

# POINTS OF Possibility

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## A Powerful and Underutilized Retirement Plan for Self-Employed Business Owners:

### THE FINANCIAL INDUSTRY'S BEST KEPT SECRET

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Defined contribution retirement plans have been around since the late 70's, and the most common version is the 401k. Sponsored by the employer, these retirement plans allow employees to make pre-tax contributions to their account, while the employers can make matching or discretionary contributions.

For self-employed business owners, 401k plans were not always attractive retirement savings vehicles due to costly setup and maintenance fees, as well as administrative fees to third party administrators.

That is until The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA). This act was a game-changer for 401k plans for self-employed business owners, because it leveled the playing field for large employers and the self-employed, providing the same advantages of traditional 401k plans, with higher contribution limits, and lower administration hassle and fees. Finally, a break for the little guy!

Before EGTRRA, most self-employed professionals were relegated to using either a SEP-IRA or a SIMPLE IRA as their retirement plan of choice. The SEP-IRA remains the most commonly recommended retirement plan for this group by both tax professionals and financial advisors. SEP-IRAs and SIMPLE plans are fairly easy to understand and implement, but they are no match for today's Solo 401k plan. The chart on the following page compares the features of common retirement plans for the self-employed.

FEATURE	SEP-IRA	SIMPLE IRA	SOLO 401K
Maximum Annual Contribution	\$54,000	\$20,450 \$23,450 if age 50+	\$54,000 \$60,000 if age 50+
Age 50+ "Catch Up" Contribution	Not Applicable	\$3,000	\$6,000
"Employee Elective Deferral" Amount	Not Applicable	\$12,500 \$15,300 if age 50+	\$18,000 \$24,000 if age 50+
Roth Contributions	Not Applicable	No	Yes
Plan Loans Allowed	No	No	Yes

The following graph illustrates maximum contributions to the three retirement plan options by income level. At every income level, the Solo 401k plan allows plan participants to contribute more towards retirement than the two other retirement plans.

### MAXIMUM CONTRIBUTION BY INCOME LEVEL



The Solo 401k plan is an ideal retirement plan for a small business owner who has no full-time employees other than a spouse. Sole proprietors, LLCs, partnerships, S corporations, and C corporations all qualify for Solo 401k plans. The rules for the Solo 401k plan allow the small business owner to act as both the employer and employee, and this is where the real benefit lies.

## Contributions:

The 2017 contribution limits are \$54,000, or \$60,000 for those 50 or older. The annual contributions consist of two components: salary deferral and profit sharing. The contribution calculation differs depending on whether the business is incorporated or unincorporated.

### S or C Corporation or LLC Taxed as a Corporation:

- Salary Deferral Contribution: 100% of W-2 earnings, up to \$18,000, or \$24,000 for those individuals 50 or older.
- Profit Sharing Contribution: up to 25% of W-2 earnings

### Unincorporated Businesses:

- Salary Deferral Contribution: 100% of net adjusted business profit (net profit minus 1/2 self-employment tax) up to \$18,000, or \$24,000 for those individuals 50 or older.
- Profit Sharing Contribution: up to 20% of net adjusted business profit.

## Summary of Solo 401k Advantages:

**Larger Contributions** — What makes the Solo 401k plan so powerful compared to other self-employed retirement plans is that higher contributions can be made for identical income levels (see graph on page 2).

**Catch-up Contribution** — If the business owner is age 50 or older, he or she can make an additional catch-up contribution of \$6,000.

**Roth Provision** — SEP-IRA contributions are always made with pre-tax dollars, by the employer. A Solo 401k plan allows for Roth contributions as the employee (elective deferral). For those individuals whose income exceeds the limit to contribute to Roth IRAs, the Roth provision allows these individuals to make Roth contributions to Solo 401ks. With a Roth 401k, you pay taxes today in return for tax-free withdrawals in retirement.

**Loan Provision** — Unlike a SEP-IRA, SIMPLE IRA, or any other IRA for that matter, Solo 401k plans do allow for plan loans—up to 50% of their account value, not to exceed \$50,000. For small business owners, who may find difficulty in qualifying for a loan as a self-employed professional, the ease of a 401k loan may be a valuable benefit.

# Examples...

## OWNER-ONLY BUSINESS – INCORPORATED

Judy, a 40 year old independent nurse practitioner, earns \$130,000 in W-2 income from her S-corp. Based on those earnings she can contribute up to \$50,500 to a Solo 401k. As the employee, she can defer \$18,000 of her salary to her Solo 401k plan. As the employer, her business can contribute 25% of her wages, or \$32,500, to the plan, for a total of \$50,500. This compares very favorably with the maximum contribution of \$32,500 available in a SEP-IRA

## EMPLOYEE WITH SIDE INCOME

Steve, a 50 year old police officer, who in addition to his salary, has self-employment income from his small construction business. Steve's net business income is \$50,000. Steve is interested maximizing his tax deferral. Operating as an unincorporated sole proprietor, he can contribute to a Solo 401k as the employer (20% of net adjusted business income), and as the employee. He can contribute \$24,000 (\$18,000 plus \$6,000 catch-up contribution) as an employee, and \$9,293 as the employer, for a total of \$33,293. A SEP-IRA would only allow Steve to put away \$9,293.

### Partial list of professions which could most benefit from a Solo 401k:

Real Estate Agents, Mortgage Brokers, Independent Contractors, Consultants, Employees with a Side Business, Sole Practitioners, etc.

## Myths:

**More Paperwork:** A Solo 401k plan is no more complicated than setting up a SEP IRA or SIMPLE IRA. In fact, the paperwork is nearly identical, and with some custodians Solo 401k plans require less paperwork than the other self-employed retirement plans.

**More Expensive:** Many custodians set up and maintain Solo 401k plans at no cost. For anyone interested in adding a Roth or loan provision to the plan, those may require additional costs. However for most prototype plans offered by the large custodians, the cost is no greater than setting up other self-employed retirement plans.

**More Administrative Requirements:** Solo 401k plans are easy to operate, with no annual filing requirements until the account value exceeds \$250,000. When that happens, the owner is required to file IRS Form 5500-EZ. This two-page IRS form is quite simple to complete. Solo 401k plans are not subject to nondiscrimination testing. No other filings are required.

## What's the catch?

There isn't one! Solo 401k plans once were costly to set up and maintain. That is no longer the case. As these plans have become more mainstream the costs have been reduced to zero, and they are easier to open and maintain.

## When would a SEP-IRA be preferred over establishing a Solo 401k plan?

- If you have full-time employees, or plan on adding full-time employees in the very near future.
- If you want to establish a plan after the year is over, your only option is a SEP-IRA. Solo 401k plans must be established by 12/31. Contributions can be made up to the tax filing date, including extensions.

It has been over 15 years since the passing of EGTRRA, which dramatically increased the Solo 401k attractiveness. After all of these years, Solo 401k plans are still the best kept secret for owner-only small businesses. The popularity of these plans is increasing, but is still well below what it should be when compared to SEP-IRAs. It is essential that CPAs and financial advisors understand the value of these plans and what it can mean for their clients—larger retirement plan contributions, resulting in significant tax savings.

## Want to know more?

Contact our retirement plan advisors at [info@aplaceofpossibility.com](mailto:info@aplaceofpossibility.com) or 925-736-6410.

