Choosing a Retirement Plan

SEP, SIMPLE, Retirement Plan Contribution Deduction

Self-employed persons can deduct the cost of contributing to an IRA

Effect on Income vs. Self Employment Tax

This deduction reduces income tax, but does not reduce the self-employment tax.

Basics of Self-Employed Retirement Plans

If you have self-employment income, then you can take a tax deduction for contributions you make to a SEP-IRA, SIMPLE IRA, or solo 401(k) retirement plan. You can set up the retirement plan with a financial institution of your choice. Each plan has different deadlines and funding limits. If you are a sole proprietor, you will need an Employer Identification Number to set up the plan.

EP-IRAs

SEP-IRAs can be established and funded as late as October 15th for the previous year, provided that the taxpayer filed an extension. The maximum contribution is 20% of the person's net self-employed income, with a maximum dollar limit of $53,000 for 2015. "Net self-employment income" means self-employed income minus one-half of the self-employment tax. More about SEP-IRAs.

SIMPLE IRAs

Simple IRAs can also be funded as late as October 15th (with an extension), but the plan needs to be established by the taxpayer no later than October 1st of the tax year for which the contributions will apply. SIMPLE plans consist of a salary deferral portion with a maximum of $12,500 for 2015, plus a matching contribution of up to 3% of compensation. Taxpayers age 50 or older can contribute an additional $3,000 for 2015.More about SIMPLE IRAs.

Solo 401(k) Plans

Solo 401(k) plans combine a deferral portion with a matching portion. The maximum elective deferral is $18,000 for 2015. Persons age 50 or older can contribute an additional $6,000. The maximum matching portion is 20% of net self-employment income. The total of both the deferral and the matching cannot exceed $53,000 for 2015. Solo 401(k) plans need to be set up by December 31st, but contributions can be made as late as October 15th of the following year with an extension. More about solo 401(k) plans.

Qualifications to Take the Deduction

You must have self-employment income. Self-employment income for the purpose of this deduction means net profits from a Schedule C or Schedule F, self-employed income from a partnership, or wages as a shareholder-employee in an S-corporation. Additionally, you must set up and fund a qualified retirement plan by the required deadline.

Where to Claim Deduction

You must use the worksheets found in IRS Publication 560 for figuring your allowable tax deduction for SEP, SIMPLE, and 401(k) contributions. The allowable deduction is then reported on your Form 1040. S-Corporations report retirement contributions on the corporation's Form 1120S.

Explanation from the IRS

"SEP, SIMPLE, and qualified plans offer you and your employees a tax-favored way to save for retirement. You can deduct contributions you make to the plan for your employees. If you are a sole proprietor, you can deduct contributions you make to the plan for yourself. You can also deduct trustees' fees if contributions to the plan do not cover them. Earnings on the contributions are generally tax free until you or your employees receive distributions from the plan." (from IRS Publication 560)

Relevant Tax Laws

The deduction for SEP, SIMPLE, and other retirement plans is found in Internal Revenue Code Section 62(a)(6) and Section 404.

More Information

JK Lasser's Your Income Tax (chapter 41 has an excellent overview of retirement plans for self-employed people)
Worksheets in Publication 560 (chapter 5, PDF)
Retirement Plans for Small Business (Publication 560)

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