Help for the Self-Employed: How to Set up and Fund Your Own Pension

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THE GIG ECONOMY has created a legion of self-employed workers, who are bereft of employer-sponsored 401k and pension plans. Many of them took the plunge into the life of freelancer, consultant, or entrepreneur—or were thrust into it—without any financial planning beyond, "Can I pay my rent?" The most common mistake that these workers make is forgetting to set aside money for taxes, but a close second is failing to save for retirement. But planning and saving for your golden years doesn't have to be overwhelming.

What is a SEP?

A Simplified Employee Pension, or SEP, plan is designed to help small business owners provide retirement plans for their employees and themselves. But it doesn't matter if you are your only employee, you can still create a SEP to save for your retirement. Even if your freelance work is in addition to your day job—and even if you have a retirement plan through your regular employer—you can establish a SEP to put aside additional retirement savings from your self-employed income. All you need is at least $600 in net income from your freelance work. (The $600 threshold applies to tax years 2015 and 2016 and could be changed in future years.)

Under a SEP, you set up an Individual Retirement Account (IRA) for yourself and each of your employees (if you have any), and make contributions to that SEP-IRA account. The details are spelled out in IRS Publication 560, but a SEP-IRA account is basically the same as a traditional IRA and follows the same investment, distribution, and rollover rules as traditional IRAs. That means self-employed workers can sock away thousands of tax-deductible dollars every year.

How Do I Set up a SEP?

The three basic steps to setting up a SEP are about as simple as any IRS-regulated transaction, and if you are a one-person business, you can obviously skip step 2.

1. Adopt a written agreement.

You can create one from scratch, but it's not the easiest method. Instead, check with your bank or insurance company for an IRS-approved template, or use IRS model SEP Form 5305-SEP, *Simplified Employee Pension—Individual Retirement Accounts Contribution Agreement*.

2. Share information about the agreement with all eligible workers.

If you established the SEP using IRS Form 5305-SEP, you must include a copy of that form, its instructions, and all of the other information required by the instructions. If you used a prototype SEP or individually designed SEP, you must provide similar information.

3. Establish a SEP-IRA for each eligible worker.

Set up a SEP-IRA for each eligible employee with a bank, insurance company, or other qualified financial institution. The employee owns and controls the SEP-IRA, but does not make contributions. In a freelance situation, as both the employer and the employee, you fund your own account.

How Does It Work?

Once you have set up your SEP, making contributions works almost exactly like a traditional IRA. You contribute pre-tax money that reduces your taxable income and your tax bill for the year. When you retire and withdraw the money, it's taxed as ordinary income.

The biggest difference between the traditional IRA and the SEP-IRA is the contribution limit, and it's a big one. You should use the IRS worksheet to figure out your exact SEP contributions, but the basic rule for maximum contributions is easy enough to keep in mind: you can contribute up to 25 percent of your income (unless you make more than $212,000, then your contributions are capped at $53,000.) Your contributions are pre-tax, and you don't have to contribute the same amount every year. So if you have a good year, you can contribute more, but you can skip an entire year if money is tight.

The deadline for making contributions in any year is the same as your deadline for filing taxes—April 15. So, for example, you have until April 15, 2017 to make a tax-deductible SEP contribution for tax year 2016. And if you have any questions about setting up a pension, you may want to talk it over with a business lawyer to make sure your ducks are all in a row.

Don't let another year pass by without taking advantage of this opportunity to save for your retirement. You don't want to be freelancing forever, do you?

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