e-mail ALERT

NH HICKS

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Individual 401(k) Plans Beware

Individual 401(k) plans, aka solo(k)s, uni(k)s etc., have become a very popular retirement vehicle for owner only businesses and their spouses. When used correctly, these plans are excellent tools for making tax deductible contributions and accumulating assets for retirement. However, they still must adhere to a number of rules and regulations.

Solo(k) plans are basically a marketing concept that is not specially mentioned in the Internal Revenue Code. They are simply 401(k) profit sharing plans. However, because there are no common law employees, the plans automatically pass the discrimination test that all plans are subject to. Owners can make employee and employer contributions each year up to the statutory limits.

Contribution Limits

The 2024 limits are detailed below.

- Employee contributions, pre-tax and Roth 401(k), \$23,000 with an additional catch-up contribution of \$7,500 for participants age 50 and older.
- Maximum deductible employer contribution, 25% of W-2 wages or for self-employed individuals, the maximum is 20% of net self-employment income less ½ self-employment tax.
- Maximum annual additions, \$69,000 from employee and employer contributions plus \$7,500 catch-up if eligible.
- Maximum compensation used for contribution calculation purposes \$345,000.

Potential Traps

Individual 401(k) plans are fairly straightforward, but they are company sponsored retirement plans that are covered by governmental rules and regulations. The following is a list of common plan requirements that are often over looked.

- **Failure to keep plan documents up to date**. The IRS requires plan documents to be periodically updated. This requirement applies to individual 401(k) plans as well. Most recently, preapproved plans needed to be restated by July 31, 2022. Failure to meet this requirement results in a document failure, a qualification issue. This may be corrected, but only if determined prior to an audit.
- **Failure to file form 5500-EZ** when the value of the plan's assets exceeds \$250,000. If plan assets exceed the threshold and the 5500-EZ was not filed, significant penalties could be assessed by the IRS. The SECURE Act increased the IRS penalties to \$250 per day, up to \$150,000 for each late Form 5500-EZ plus interest. There is an IRS Relief Program to submit the form(s) with IRS fees of \$500 per late return, up to a maximum of \$1,500.
- **Exceeding Contribution and Deduction Limits**. Since there are two sources of contributions into an individual 401(k) plan (employee and employer), it is important that each source is limited to the appropriate dollar amount. Failure to observe the dollar limits could be picked up easily on audit.
- **Exclusion of Common Law Employees**. Individual 401(k) plans lose their solo status when the business hires employees who become eligible to enter the plan. It is important to incorporate service requirements into the plan's eligibility requirements, so the owner isn't required to cover employees immediately once employees are hired. The plan will need to be redesigned with a new document and reporting requirements.
- **Exclusion of other Companies**, especially in Controlled or Affiliated Service Groups. The Controlled and Affiliated Service Group rules were designed to ensure that an employer does not establish one company for owners with rich benefits and another company for employees

with no benefits. Employees of commonly owned businesses would be eligible for the same benefits as those under the individual 401(k) plan.

Bottom Line

The benefits of the individual 401(k) plan are undeniable. However, they are not an "set it and forget it" arrangement. They are highly regulated with many complex rules and requirements. Without the proper supervision, a plan can quickly become a liability. Spending a few dollars annually to ensure compliance can certainly save future headaches. Since the IRS has specifically listed these plans as a target for their future audits, it is imperative that you review these plans with your clients.

Weekly, we talk to employers who have missed filing 5500-EZ forms or have not updated their plan documents. Let us help you look better to your clients before the IRS looks at them.

Please contact Tom Hicks or Debbie Rath if you have any questions or would like additional information.

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