17. Retirement Plans for the Self-Employed

Introduction

Self-employment has long been part of the American dream. The continued willingness of entrepreneurs to accept the risks of starting their own business is testament to the strength of this dream.

Since 1962, federal policy has encouraged the provision of pensions for the self-employed and their employees through the Self-Employed Individuals Tax Retirement Act. This law created Keogh plans, named for U.S. Rep. Eugene J. Keogh of New York, who sponsored the original legislation. (Sometimes these plans are referred to as H.R. 10 plans, after the number assigned to an early version of the bill.) The act allowed unincorporated small business owners, farmers, and those in professional practice to establish and participate in tax-qualified plans similar to those of corporate employers. The self-employed may either be sole proprietors or members of a partnership.1

Prior to 1962, many small business owners found that their employees could participate in a tax-qualified pension plan, but the employers themselves could not. Self-employed individuals without employees also could not participate in a tax-qualified plan. Furthermore, where two people operated similar businesses and realized similar profits—but one was a sole proprietor and the other was incorporated—the corporate operator could benefit from a pension plan even though he or she was the only employee of the corporation, but the sole proprietor could not.

Legislative History

Keogh plans originally were subject to tighter limits on contributions and benefits and stricter rules governing plan operation than corporate retirement plans. Self-employed individuals were limited to a contribution of $2,500 per year, while (at that time) there was no limit imposed on corporate plans. This provision led to otherwise unnecessary incorporation by self-employed persons solely for the purpose of obtaining the tax benefits for retirement savings. In addition, Keogh plans had stricter limits on vesting and contributions for owner-employees (those with a certain percentage ownership interest). To achieve somewhat greater equity with corporate plans, the Employee Retirement Income Security Act of 1974 (ERISA) increased the annual limit for deductible contributions to Keogh plans to 15 percent of earned income or $7,500, whichever was lower.

In 1981, Congress reviewed Keoghs at the same time that it expanded eligibility for individual retirement accounts (IRAs). The Economic Recovery Tax Act of 1981 retained the 15 percent of compensation deduction limit but increased the dollar maximum to $15,000, effective January 1, 1982.

In the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), Congress established parity between corporate and noncorporate retirement plans. To this end, most of the special rules applicable to Keogh plans were eliminated. Maximum limits for a defined benefit or defined contribution Keogh plan were changed to be the same as those for corporate plans. And many of the provisions relating to owner-employees were repealed. By treating Keogh plans and corporate plans more equally, Congress intended to mitigate the tendency for professionals to incorporate simply to take advantage of the higher amounts that were tax deductible under prior law.

At the same time that many of the rules applicable specifically to owner-employees in Keoghs were repealed, TEFRA added new top-heavy rules for all qualified plans. The rules took the owner-employee concept, expanded it to include officers and other types of company
owners, and applied stricter vesting and contribution limits to plans that benefited a certain proportion of key employees. (For further discussion of these rules, see chapter 4 on pension plans.)

The Tax Reform Act of 1986 made numerous changes in the rules governing all qualified retirement plans, which also affect Keoghs. (For further discussion of these rules, see chapter 4 on pension plans.)

**Eligibility**

The self-employed individual is treated as an employer as well as an employee for tax purposes in contributing to a Keogh plan. In addition, the self-employed individual must make contributions to the plan on behalf of his or her employees.

Keogh plans may be classified as either defined contribution or defined benefit plans. Defined contribution plans are those in which the contributions are defined, and the eventual benefit depends on the total amount of contributions and their investment performance. Defined benefit plans do not specify the amount of contribution but instead define the future retirement benefit in terms of a monthly pension. (For a discussion of the differences between defined benefit and defined contribution plans, see chapter 5.) Self-employed individuals are also eligible to contribute to an IRA but may only make deductible contributions to both an IRA and a Keogh plan if their taxable income is below the levels established for IRAs. (For further discussion of contribution levels, see chapter 16 on IRAs.)

**Contributions and Benefits**

Contributions made by self-employed individuals are not currently taxable to the self-employed individual, and the contributions by the self-employed individual on behalf of his or her employees are not currently taxable to employees. The contributions and any earnings accumulate tax free until distribution, when they are subject to normal income taxes. If distribution occurs prior to age 59½, a penalty tax may be assessed (discussed in section on distributions).

Employee after-tax contributions are also permitted. These contributions, which are currently taxed, generate tax-sheltered earnings. However, special nondiscrimination rules for after-tax contributions may effectively reduce this limit for some employees (discussed in section on nondiscrimination). Keogh plans are subject to the same contribution and benefit limits as other corporate retirement plans under Internal Revenue Code sec. 415. For defined contribution plans, the maximum annual addition may not exceed the lesser of 25 percent of the employee’s compensation (or earned income)² or $30,000 per year. The maximum annual benefit to a participant under a defined benefit plan is $120,000 or 100 percent of the participant’s average compensation for his or her three consecutive highest-earning years. The $30,000 and $120,000 figures are scheduled to be adjusted in the future to reflect changes in the cost of living.

**Distributions**

Keogh plan distributions can be paid in the same manner as other plans, namely in a lump-sum payment (where the entire account balance is distributed in one sum) or in periodic distributions from accumulated reserves as an annuity. The annuity can be in the form of a life annuity—in which a monthly payment is made to a retiree for his or her remaining lifetime and ceases on the retiree’s death—or in the form of a joint and survivor annuity, in which the surviving spouse continues to receive monthly payments after the retiree’s death. Plan distributions can also be paid out in regular installments for a fixed
number of years. (For further discussion of plan distributions, see chapter 4 on pension plans.)

**Taxation**

At retirement, Keogh plan benefits are taxed as they are received. The tax treatment depends on the type of distribution—annuity or lump sum—and generally follows normal qualified plan rules. (For further discussion of taxation, see chapter 4 on pension plans.) A self-employed individual is limited in the use of income averaging\(^3\) and capital gains treatment to distributions that are made after the attainment of age 59\(\frac{1}{2}\) or on account of death or disability. Distributions from a Keogh plan, like those from other qualified plans, prior to age 59\(\frac{1}{2}\) are penalized. Unless the distribution meets one of a limited number of exceptions, it is subject to a 10 percent excise tax in addition to regular income tax. (For further discussion of distribution rules, see chapter 4 on pension plans.)

**Rollovers**

Prior to the Deficit Reduction Act of 1984 (DEFRA), tax-free rollovers of lump-sum distributions could not be made by a self-employed individual from a Keogh plan to an employment-based pension plan or another Keogh plan. DEFRA permitted a tax-free rollover from one qualified plan to another of a distribution attributable to contributions made on behalf of a participant while he or she was self-employed. Tax-free rollovers of Keogh plan distributions can also be made to an IRA.

**Loans**

Loans to participants in Keogh plans are permitted under the rules governing all qualified plans. (For further discussion of these rules, see chapter 4 on pension plans.) However, a Keogh plan may not make loans to self-employed individuals who are owner-employees.

**Nondiscrimination**

Keogh plans must satisfy the same nondiscrimination requirements as other qualified retirement plans. These are designed to guarantee that highly compensated employees do not disproportionately benefit in terms of participation in the plan or in benefits provided. (For further discussion of these requirements, see chapter 12 on nondiscrimination requirements for pension plans.)

**Conclusion**

Over the past two decades, Congress has passed a number of laws designed to provide tax incentives for self-employed individuals to supplement retirement income in addition to their Social Security benefit. Despite these incentives, the unincorporated self-employed have not participated in Keogh plans at a very high rate. However, there is some evidence of growth.

\(^1\)In addition to Keogh plans, the self-employed are also eligible for simplified employee pensions (SEPs). (For further discussion of SEPs, see chapter 11.)

\(^2\)For purposes of computing the limitations on deductions for contributions to a Keogh plan, earned income is computed after taking into account amounts contributed to the plan on behalf of the self-employed individual (i.e., the self-employed individual's earned income is reduced by the deductible contributions to the plan). Furthermore, earned income is computed after the deduction allowed for self-employment taxes.
This distinction will no longer exist for tax years beginning after December 31, 1999, when five-year averaging for qualified lump-sum distributions will be repealed.