

For Entrepreneurs A SIMPLE Plan May Be Best

Q: I own a small decorating business and I'll be the first to admit that I don't know anything about taxes or retirement plans. I'd like to set up a 401(k) or an IRA or some other kind of retirement plan for me and my three employees. What are the various retirement plan options available for a small business owner and in your opinion, which would work best for me?

-- Wanda S.

A: Wanda, I appreciate your confidence in my humble opinion, but asking me for financial advice is like asking Donald Trump for a recommendation on hair care products. I can tell you what works best for me and my business, but you'll need to do your homework and seek professional advice to figure out what would work best for you. As a side note, I hear that Donald Trump is coming out with his own line of hair care product soon to be called "Big Head." The formula is 1% mousse, 1% liquid nails, and 98% hot air. It should be a big seller among the high brow, comb-over crowd.

Here's my best advice on retirement plans: find yourself a financial advisor (or financial planner) who has experience working with small businesses and have him or her explain the options available and make a recommendation as to the type of plan best suited for you and your business. When I say "financial advisor" I'm not talking about your know-it-all brother-in-law or your accountant. I'm talking about a broker or financial planner (or other licensed professional) who has a proven track record of making his clients money and is an expert on IRAs, 401(k)s, mutual funds, etc.

The best way to find a good financial advisor is to ask for referrals from your most successful friends and associates. Find the richest, stingiest man in town and ask who his advisor is. Meet with several advisors, explain your situation, and ask for their recommendations. You should also make sure the advisor is a good fit for your personality and your business. If all goes well you will be doing business with this person for many years to come, so make sure the relationship feels comfortable to you and that you are confident in the advisor's ability to manage your money.

Let me give you a quick overview of a few of the retirement plans available to small businesses so you at least have an idea of what's out there before you start your search for a good financial advisor.

As a small business you basically have three types of retirement plans that you can take advantage of: the Self-Employed 401(k); the Simplified Employee Pension Plan or SEP IRA, and the Savings Incentive Match Plan for Employees or SIMPLE IRA. Each allows you to make pre-tax contributions to the plan, which lets you save for retirement and lessen your taxable income by the amount of the contribution. Your investments also grow tax-deferred until withdrawal.

A Self-Employed 401(k) is an option for self-employed individuals or business owners with no employees other than a spouse. The business can be a sole proprietorship, a partnership, or a corporation, including S corps. You can make salary deferrals to this type of plan of up to \$14,000 for 2005.

Next is the Simplified Employee Pension Plan or SEP IRA. A SEP is an option if you earn a self-employed income from a full or part time business, even if you are covered by a retirement plan at your fulltime job. A SEP allows you to contribute up to 25% of earned income, up to \$41,000 for 2004 and \$42,000 for 2005.

My preferred type of retirement plan is the Savings Incentive Match Plan for Employees or SIMPLE IRA. The SIMPLE IRA was created to make it easier for small businesses with 100 or fewer employees to offer a tax-advantaged, company sponsored retirement plan.

With a SIMPLE IRA you and your eligible employees may contribute up to 3% of earned income (with a maximum contribution of \$10,000) on a pre-tax basis to individual SIMPLE IRAs. You must deduct Social Security and Medicaid from your gross income, but you can then make your SIMPLE IRA contribution before other taxes are levied, effectively lowering your taxable income.

As the employer you must make "matching" or "non-elective" contributions into your employees' SIMPLE IRA accounts. Matching contributions means that the business matches the elective deferral contributions made by employees. For example, if the employee opts to contribute 3% of his salary to the plan, the employer must match the 3% contribution.

At first you might cringe at matching your employees' contributions, but as the business owner and an employee yourself this can be great news. As an employee of your own business you can contribute up to \$10,000 to your SIMPLE IRA and the business can then match your contribution dollar-for-dollar, which means that you can put up to \$20,000 in tax free dollars into the plan per year. The cost of the contributions is also deductible as a business expense.

The non-elective contribution option requires that the company contribute 2% of every employee's earned income to the plan on the employee's behalf

regardless of whether or not the employee contributes to the plan himself. For 2005 the maximum contribution you would be required to make is \$4,200.

Like a traditional IRA, you can withdraw money from a SIMPLE IRA at any time; however distributions within the first two years of participation are subject to higher early withdrawal penalties than traditional IRAs or Roth IRAs. Withdrawals within the first two years are subject to a 25% early withdrawal penalty. Withdrawals taken after the first two years are subject to a 10% early withdrawal penalty.

As the employer, the advantages of a SIMPLE IRA include: company contributions to the plan are tax deductible as a business expense; plan documents are simple and easy to administer; administration costs are low; and there is no government reporting required by the employer.

The advantages of a SIMPLE IRA for your employees include: contributions are immediately 100% vested; contributions and earnings are tax-deferred until withdrawal; employees can contribute 100% of earned income up to \$10,000 for 2005; and employees can direct their own investments within the IRA.

This is a complex topic and I've just tipped the iceberg here, but hopefully this will give you enough information to get the investment ball rolling.

About the Author

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