save is to stash some cash under your mattress or in a bank savings account. Unfortunately, this is not the most efficient way to accumulate sufficient funds for retirement, particularly in a low interest rate environment. After investing in his or her business, the self-employed business owner could purchase mutual funds, real estate, or other taxable investments that may provide income during retirement. These investments can be cumbersome to monitor, gains on certain investments are taxed each year, and a typical self-employed business owner may not have the time to find and maintain a diversified portfolio of appropriate investments.

Life insurance

Many people don't know that they can use life insurance as a savings vehicle. For the self-employed business owner, an insurance-based income ("IBI") solution may be a better option than a taxable investment for accumulating funds for the future. An IBI solution combines the benefits of:

- Income tax-free death benefit to the business owner's family
- Tax-deferred accumulation of cash value
- Possible loans against the cash value to provide tax-free supplemental income
- Tax-free withdrawals if the IBI solution is funded with universal life or variable universal life insurance

These benefits are available when cash value life insurance is purchased and is not a modified endowment contract (often referred to as a "MEC"). There are a number of insurance products that do not require the business owner to monitor the allocation of cash value among investment alternatives.

In addition, some life insurance policies offer riders to cover long-term care needs, no-lapse guarantees, and other life events for which a self-employed business owner may need to plan.

Other plans

Because sole proprietors and working partners in a partnership, or working members of an LLC taxed like a partnership, cannot take a deduction for "wages" paid to themselves, there are no tax advantages to establishing a nonqualified deferred compensation plan or executive bonus (section 162) plan using life insurance. These types of plans would be appropriate for the employees of a self-employed individual, partnership or LLC.

Case study

John (age 38) and Mary (age 34) are married and practice law together. Like many small firms, they have one employee, Jennifer. Their business is a limited liability partnership (LLP). Together, John and Mary have earned income of $500,000[8] ($250,000 each) this year. Jennifer's compensation from the firm is $45,000 a year and she has worked for John and Mary for 7 years.

Between paying down student loans and establishing their firm, John and Mary have not been able to really think about planning for their financial future. They would like to retire when John reaches age 65, and they plan to have a child in the next few years. Because their success depends on both of them, John and Mary think life insurance is probably a good idea. After meeting with a financial advisor, John and Mary agree to the following plan:

1. Planning for the unplanned

Cash for short-term emergencies
John and Mary will increase the monthly contribution to their emergency cash account at the local credit union. The goal is to keep at least six months' worth of expenses, plus a little extra for increasing property taxes, home repairs, etc. in that account.

Insuring against a disability
John and Mary decide to purchase individual long-term disability insurance on each of them with a 180-day elimination period to keep the premiums lower. (They have medical insurance through their local bar association.) Because they are professionals and in good health, they are able to obtain coverage to age 65 that cannot be cancelled by the insurance company and that protects them against the inability to practice law.

Insuring against premature death
Because John and Mary are planning to start a family and both are responsible for generating income, they agree that they should purchase life insurance on both their lives. An analysis by their financial advisor reveals that they should each be insured for at least $1.2 million.

2. Saving for college

John and Mary believe that they will set aside funds for their child's education, but decide to postpone setting up a separate savings vehicle until they actually have a child.

3. Saving for retirement

John and Mary have about 27 years until retirement, during which time they expect their earnings to increase. They also hope that, over time, the law firm will grow and that they will be able to hire associates and staff. Ultimately, they would like the firm to continue even after they're gone.

- Because the firm is still small, John and Mary decide to establish a Simplified Employee Pension (SEP) plan using the IRS Model SEP. By doing so, they avoid costly administration and reporting to the IRS. The Model SEP requires that they include Jennifer in the plan because she has met the minimum requirements for inclusion. The maximum contribution to each individual's account is the lesser of 25% of compensation or $56,000 (2019 limit). The maximum deductible contribution to the SEP would be
  - Jennifer (25% X $45,000) = $11,250
  - John (20% X $250,000) = $50,000[9]
  - Mary (20% X $250,000) = $50,000

- John and Mary decide they will contribute 12% of compensation for the next 3 to 5 years, but will evaluate their ability to increase it annually. So, for the current year, they will contribute $5,400 to Jennifer's SEP account and $26,786 to each of John and Mary's accounts. (Note: if John and Mary's contribution increased by 3% each year and had an annual rate of return of 5%, they would have about $2 million in each account at the end of 27 years.)

- Depending on how fast and large the firm grows, John and Mary have the option of stopping all contributions to the SEP (termination of the plan) and establishing a 401(k) plan in the future for the growing number of employees. That plan could include matching contributions as well as profit sharing contributions to John, Mary and their employees.

  - A SEP will provide a savings vehicle for retirement, but it does have some disadvantages: 1) withdrawals before age 59½ will be subject to a 10% early withdrawal tax in addition to ordinary income tax on the amount withdrawn; and 2) loans are not permitted from the SEP.

    To satisfy their need for life insurance and to provide a source of funds that can be withdrawn income-tax free or taken out as a loan in the future, John and Mary decide to purchase an IBI solution that combines both term and permanent life insurance. In addition, because they are still young and healthy, they add a long-term care rider to the permanent insurance.

Conclusion

Although sole proprietors and working partners in a partnership and working members of an LLC are not able to treat themselves like employees for all tax-qualified and nonqualified retirement savings vehicles, there are still tax-deferred and tax-preferred ways to accumulate savings for retirement (or for college education, a vacation home or one of life's curve-balls). Depending on the amount and stability of earned income and the number of years until retirement, a SEP together with an IBI solution is one way to provide a self-employed individual or couple with:

- Flexibility in the amount and timing of contributions to the SEP and IBI solution
- Permanent life insurance to
  - o protect loved ones against the possibility of premature death
  - o provide long-term care insurance
  - o provide income tax-free distributions (or loans) from the IBI solution's cash value

Just like John and Mary in the case study, clients need to understand that planning for their financial future, staying on track, and achieving their financial goals is an on-going process that needs to be reviewed regularly. Planning for events beyond their control — death, disability, daily living assistance – are a few of the things that they can insure against, much like damage due to a hurricane or fire. In addition, there are goals that clients can set with respect to events over which they have some control, such as having children, paying for college and saving for retirement. The old adage that "failing to plan is planning to fail" is as true today as ever. Average life spans continue to increase, and medical innovations keep us healthier longer. It is imperative to begin planning for the future now.

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[1] *Lifetime Income Initiative, Risky Business: Living Longer Without Income for Life, Actuarial Considerations for Financial Advisers,* October 2015, www.actuary.org.

[2] Under Internal Revenue Code sec. 401(c) a self-employed individual is a person who has earned income; that is, net earnings from a trade or business in which personal services are a material income-producing factor. An owner-employee is an employee who owns the entire interest in an unincorporated business or a partner who owns more than 10% of either the capital or profit interest in a partnership.

[3] Assumes that neither the individual nor his/her spouse is an "active participant" in a qualified plan, SIMPLE IRA, SEP, 403(b) plan or a government plan.

[4] A taxpayer can make non-deductible after-tax contributions even if one or both of them participates in another plan.

[5] All employees who are at least age 21, received no less than $600 in compensation during the year and worked for this employer in at least 3 of the immediately preceding 5 years.

[6] If the employer maintains another defined contribution plan, the limit on contributions to all plans combined is the lesser of 100% of compensation or $56,000 (plus the catch-up if age 50 or over).

[7] A self-employed individual with a spouse employee (and no other employees) can establish a "Solo 401(k)" plan. No Form 5500 is due until assets reach $250,000; no nondiscrimination testing required.

[8] Calculations in this case study have been simplified for ease in explaining and understanding certain concepts.

[9] Because John and Mary are self-employed, they must calculate the maximum deductible contribution based on a special calculation that already takes into account the deductible contribution to the SEP when figuring net earnings from self-employment.

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