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KEOGH Retirement Plans

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Financial security during retirement is of concern to everyone in today's uncertain economy. Rising prices and unemployment, as well as concern over the Social Security system, are perceived by families as the major contributors to the uncertainty.

The question arises, "What can a family do to enhance its financial security prospects during retirement?" One answer to this question, for self-employed families, is to participate in a KEOGH retirement plan. For families not self-employed, the answer is discussed in Home Economics Guide 3442, "Individual Retirement Accounts."

What is a KEOGH Plan?

The KEOGH retirement plan program was started in 1962 when Congress passed the KEOGH Act. This law, also known as HR10, was amended by pension legislation in 1974 and more recently by the Economic Recovery Tax Act of 1981. It now says that qualified individuals may deposit up to 15 percent of their income from self-employment, with a maximum of $15,000 per year. Taxes on both the income deposited and the earnings on those deposits is deferred until withdrawal upon the individual's retirement. These funds may be invested with a bank, mutual fund, stock broker, insurance company, or other financial institution that provides the service. The most recent legislation has made it possible for the self-employed to open Individual Retirement Accounts in addition to the KEOGH Plan.

KEOGH Eligibility

If you are a full-time business person or professional, not incorporated, and your earnings come from personal services or efforts, you are eligible to establish a KEOGH. If federal income tax is not withheld from your income, you may be self-employed according to the law. You are also self-employed if you report your income on Schedule C of the federal tax return. You may qualify, however, even if you are not in business for yourself on a full-time basis. Persons who are self-employed at night or weekends, for example, can set up KEOGH Plans for their extra income, even if they are already covered by a pension plan at their regular job.

You may set up a plan whether you conduct your business as a sole proprietorship or as a partnership, regardless of whether or not you employ any other persons. Your plan must be set up by you as the individual owning the business or by the partnership. One partner cannot set up a KEOGH Plan just for oneself.

Employee Coverage Under KEOGH

In order to establish a KEOGH Plan, a self-employed person who is also the employer of other individuals, must establish and contribute to plans for full-time employees who have worked for three or more years. A full-time employee is anyone who works at least 1,000 hours per year. Those who work less than 1,000 hours are part-time and may be excluded. Of course, the KEOGH employer can include part-timers, if desired. The law says that an employer must contribute at least the same percentage of eligible employees' salaries to the retirement plan that the employer contributes to one's own plan out of one's own earnings.

Deductible Amounts

You may ordinarily deduct up to 15 percent of your earned income or $15,000, whichever is less, from your taxable income when you deposit this amount into an approved KEOGH retirement fund. Earned income does not include investment returns such as dividends, interest, and returns from real estate. For example, if a person has an annual earned income of $70,000 and has yearly dividend income of $20,000, a maximum of $10,500 (15% of $70,000) may be set aside into a KEOGH fund. The $20,000 of investment income may not be used to determine the amount paid into a KEOGH.

If you (as an employer) have an employee in your KEOGH Plan, you are allowed to contribute up to $2,500 more. While the tax on this voluntary contribution is not deferred, the taxes on the accumulated interest, dividends and gains will be deferred. The law also permits an individual whose adjusted gross

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income from all sources (interest, dividends, salary, self-employment income, etc.) is $15,000 or less to make a KEOGH Plan contribution of the lesser of $750, or 100% of his/her self-employed income. Thus, if you have an adjusted gross income of $14,000 ($1,000 of which is from self-employment) you may set aside $750 in a KEOGH Plan. This represents 75% of your self-employment income, not 15%.

Contributions to a KEOGH retirement fund above the permissible limits are subject to a 6% penalty tax. This penalty can be avoided by withdrawing the excess money and its earnings before the tax due date, usually April 15. Or, if the employer contributes more to a KEOGH Plan than the ceiling on allowable contributions, the excess may be carried over and applied to subsequent years.

Methods of Investment

Whatever amount of money you decide to set aside must be put into a retirement fund established in a prescribed legal form approved by the Internal Revenue Service. KEOGH Plan contributions may be invested in securities, mutual funds, annuities, government bonds and other investments, subject to a few restrictions. Investments are made through a trustee or custodial arrangement with the institutions that invest funds. Commission and management fees are charged for KEOGH Plans involving investment in stocks, bonds, or mutual funds. Some institutions and some methods of savings have minimum deposit requirements.

KEOGH funds may be diversified by dividing them up among different investments, or by using a single trustee who will allocate the money as you direct. A transfer system is available when you wish to switch funds from one form of investment to another, or from one trustee to another. Forms used to transfer funds usually are available from financial institutions that serve as trustees. If you decide to transfer to another KEOGH account, check for penalties assessed by the financial institution for closing your KEOGH.

Usually, the institution with which you plan to establish a KEOGH Plan - bank, mutual fund, stock broker, insurance company - will provide you with a Master KEOGH Plan that they have already filed and had approved by the IRS. You will fill out a relatively simple adoption agreement in which you select the type of KEOGH Plan desired. It is advisable to have your lawyer review the plan with you. In unusual cases, you may want to have a lawyer, an actuary, or both, design a tailor-made KEOGH Plan for you. If you choose to do this, obtain IRS approval for your plan.

Withdrawing Your Retirement Funds

Since KEOGH Plans are designed to provide retirement income, it is important to be familiar with procedures for withdrawals. The tax-deferred aspect of KEOGH assumes you leave the funds in the account until age 59½ (unless you become disabled before that). If you withdraw any of these funds for any other reason, you must pay a penalty of 10%, plus the amount withdrawn will be taxed as income that year. Additionally, you cannot make any contributions to your KEOGH for 5 years following the premature withdrawal. If you die before age 59½, your beneficiaries receive the funds. Whether or not you retire, you must begin withdrawing from your account by age 70½. Amounts of withdrawals must be large enough to deplete the fund over your lifetime, as determined by an IRS table.[1]

Funds may be withdrawn in a lump sum, installments, or annuity payments. At this stage, the proceeds are subject to income tax. Thus, in order to maximize the tax treatment received by investing in a KEOGH Plan, you should be careful how the funds are withdrawn. If withdrawn as a lump sum (if it is a sizable amount), your marginal income tax rate may be very high. Thus, you will wind up paying a large amount of tax on both your accumulated contributions and the accumulated earnings on those deposits. For example, if your KEOGH fund is $100,000, should you decide to withdraw it as a lump sum and you are married filing jointly (according to 1981 income tax law), you would potentially be liable for nearly $42,000 in income taxes.

Is a KEOGH Plan the One for You?

The KEOGH Plan does not necessarily produce the best pension program for everyone who qualifies. Self-employed persons in the higher income brackets should also consider the advantages of incorporation. This procedure may allow larger tax-deferred contributions to a retirement fund and also offer tax advantages on the costs of health insurance and life insurance. Self-employed persons in moderate income levels with full-time employees (one or more), should weigh the benefits of KEOGH against the contributions required of you for your employees. And lastly, for individuals with lower incomes, the Individual Retirement Account program (referred to at the beginning of this discussion) allows annual tax-deferred contributions of up to $2,000. IRAs also receive basically the same tax benefits as a KEOGH. Also, these accounts don't require that employee coverage be provided.

[1] Due to the leniency of estate tax laws, if the fund is not depleted prior to death, it can be passed to a spouse free of estate tax. In the event of simultaneous death of both spouses, a KEOGH fund of $550,000 in 1983; $650,000 in 1984; $800,000 in 1985; $1 million in 1986; and $1.2 million thereafter, can be transferred to children without being subject to estate tax.

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