Self Employed Retirement Plans

Solo 401k Plan

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Most people have a pretty good handle on personal finance and basic retirement savings, and while the principles are generally the same in the small business world, a lot of business owners have a deer caught in your headlights at 2:00AM look when it comes to leveraging their business for retirement. And there is good reason- retirement planning within your small business carries a bunch more options and potential pitfalls (sounds like life in general, doesn't it?).

Self Employed Retirement Plans

We are going to put the carriage in front of the horse, and show you a comparison of basic small business retirement options before explaining each plan. We cheated, and used Bankrate's online calculator to demonstrate these differences. Why re-invent the wheel? And frankly, Bankrate does a fantastic job at this type of stuff. Here is their link-

BankRate Calculator

We took a handful of salaries (for corporations) and net incomes (for sole proprietors and partners in partnerships) and plugged them into Bankrate's calculator, and came up with the following table based on **2019 limits-**

Salary/Income	Entity	Max 401k	Max SEP IRA	Max SIMPLE
40,000	Sole Prop	26,435	7,435	14,083
40,000	Corporation	29,000	10,000	14,200
60,000	Sole Prop	19,000	11,152	14,624
60,000	Corporation	34,000	15,000	14,800
80,000	Sole Prop	33,870	14,870	15,165
80,000	Corporation	39,000	20,000	15,400

148,000	Sole Prop	46,556	27,556	17,013
148,000	Corporation	**56,000**	37,000	17,440
175,000	Sole Prop	51,884	32,883	17,789
175,000	Corporation	56,000	43,750	18,250
196,000	Sole Prop	**56,000**	37,027	18,392
196,000	Corporation	56,000	49,000	18,880
224,000	Sole Prop	56,000	42,552	19,197
224,000	Corporation	56,000	**56,000**	19,720
293,000	Sole Prop	56,000	**56,000**	21,155
293,000	Corporation	56,000	56,000	21,400

Note the red, bolded **$56,000** number. This is the maximum defined contribution amount permitted in 2019 per plan (and Yes you can have two plans- we'll talk about Greg and his two plans in an example later).

Crazy! Some quick observations-

- In 2019, the maximum you can contribute to a qualified retirement plan is $56,000. You can go above this with a defined benefits pension (cash balance)- more on that later.

- Partnerships (those required to file Form 1065) follow the same limits as Sole Prop above.

- $148,000 in W-2 salary from your C Corp or S Corp is the magic number for maximizing your 401k. After that, any increase in salary does not help. Your fastest way to reach your contribution limit is through a 401k plan.

- $224,000 in W-2 income from your S Corp is the minimum salary for a max SEP IRA contribution.

- $293,000 from your small business or K-1 partnership income from your Schedule E as reported on your individual tax return is the magic number for maximizing your SEP IRA contribution. SEPs are old school and used for crisis management rather than planning (more on that too).

- Earned income from a sole proprietor is net profit minus 50% of your self-employment tax minus your contribution. Since

the contribution actually adjusts the maximum contribution, this can be a circular reference. And No, 401k or SEP contributions do not reduce SE tax.

- 401k max is computed by taking $19,000 employee (you) contribution, plus 25% of your W-2 or earned income (as adjusted).

- SEP IRA max is computed by taking 25% of your W-2 or earned income (as adjusted).

- Max SIMPLE 401k is basically $13,000 plus 3% of your W-2 or earned income (as adjusted). Don't spend too much time thinking about SIMPLE 401k plans.

- You can add $6,000 for catchup contributions if you are 50 years old or older.

Let's talk about each of these qualified plans in turn, starting with the 401k. Out of the box, or non-traditional retirement plans will follow (profit sharing plans, defined benefits pensions, cash balance plans, Section 79 plans, etc.). Exciting!

Small Business Retirement Plan Basics

There are two plan basics, either a defined contribution plan or a defined benefits plan.

A defined benefit plan is a benefit that is payable to you upon retirement. It is usually based on formulas to compute the periodic payments made to you during retirement. These are sometimes referred to as a pension or annuity since a benefit is defined, and the paid to you. For example, military personnel who meet certain obligations are paid a recurring benefit for the rest of their lives. It might be indexed each year for cost of living increases and it might have survivor benefits. Either way it is a guaranteed payment based on a formula. If you live to 100, you might "beat the system." If you die at 55, the pension payment ends and the money set aside for you is lost.

In contrast, a defined contribution plan specifies how much money will be contributed to a retirement plan today. This is precisely how 401k plans work. It removes a lot of the guesswork and risk from guaranteeing a certain defined benefit to you upon retirement. Rather, the risk is all yours- the amount you invest, how long you invest and how you invest it will dictate the retirement benefit. This benefit might be projected with planning software, but it is not technically defined or guaranteed.

Tax Savings and Tax Deferrals

There is some concern involving tax deferrals being confused with tax savings. Tax deferrals might be tax savings under certain circumstances, and tax deferrals might be tax bombs just the same. Please click on the buttons below to read more-

Tax Deferrals and Savings

Retirement Tax Bomb

Using a 401k Plan in Your Small Business

A 401k plan is a defined contribution plan. Specifically, the name 401k refers to the section in the IRS code that allows for retirement plan contributions to give you an instant tax savings. Technically it is Title 26, Chapter 1, Subchapter D, Part I, Subpart A, Section 401, Subsection K.

Subchapter D deals with deferred compensation. Part I deals with pensions, profit sharing, etc. Subpart A deals with the general rule. Section 401 deals with qualified pensions, profit sharing, etc. And Subsection K deals with deferred arrangements. Who knew?

But from there, the 401k plan has several variants and options. We'll be exploring-

- i401k, Solo 401k, Solo K, Uni K, Exclusive K (Owners Only 401k)
- Traditional 401k (when you have a staff, yuck)
- Safe Harbor Provisions for 401k Plan Testing
- Roth Options with a 401k Plan
- Two Plans, Rolling Old Plans
- Age Based or Tiered Profit Sharing Add-On to a 401k Plan
- Defined Benefits Pension / Cash Balance Add-On to a 401k Plan

The Owners-Only 401k Plan

The i401k, solo 401k, solo k, uni k, Exclusive K or one-participant 401k is a great small business retirement plan for a one-person show, or a one-person show with a spouse who also works for the company (more on this in a bit). The Economic Growth and Tax Relief Reconciliation Act of 2001 modified the contribution limits and rules, and allowed for an emergence of the owners-only

401k or solo 401k plan.

Due to special tax rules, you can contribute more to a solo 401k plan than other comparable retirement plans. The previous table in the beginning of this page illustrated this point with real life numbers. Under the usual rules for defined contribution plans such as SEP IRAs and profit-sharing plans, the deductible contribution is capped at-

- 25% of your salary or 25% of your earned income (as adjusted), or

- $55,000 for 2018 (or $61,000 for catch-up) whichever is more restrictive.

Deferrals and contributions are discretionary, so you can cut back as cash flow and objectives change.

Solo 401k plans are also very economical to administer, allow for excellent retirement savings for you and your spouse, and remain simple enough to avoid all the hassles of a full company sponsored plan. A company sponsored plan (in contrast to a solo 401k plan) will cost about $800 to $1,000 per year.

The only downside is you cannot have this type of 401k if you have employees. Even one part-time admin might blow this up. Read more about the owners only 401k plan here-

Solo 401k Plans

Having Staff with a Solo 401k Plan

If you have a staff, but you do not want to deploy a company sponsored 401k plan, you can still maintain a solo 401k plan by excluding employees.

- Your plan can exclude any employee who has not reached the age of 21.

- If the employee is 21 years old, and during a calendar year, the plan year (which is usually the calendar year) or any rolling 12-month period does not work at least 1,000 hours, he or she may also be excluded.

If one of these conditions is true, then you can maintain your solo 401k plan.

Traditional 401k (A Company Sponsored Plan)

Typically an employee must be allowed to participate in the 401k small business plan after obtaining 21 years of age and one year of service. One year of service is defined as 1,000 hours in any calendar year, plan year or rolling 12-month period of time.

Plans can be modified to have less restrictive eligibility requirements.

Full blown 401k plans cost around $800 to $1,000 annually for the plan administration from a TPA (third party administrator) and there are asset management fees of 1.5% to 3.0% as well.

So you will have two vendors with a traditional or company-sponsored 401k plan. You will have a plan administrator and you will have a custodian / asset manager.

Be very leery of ADP, Paychex and Wells Fargo. Those are the top 401k plans that are lost to competitors who offer better customer service, better choices and overall better plans for you and your employees. Wells Fargo is notorious for offering "free" 401k plans, and once you are committed, you discover that the plan is very limiting and underperforms. Free? Really? When is the last time you received something for free that was worth keeping? You don't work for free, so be careful of those who claim to.

401k Plan Safe Harbor Provision

Solo 401k plans do not need a safe harbor provision- this is reserved for company sponsored 401k plans. Regardless, we believe you should understand the rules.

Congress and the IRS want to ensure that retirement plans do not favor highly compensated employees (HCEs). To be a highly compensated employee you must either own more than 5% of the company or earn more than $120,000 in salary (was $115,000 for a while until 2015). So essentially all small business owners are HCEs from an ownership perspective regardless of salary.

There are three tests-

- You cannot defer more than 2% above the average deferral of non-HCEs. Take a standard deviation curve, go out 2%, and draw a line in the sand. This is the ADP test (Actual Deferral Percentage).

- Another test looks at matching contributions from the employer (your company). This is the ACP test (Actual Contribution Percentage).

- Lastly, the top-heavy test ensures that HCEs don't have more than 60% of the entire plan's value.

As a small business owner, it is easy to fail any of these tests and more likely all three. A common example is where you have several plan participants, but only your HCEs are deferring close to the maximum. This creates a top-heaviness to your small business 401k plan, and the tax code will fail your plan by suggesting it discriminates in favor of a few highly compensated employees. Not your fault of course since you cannot force your staff to make deferrals into the 401k plan, but if the cookie crumbles that way the plan fails.

But isn't that the point? Isn't the point of a 401k plan is to give the people who are worth the most, the most of the company's benefits and resources (i.e., the owners)? Of course it is. At the same time, we have to play by the rules. So help is on the way through the Safe Harbor provision. You can defer the maximum, and also have the company match it, without the HCE testing. What's the catch? There's always a catch in the "harbor."

A Safe Harbor plan must satisfy four requirements, with **required contributions** being the main one. This entails using one of several formulas. Click on the button below for more information-

Safe Harbor 401k Plan

401k Plans with Roth Option (Roth 401k)

If you want your retirement savings to grow tax free, you need a Roth IRA or Roth 401k. But don't get too hung up on the phrase tax free growth. Roth IRAs and Roth 401k's are not for everyone, and tax deferral today (non-Roth investments) might be the better answer as alluded to earlier (see Tax Savings and Tax Deferrals). Let's back up the truck a bit and chat about the Roth tag on an IRA or 401k. And Yes, a Roth IRA is different than a Roth 401k. The words have dramatically different meanings.

The Roth IRA is not a tax deferral system like a traditional IRA. It is a pay tax now and avoid paying tax later system. But all that glitters is not gold as Robert Plant would say. A Roth IRA is only available to those who earn less than $199,000 per year for married filing joint taxpayers ($135,000 for single taxpayers) for the 2018 tax year, and a Roth IRA has very low contribution limits of $5,500. Yuck. Now what?

Enter the Roth 401k which is a hybrid of a 401k and a Roth IRA. All the taste of a Roth IRA without the calories. Starting January 2006, many companies amended their 401k plans and started introducing Roth options. So, even if your small business doesn't adopt a 401k plan, your spouse's job or your main job might benefit from the Roth 401k. Ask your benefits administrator to see if your other job or your spouse's other job offers the Roth 401k option.

A Roth 401k has no income limitations, and employees (you) can defer up to $18,000 (or $24,000 with catchup). But company contributions cannot be designated as Roth. Since the company matching or profit-sharing is a deduction to the company, these funds are considered pre-tax and will not enjoy tax free growth. In other words, your contributions as an employee may be designated as after-tax or Roth type contributions, and the company's contribution will be automatically designated as pre-tax or traditional type contributions.

In essence, the Roth 401k has two accounts which can be managed separately with the plan, one after-tax and another pre-tax.

Since the biggest challenge in deciding on using a Roth IRA or Roth 401k pivots on your marginal tax rate during retirement, and crystal balls don't have the accuracy they used to, a good plan is to hedge against both. A Roth 401k has this feature built-in. Your deferrals as an employee can be Roth (post-tax) which hedge against retirement tax rates being similar to wage earning tax rates. Conversely, company funds are traditional (pre-tax) and hedge against retirement tax rates being lower than wage earning tax rates. Got it? How about this-

Employee deferral into 401k	Pre-Tax (deduction to you)
Employee deferral into Roth 401k	Post-Tax
Company contributions into 401k	Pre-Tax (deduction to you vis a vis the company)
Company contributions into Roth 401k	Not allowed

Two 401k Plans

Another twist. Let's say you have a side business and a regular W-2 job where you max out your deferrals into the 401k plan. You cannot make employee deferrals to your side business solo 401k plan since you are collectively limited to $18,000 (or $24,000 with catchup), but your business can make a profit sharing contribution up to $53,000. Here is the word for word example from the IRS (occasionally they illustrate things fairly well)-

> *Greg, 46, is employed by an employer with a 401(k) plan and he also works as an independent contractor for an unrelated business. Greg sets up a solo 401(k) plan for his independent contracting business. Greg contributes the maximum amount to his employer's 401(k) plan for 2016, $18,000. Greg would also like to contribute the maximum amount to his solo 401(k) plan. He is not able to make further elective deferrals to his solo 401(k) plan because he has already contributed his personal maximum, $18,000. He has enough earned income from his business to contribute the overall maximum for the year, $53,000. Greg can make a non-elective contribution of $53,000 to his solo 401(k) plan. This limit is not reduced by the elective deferrals under his employer's plan because the limit on annual additions applies to each plan separately.*

You can read more about how this works with the following button-

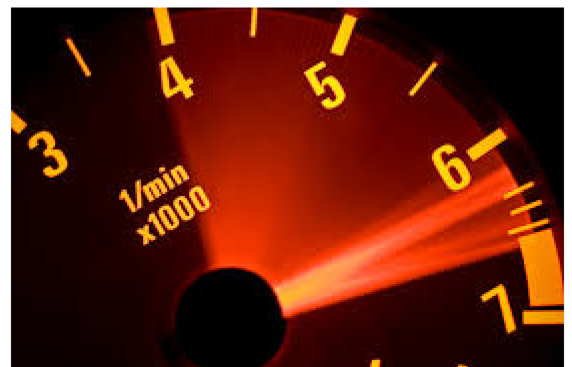
Two 401k Plans

Rolling Old 401k Plans or IRAs into Your Small Business 401k Plan

Other benefits of having a 401k within your business include being able to consolidate other plan assets such as profit sharing, money-purchase plans, traditional IRAs and SEP IRAs into your 401k plan. And you can gain some elegance with this- for example, often times your IRA will have both deductible and non-deductible contributions. You could roll the deductible contributions into your solo 401k plan and roll the non-deductible contributions into a Roth IRA or Roth 401k (a Roth conversion). Ask us for help. No, Roth IRAs cannot be rolled into your 401k unless the 401k has a Roth option.

Some words of caution. Rolling old IRAs and such into your shiny new 401k plan might not be the best idea. In some cases, the rollovers will be captive or trapped in the 401k plan. For example, let's say you have a $50,000 IRA and you move it into your 401k. Two years later you have a crisis, and need to access the $50,000. Your 401k plan might not allow you to withdraw this money without a hardship, have an in-service rollover or allow loans against the plan assets. These features or some would say poorly documented limitations vary among plan providers.

Also, 401k small business plans (beyond the solo 401k plans) might have higher fees and fewer options. In our observation, many 401k plans have an annual asset management fee of 1.5% to 3.0% of assets, whereas most IRAs (and solo 401k plans) operate for less than 1.5% annually.



Turbo Charged 401k Plans

Oftentimes business owners want to put away a ton of money in a 401k plan, but cannot due to inherit limitations within the plan. There are additional options such as profit sharing plans and cash balance plans that can piggyback onto a 401k plan. We have a whole webpage dedicated to these turbocharged 401k plans here-

Turbo Charged 401k Plans

SEP IRA

Simplified Employee Pension Individual Retirement Arrangement. Yes, the A in IRA does not stand for Account, it technically is Arrangement but if you say Account it's okay. We know what you mean. But if you call your IRA a 401k, our OCD does not allow us to let that one go. IRAs are not 401ks and 401ks are not IRAs. From what we understand, we can no longer say "our OCD." Our apologies.

How about this? Our super highly stressful and highly technical profession coupled with the desire to be hyper accurate cannot let you call your 401k and IRA and vise versa. Bagels and donuts are both breakfast foods, but that is where it ends. Hopefully that explanation is better than the OCD reference.

Back to business. As an employee, you do not make contributions to a SEP IRA, the company does so on your behalf. And Yes, it is a tax deduction to the company which is essentially a tax deduction to you. The company can contribute 20% of business income (for sole proprietors, single member LLCs and partnerships) or 25% of your salary (for corporations such as S Corps). There is no catchup provisions since the company is making the contribution.

All eligible employees must have a pro-rata employer contribution. So, if you make $100,000 and your assistant makes $30,000, if the company contributes 10% on your behalf it must do the same for your assistant.

Four reasons why these are fading (but there is a silver lining below)-

- SEP IRAs require much higher salaries to reach the $55,000 maximum retirement savings for 2018,
- Pro-rata contributions strictly based on salaries is no more beneficial or less restrictive than a 401k with Safe Harbor, and
- The administrative costs of 401k plans have been reduced to that of a SEP IRA.
- Another consideration is that the SEP IRA does not allow for plan loans whereas 401k plans do (up to $50,000 usually).

SEP IRA contributions are due with the associated tax return including extensions (similar to employer contributions in 401k plans). An interesting yet allowed tactic is to always file an extension for your tax returns. This allows you to file your tax returns any time up to the extension deadline, but not make the employer contribution until the extension deadline.

SEP IRAs are old school in favor of the 401k small business plan. Unlike 401k plans which must be implemented before the calendar year is over, SEP IRAs can be used for crisis management after the fact. So December 31st can come and go blowing up your desire to have a 401k plan, but a SEP IRA can be created after January 1 and allow for previous year contributions and

tax deductions. Again, this is crisis management. Proper planning prevents the need for a SEP IRA.

ExPatriates or ExPat Tax Deferral Planning

For our small business owners or contractors working overseas, there is a consideration when it comes to tax deferred retirement planning. Currently the amount of foreign earned income that can be excluded from ordinary income tax is $104,100 for 2018. So, if you qualify as an expat and your income is less than $104,100, all your income is excluded.

Fast forward, if you elect to defer some of your earnings into a tax deferred retirement account you might be creating a tax liability unnecessarily. In other words, if your income was already being excluded from income tax, why put money into a tax deferred retirement account just to pay tax on the money later when that money was never supposed to be taxed in the first place. Huh? Stay with us.

You make $104,100. You pay $0 in taxes. You put $5,500 in a normal trading account. This $5,500 was never taxed and never will be. You make $10,000 on it because you're smart. You sell the investments and recognized a $10,000 taxable gain all at capital gains rates.

Same situation, but with an IRA-

You make $104,100. You pay $0 in taxes. You put $5,500 in an IRA. This $5,500 is not taxed. You make $10,000 on it because you're smart. You sell the investments, withdraw the money and recognized a $15,500 taxable gain, all at ordinary income tax rates.

There are more devils in the details of course, but you get the general idea. To put money away in a tax deferred retirement account when that income was already going to be excluded generally does not make sense. A Roth IRA in this situation would be more ideal.

Implementing a 401k plan sidesteps this problem. If you are a self-employed expat and you elect S corporation status, you can defer a portion of your salary and the company can make a profit sharing contribution (which reduces business income and subsequent taxes), yet you enjoy the full $104,100 exclusion on your W-2 and K-1 incomes. Save taxes with the exclusion, and defer taxes with the 401k plan. Not a true double-dip, but a good way to use two systems for tax savings simultaneously.