Retirement Savings for the Self-Employed

Many tax-favored options are available to self-employed individuals to provide for their retirement. Tax planning for retirement can include deductible contributions to a traditional or Roth IRA, SEP plan, SIMPLE plan or a one-person 401(k) plan. You may wish to consider implementing one of these plans for yourself and/or your employees to benefit from a current tax year deduction and accumulate tax-deferred retirement savings.

Each of these plans has advantages and disadvantages, and some may not be applicable to your situation. For example, a sole-owner 401(k) retirement plan allows a contribution for you as both an employer *and* as an employee. Therefore, a sole-owner 401(k) plan may provide for the largest deductible contribution. However, a sole-owner 401(k) is not available to the self-employed with employees other than a spouse or relative. As an alternative, a SEP or SIMPLE plan may have less administrative costs. Ultimately, the choice of savings vehicle will depend on factors related to your business and your retirement needs. Regardless of which plan you qualify for or what your retirement needs are, it is important to begin planning now for your retirement.

Solo 401(k)s

A one-participant or solo 401(k) plan is similar to a traditional 401(k), except that it covers only the business owner or owner plus spouse. These plans have the same rules and requirements (for the most part) as any other 401(k) plan. They can include the owner's spouse, or partners and their spouses.

The business owner is both employee and employer in a 401(k) plan, and contributions can be made to the plan in both capacities. The owner can contribute both:

- Elective deferrals up to 100 percent of compensation (earned income in the case of a self-employed individual) up to the annual contribution limit ($22,500 for 2023 with a $7,500 catch up contribution if at least age 50; and $20,500 for 2022, plus $6,500 if age 50 or older); and

- Employer nonelective contributions up to 25 percent of compensation as defined by the plan (for self-employed individuals the amount is determined by using an IRS worksheet and in effect limits the deduction to 20 percent of earned income).

For 2023, the Solo 401(k) total contribution limit is $66,000 or $73,500 if you are age 50 or older.

Traditional or Roth IRA

A traditional IRA allows a taxpayer to deduct contributions on their income tax return or elect to treat those contributions as nondeductible. Earnings in the IRA are allowed to grow tax-deferred and are only subject to income tax when they are distributed. There is no age limit for making contributions. Distributions are required to be taken annually when the IRA owner reaches age 72. For 2023, total contributions to a taxpayer's traditional and Roth IRAs cannot be more than the lesser of $6,500 ($7,500 if they are age 50 or older), or their taxable compensation for the year. In 2021 and 2022, total contributions max out at the lesser of $6,000 ($7,000 for age 50 or older), or their taxable compensation for the year. In addition, the taxpayer may not be able to deduct all contributions if the taxpayer or the taxpayer's spouse participates in another retirement plan at work.

A Roth IRA is generally subject to the rules that apply to a traditional IRA. Unlike a traditional IRA, however, a taxpayer cannot deduct contributions to a Roth IRA and qualified distributions from a Roth IRA are tax free. In addition, the taxpayer's Roth IRA contribution can also be limited based on filing status and income.

Simplified Employee Pensions (SEPs)

A SEP (Simplified Employee Pension Plan) IRA is a type of IRA for small business owners or self-employed individuals. This type of IRA allows the employer to make contributions to the accounts set up for employees. Contributions are tax-deductible and earnings are not taxable until withdrawal. One advantage of this type of IRA is the higher contribution limit. For 2023, employers can contribute up to 25% of income or $66,000, whichever is less ($61,000 for 2022).

SIMPLE IRA Plan

A SIMPLE (Savings Incentive Match Plan for Employees) IRA Plan is a plan, set up by an employer, in which employees can make contributions of a portion of their pre-tax wages. Employers must also make contributions whether or not an employee elects to defer a portion of their income to the plan. Contributions are tax deductible and investments grow tax deferred until the owner is ready to make withdrawals in retirement. It follows the same investment, distribution and rollover rules as traditional IRAs. SIMPLE IRAs have higher contribution limits than traditional and Roth IRAs and, unlike a SEP IRA, employees can make contributions to their accounts. Any employer that had no more than 100 employees with $5,000 or more in compensation during the preceding calendar year can establish a SIMPLE IRA plan. An employee may defer up to $15,500 in 2023 ($19,000 for employees age 50 or over).

Please consult your tax advisor for how these rules may impact you specifically. Your individual circumstances may require further analysis or consideration of how these rules interact with other elements of your overall tax situation.