You don't need big firm to get 401(k)

Options exist for self-employed

By COLLEEN BURKE - GM Today Correspondent *October 3, 2006*

Individuals who work for themselves or own their own business without employing anyone else may want to consider an individual 401(k) to save more money for retirement.

The individual 401(k) has features that may make it more appealing than an IRA or SEP (Simplified Employee Pension), the biggest among them being the higher contribution limits, said Pat Shelton, director of practices at Benefits Plans Plus.

With a SEP-IRA, an employee in an incorporated business can contribute 25 percent of compensation up to $44,000, or 20 percent for sole proprietors, according to Rick Meigs, president of the online source www.401khelpcenter.com.

With an individual 401(k), the maximum contribution is $44,000 or $49,000 for those age 50 and older (because of catch-up contribution rules).

This number is arrived at by adding the person’s profit-sharing contribution (either 20 percent or 25 percent of pay, based on business status) to his or her 401(k) deferral (up to 100 percent of the first $15,000 he or she makes).

An example with numbers plugged into online calculators illustrates how these plans can differ.

A 37-year-old self-employed man claiming sole proprietorship has net earnings of $30,000 in 2006. After calculating various taxes, his self-employment income is $27,880.57.

Under SEP rules, he can sock away $5,576.11, which is 20 percent of his self-employment income.

Under individual 401(k) rules, he can contribute $5,576.11 (20 percent of his pay) - plus $15,000, for a total of $20,576.11.

"The individual 401k is the best of both worlds," Shelton said. "It’s for all kinds of corporations, you can start the plan at any time and you can roll over other money from other retirement plans into it."

Another bonus is the fact that you can borrow against it, an option not available through SEPs.

There is the possibility of tax savings with an individual 401(k) that won’t be fully realized with an SEP.

Downsides to 401(k)

Investors should be aware of the downsides to this product, Shelton said.

Withdrawals from an individual 401(k) are limited to qualifying events such as retirement, disability or death.

"It’s a downside, but I think it’s offset by the loan features," Shelton said.

Individuals who end up taking on other employers will have to give up the individual 401(k) plan. The only exception is adding a spouse as an employee.

Some also may find the costs of setting up and maintaining an individual 401(k) to be prohibitive.

"There is a very select group of people who can fully fund an individual 401(k)," Shelton said. "You need to be willing to use it and have the finances to fund it. If you have a good income and need deductions, you’ll want to use an individual 401(k)."

This product, Shelton said, should be especially appealing to those making between \$50,000 and \$153,000. "If you’re making less than \$50,000, you may not be able to afford funding one."

The self-employed - among them contractors and freelancers - should consult a tax expert or accountant to determine if an individual 401(k) is their best course of action.