SELF-EMPLOYED PENSION PLAN

KEOGH OR HR-10 PLAN

Self employed proprietors or partners may establish a tax sheltered retirement plan under the provision of HR-10, the Keogh Act. The result is a tax deferment of the top dollars earned, plus a shelter of all earnings on these deposits until retirement.

The fund can grow substantially by the "magic" of compound interest and the interest on dollars that would have been paid in taxes during the accumulation years. The maximum contribution is the lesser of 100% of current earned income or $44,000 (for 2006 as amended by EGTRRA and subject to indexing for inflation in future years).

For purposes of the deduction limit, "earned income" of a self-employed individual does not include the contribution on behalf of the self-employed person. In determining his adjusted gross income, a self-employed person deducts his plan contributions directly from gross income – the deduction is allowable whether or not he itemizes deductions.

Execution of a Keogh Plan requires guidance by a financial planner since there are traps one may fall into unknowingly. There are several options.

DEFINED CONTRIBUTION PENSION

Option 1 - The contribution formula you initially establish locks a person in at that percentage. In other words, no flexibility exists. The formula might be a fixed percentage of all employees' wages, such as 10 percent.

Option 2 - Each year an individual determines what percent of wages is desired to contribute, retaining total flexibility. This is referred to as a profit sharing type of Keogh plan.

The combination of both options provides for flexible planning. For example under Option 1, five percent (5%) could be committed and then under Option 2, a percentage may be determined not exceeding the maximums for defined contribution plans.

DEFINED BENEFIT PENSION

Option 3 - A plan may also be established that will allow larger contributions, based on funding a specific retirement benefit. If there were only a few years until retirement, this would produce a very large payment, which may be very desirable for some individuals. This type of plan calls for a large fixed contribution and is normally suitable for older owner(s).

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INVESTING PENSION PROCEEDS

Funding may occur through a variety of investment vehicles including bank accounts and bonds. There are advantages to each.

The situation, time until retirement and other investment holdings will dictate the most effective funding method.

RECEIVING THE BENEFITS

Funds may be withdrawn in a lump sum and taxes paid on the entire amount (special ten-year averaging rules are available if you were age 50 on or before January 1, 1986). A series of payments can also be taken such as an annuity guaranteed for a lifetime and perhaps the spouse's lifetime too.

A tax penalty of 10% is required for withdrawals made by plan participants prior to age 59 ½, unless disabled; withdrawal used for higher education expenses; up to $10,000 for a new home purchase; or self-employed health care expenditures.

Keogh funds are includible in the gross estate for Federal estate tax purposes. The funds may be paid to a non-marital trust in order to escape taxation at the death of the surviving spouse.

Accumulated funds may also be converted to an annuity, using a variety of the funding products offered by life insurance companies.

REPORTING REQUIREMENTS

In 1982, the Tax Equity and Fiscal Responsibility Act (TEFRA) were signed into law by the President. The effect on Keogh plans is described in the following paragraphs.

On or before July 31, 1985, individuals who have established Keogh plans must have filed IRS form 5500-C. Form 5500-C covers investments, income and expenses from the previous year and is five pages long with questions related to plan administrators, funding arrangements and vesting.

Form 5500-C must be filed in the first year of reporting and every third year thereafter.

Form 5500-R, a two-page form, can be filed in intervening years, or Form 5500-C can be filed for each and every year.

Failure to file could result in IRS penalties of $25 per day per Keogh account up to a maximum of $15,000 unless reasonable cause is established.

For taxpayers on a calendar year basis, IRS extension Form 5558 must be filed on or before July 31 of the current reporting year for a two and one-half month extension. For taxpayers on a fiscal year, the deadline is the last day of the seventh month following the end of their fiscal year.

Source: Tax facts 2006, National Underwriter Company

This information is not intended to be a substitute for specific individualized tax, legal, or investment planning advice. We suggest that you discuss your specific tax issues with a qualified tax advisor.

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