SOLO 401(K) PLANS: THE GOOD AND THE BAD

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.

THE GOOD

A solo 401(k) plan has high and flexible contribution limits, typically allowing larger contributions and deductions than SEPs, traditional IRAs and Roth IRAs or SIMPLEs. The Contribution Limits for 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.

The 2025 limits can be found on our chart of limits.

Most solo 401(k) plans include pretax or Roth 401(k) contributions along with discretionary employer contributions. You should make sure your document also allows for voluntary after-tax contributions, in-plan Roth conversions and participant loans to maximum your benefits of a solo 401(k) plan. Our document includes all of these features.

Your plan can include a self-directed account that allows you to invest in both traditional and alternative assets.

THE BAD

Solo 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 file form 5500-EZ** when the value of the plan's assets exceeds $250,000. Make sure to include all assets, even those held outside the custodial account such as participant loans, real estate, mortgages etc. 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. There is an IRS Relief Program to submit the late forms.
- **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.
- **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 solo 401(k) offers one of the best options for the self-employed to save money quickly, and if your spouse is involved in your business, you can really take maximum advantage of the program. However, these are not an "set it and forget it" arrangement. Spending a few dollars annually to ensure compliance can certainly save future headaches.

Check out our solo owner-only marketing materials:
- Solo 401(k),
- Solo Defined Benefit Plan, and
- Plan Comparison of Owner only Plans.

If you have any questions, want a proposal, or need to set up a solo plan for 2024 or 2025, contact me at drath@nhhicks.com or 530-232-3395.

We are here to help at this busy time of the year.