The Automatic Millionaire
by David Bach

Six Retirement Plans for Small Business Owners

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Running your own business can be extremely rewarding, and if you do it right can even lead to great wealth. It can also lead to long hours, exhausting work, and ultimately very little wealth.

Unfortunately, many small-business owners are so busy running their companies that they don't acknowledge that risk and take the time to deal with planning for retirement. Instead, they hope to someday sell their business, and use that money as their retirement plan.

The fact is, if you run your own business, you need a real retirement plan -- above and beyond the hope of someday selling your company for a profit.

Pay Yourself First

One of smartest things you can do when you run your own company is to make a decision to pay yourself first.

Doing so means that you set up a retirement account for yourself, and that you decide to keep a percentage of every dollar that comes into your company. Paying yourself first means that this savings will be tax deductible, so that you avoid paying state and federal tax on your earnings.

While this may sound obvious, many small-business owners don't have a retirement account -- or if they do, they don't come close to fully funding it.

Help from the Government

Small business is the engine that fuels the country's economy. According to the Small Business Administration, there were 25.8 million small businesses in the United States in 2005, providing employment for more than 57 million workers, or roughly half the jobs in the country.

One of the things the government does to help small-business owners is make it easier for them to save more money tax-free. If you own your own company, using the government's generous tax breaks can truly make you rich.

Six Great Plans for Retirement

There are more retirement plan choices today than ever before for small-business owners -- the secret is to set one up. Let's go over the basics and see which one makes sense for you:

Option 1: Solo 401(K) Plan

This plan is relatively new and came about as the result of the 2002 tax law changes. It's designed for self-employed individuals with no employees other than a spouse, and is a great option for a small-business owner because it allows you to contribute to the plan as both an employer and an employee, maximizing what you can stash away.

You can fund up to 100 percent of your income to a maximum of $15,000 in 2006 or $20,000 if you're age 50 or older. On top of that, you can use the profit-sharing portion of the plan to contribute up to an additional 25 percent of your income to a maximum of $44,000. In total, your employer/employee contributions cannot exceed $44,000 (or $49,000 if you're age 50 or older).

Check out this math: If you're under 50 and earn, say, $50,000 as a self-employed businessperson, with a solo 401(k) plan you could put the first $15,000 you earn into the 401(k) portion of the plan and then put another $12,500 (25 percent) into the profit-sharing portion. That's a total of $27,500 in pretax savings -- on a $50,000 income!

This is why business owners can get rich faster than regular employees. The deadline to set up your solo 401(k) plan in order to make contributions for this tax year is December 31 (or your fiscal year-end).

Option 2: Simplified Employee Pension (SEP) IRA

This is the simplest plan to set up. If you're incorporated, the maximum you can contribute in 2006 is 25 percent of your income, to a maximum of $44,000. If you're self-employed, you can contribute 20 percent of your net Schedule C income (minus one-half of your self-employment tax) to a maximum of $44,000. To make contributions for this tax year, you need to establish and fund your SEP IRA by April 15, 2007.

Option 3: SIMPLE IRA

With a SIMPLE IRA, you establish a retirement plan for you and up to 100 employees. Employer contributions are mandatory, while employees have the option to fund their own account as well.

In 2006, employees can contribute up to 100 percent of compensation to a maximum of $10,000 (age 50 or older can contribute up to $12,500). As the employer, you're required to match 100 percent of the first 3 percent of compensation for eligible employees (which can be reduced to 1 percent in any two out of five years), or you can choose 2 percent of each eligible employee's compensation. The deadline to establish a SIMPLE IRA was October 1.

Option 4: Defined Benefit Plan

Depending on your age, a Defined Benefit Plan allows you to contribute significantly higher dollar amounts than most other plans.

For example, the maximum amount that a Defined Benefit Plan can provide as an annual benefit is $175,000, depending on your age, income, and retirement date. For a business owner, it's not uncommon for contributions to be in excess of $100,000 per year per individual owner.

This isn't a do-it-yourself plan, though. It's necessary to hire a qualified actuary who specializes in Defined Benefit Plan administration. The actuary should provide full administrative services, including annual reporting and tax filing.

If you're a high-income earner and looking for the highest tax deduction, a Defined Benefit Plan is worth exploring. Your plan must be opened by the end of your businesses fiscal year -- usually December 31s -- in order to make contributions for this tax year.

Option 5: Traditional IRA

A self-employed person has the same option as anyone else working in 2006 who doesn't have a tax deductible plan in place -- and that's to save up to $4,000 pre-tax if you're under age 50, or up to $5,000 if you're 50 or older.

The deadline to establish and fund your plan for 2006 is April 15, 2007. If you fully fund a solo 401(k) plan, SEP IRA, SIMPLE IRA, or Defined Benefit Plan, you won't be eligible for a tax deductible IRA. Instead, you may want to consider using a Roth IRA if you qualify.

Option 6: Roth IRA

Self-employed people can also fund a Roth IRA -- again, up to $4,000 for those under age 50 and up to $5,000 for age 50 or older. Roth IRAs allow you to grow your money tax-free and ultimately withdraw it tax-free, but there's no tax deduction up front.

Before you fund a Roth IRA you must confirm that you qualify to do so. The maximum contribution to a Roth IRA is phased out for single taxpayers with adjusted gross incomes (AGIs) between $95,000 and $110,000 and for joint filers with AGIs between $150,000 and $160,000. Like a traditional IRA, your plan must be set up and funded by April 15, 2007.

The Bottom Line

My recommendation: If you don't have any employees and want to get saving quickly, open a SEP IRA. It allows you to save significantly more money than a SIMPLE, Traditional, or ROTH IRA, and can be opened in 10 minutes at most full-service financial firms, mutual fund companies, or at a bank.