Keogh or SEP for the Self-Employed Person?

If you're contemplating setting up an easy-to-administer retirement plan, you have a few options available. You can set up a Simplified Employee Pension plan (known as a SEP), or one of two different types of Keogh plans, either a profit-sharing plan or a money-purchase plan. Which is best for you depends upon your particular circumstances. To help get you started, we're highlighting some of the differences among the different types of plans.

What's the easiest plan to set up? There's no question that the SEP wins hands down. A SEP can be set up easily at a bank or brokerage house, with separate accounts for each participant. A simple IRS form can be used to establish a model SEP. Setting up and administering a Keogh plan is a little more complicated, and in most cases returns have to be filed periodically.

How much can you contribute and deduct? If you're looking to make the biggest deductible contributions possible, the money purchase Keogh has the edge. You can contribute as much as 100% of your earnings, up to a maximum of $40,000 (adjusted for inflation). With a profit-sharing Keogh or SEP, the percentage is lower. In either event, contributions can't be based on earnings over $200,000 (indexed for inflation) a year. The down side of the money-purchase plan is that you must make set contributions every year. With the profit-sharing Keogh or the SEP you can vary contributions from one year to the next, depending upon how the business is doing.

Do you have to cover employees? With any plan, you generally must if they are age 21 or older. However, with a Keogh plan, you don't have to cover employees who haven't completed at least one year of service (two years in some cases). Because of the way a year of service is defined, many part-timers don't have to be covered at all. With a SEP the rules are a little different: You only have to cover employees who have worked for you during three of the past five years. But once that condition is met, even most part-timers have to be covered.

When do benefits vest? A Keogh plan can be set up so that employees aren't entitled to their accrued benefits unless they have been plan members for a certain number of years (sometimes three, sometimes five). Or they can become entitled to their benefits gradually over a seven-year period. If the employee quits or is fired, he or she is only entitled to "vested" benefits. No such waiting period is allowed for SEP participants.

Profit-sharing Keoghs can have cash or deferred arrangements allowing employee pre-tax contributions, which can help keep employer costs down. The rules are slightly different for each type of plan.

If you find you haven't made a decision by year-end there is a feature of a SEP that is useful. It can be set up and funded by the tax return due date. Contributions can be made after year-end to a Keogh plan only if the plan was actually set up by the end of the previous tax year.

After you've considered these points, you might want to consult with us about some of the finer points. We would be happy to help you come to a decision that will work best for you.