Putting Money Away

by Sid Hymes

There aren't many better deals for self-employed carpenters or small construction businesses than tax-deductible pensions, like Keogh plans or IRAs. The money you put in comes right off the top of your income, so you don't have to pay tax on it — not in the year you earned it, and not while it sits in the account, accumulating interest. In fact, you don't pay income tax on these types of pension plans until you retire and starting collecting the money, by which time you could be in a lower tax bracket.

But only about 5% of the people who are eligible for an IRA or Keogh pension actually have one. This may be yet more proof of the adage "Youth is wasted on the young." While it's true that cash is short for young workers, a 20-something carpenter only has to sock away a small amount of each paycheck, because the money has almost 40 years to multiply.

My theory, however, is that people think it's too complicated. When they hear terms like "defined benefit" and "defined contribution," their eyes roll back in their heads and they stop listening. But this stuff is simpler than it sounds. Here's a brief look at how pensions work and what's available. I've oversimplified a bit, but the information here will give you a place to start.

Two Types of Plans

All pensions determine how much money you put into the fund in one of two ways. With a *defined contribution* plan, you figure out how much money you can spare, and put that amount into your pension. The other way, called a *defined benefit,* calculates contributions by figuring backwards from how much money you want to collect when you retire. As in Jeopardy, you get the answer first, then figure out the question.

Fortunately, you don't have to do the math yourself for a defined benefit plan. If you decide you want a pension income of $800 a month, the company that administrates your pension will calculate how much money you'll need to put away each year to wind up with that amount.

IRA

Where do you put the money? The simplest pension around is an IRA, or Individual Retirement Account. If you have no other pension, you can contribute up to $2,000 each year to an IRA. That's $2,000 on which you don't have to pay income tax. Your spouse can also sock away an additional $2,000, providing he or she meets the criteria. (If you're covered by another pension, check the terms — you might still be able to contribute some money to an IRA.)

The tax aspect of a new type of IRA, called a Roth IRA, works backwards. You pay taxes on contributions now while you're still working, but you don't pay tax on disbursements when you retire.

Keogh Pensions

With a Keogh plan (also called an "HR10" plan), a small business owner or self-employed person can put away as much as 25% of net business income, depending on how the plan is structured. That's 25% of your income you don't have to pay taxes on, but you'll still have the money — it doesn't get any better than that. No matter how your pension is structured, however, you can't put more than $30,000 a year into it. If this is your only problem, you can probably learn to live with it. Unfortunately, a Keogh plan is more complicated to set up and is usually more expensive to manage.

SEP-IRA

SEP stands for Simplified Employee Pension. With this type of IRA, an employer contributes both to his or her own pension and to the pensions of company employees. A SEP-IRA is simpler and cheaper than a Keogh, and it's better than a regular IRA, because you can put more money into it. The catch is that you have to match the contributions to your own pension with contributions to eligible employees, so it costs your company more. The good news is that the money you put into your employees' plans is tax deductible as a business expense.

Who Holds Your Money?

Whatever pension plan you decide on, you will need a custodian or "sponsor" to set up the pension for you, collect the money, and invest it. That sponsor can be a bank, a stock broker, a mutual fund, or an insurance company.

Before the sponsor can accept somebody's pension money, the pension management plan must be approved by the IRS. Once the plan is approved, the sponsor takes care of the paperwork and handles all the pension money. Of course, they don't do this for free: There are setup charges and annual management fees. The main thing to remember, though, is that you don't have to manage your pension yourself. Plenty of people make their living doing that, and they'd love to hear from you.

Pension plans are too good a deal to pass up. After all, you're not getting any younger.

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