



Managing Your Finances

A Pension Plan For the Self-Employed

If you're self-employed, your retirement choices are not restricted to IRAs, individual 401(k)s and other defined-contribution plans. Free agents can establish traditional defined benefit pension plans — the kind of retirement plans that are a dying breed among large companies. The annual tax-deductible contributions you can make are much larger than the \$54,000 maximum allowed with the most generous defined-contribution plan.

Solo pension plans are a great option for entrepreneurs, doctors and real estate agents who want to slash their taxes and turbo-charge retirement savings. "Many of our clients were executives or high in government, retired at 55, and became consultants," says Karen Shapiro, Chief Executive Officer of Glendale, CA-based, Dedicated Defined Benefit Services, which sets up defined-benefit plans for sole proprietors and small businesses.

Also, says pension actuary Joseph Nichols, someone with a full-time job could set up a pension plan to stash earnings from a side business. "They may be hitting the 401(k) contribution limit at work, but would like to defer taxes on outside income," says Nichols, whose Liberty, MO, firm establishes defined-benefit plans. Often, an entrepreneur can live off another pension or a spouse's income and stash away almost all business earnings into the plan.

With a defined-contribution plan, such as a SEP IRA or a solo 401(k), you set aside a percentage of your income each year. The size of your nest egg will depend on the amount you sock away and how well your investments perform. With a self-funded defined-benefit plan, an actuary will help you project an annual retirement payout and then figure out a yearly contribution to meet the target.

The calculations are based on your age, compensation, years until retirement and estimated investment returns of 5% or 6%. The older you are, the larger the annual contribution you can make.

Consider a 56 year-old consultant who earns \$150,000 and plans to retire in six years. He can contribute up to \$120,000 a year to the plan for annual tax savings of \$45,600 at the 38% tax rate, according to Shapiro's firm. If, instead, he sets up a solo 401(k), he can contribute a maximum of \$50,400 a year (See "Build a Nest Egg When You Work for Yourself," June). The consultant is on track to accumulate \$918,000 in the pension plan in six years.

These supersized numbers attracted Tim Rose, 54, a consultant to the casino industry, who lives in Marco Island, FL. Rose had been saving with an individual 401(k), but eight years ago, as his business grew, Nichols helped him set up a solo pension plan. "I knew I wanted to retire early and enjoy life," Rose says.

In the early years, Rose and his wife, who was added to the plan, contributed an annual \$300,000. When Rose's income declined, Nichols amended the plan, and the couple began to contribute \$100,000 a year.

Costs and Other Pitfalls

While you can terminate the plan if you can't keep up contributions, it's best not to start one unless you intend to fund the plan for five years or more. Upfront costs are high: \$1,500 to \$2,000 for an actuary and plan administrator to set up the plan. It costs about \$1,500 a year, which includes the cost of updated calculations and the filing of reports with the IRS.

Once you set the future annual benefit, federal law requires that you fully fund the plan to meet the target. You may have to pay penalties if the plan becomes underfunded. "If you lose a lot of money in one year, you will need to put more money into the plan the next year," says Marcia Wagner, a pension lawyer in Boston.

With that in mind, be sure your income won't fluctuate much from year to year. Also, says Nichols, invest the funds conservatively to avoid an extra-large contribution to make up for any big market drop.

Still, you do have some flexibility to alter the contributions. The actuary can amend the plan by changing the benefit formula. At retirement you can take the lump sum and roll it into an IRA.

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