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Solo 401(k) Plans: A Retirement Plan Option for One-person Businesses

Many business owners have considered 401(k) plans to be retirement plans for large companies. Although there is no requirement to have a certain number of employees in order to establish a 401(k) plan, the high costs of setting up and administering a 401(k) have made these plans unappealing to small businesses. Now, one-person businesses are discovering that 401(k) plans are worth another look.

How does a 401(k) plan for a one-person business differ from a 401(k) plan for a large company?
Unlike a traditional 401(k), these plans are designed specifically for one-owner businesses where the owner is also the only employee. They are referred to by various names: uni-401(k), one–man 401(k), mini-401(k), and solo 401(k) plans. Administratively, these plans are less complex, less burdensome, and less costly to manage than traditional 401(k)s.

What makes solo 401(k) plans simpler?
Because a solo 401(k) covers only one person – the business owner who is also the only employee – the complex 401(k) rules on coverage and nondiscrimination do not come into play.

Are lower costs and simpler administration the main benefits of a solo 401(k) plan?
No. Depending on your earnings, you may be able to contribute more to a 401(k) than to another plan. Larger contributions may be possible because both the owner-employee and the company can make contributions for the benefit of the business owner. Since they allow higher contributions than other plans, such as SIMPLEs and SEPs, 401(k)s give you more opportunity to cut your taxes while building a bigger retirement nest egg.

How much can an individual put into a solo 401(k) plan?
You can elect to contribute 100% of your earnings to the plan, subject to a specified annual limit. If you are 50 or older, you are allowed to make additional "catch-up" contributions.

Are these contributions tax-deductible?
These contributions are actually called "elective deferrals", and they are excluded from your taxable income rather than being deducted from it. Your contributions are subject to social security tax, but they will not be subject to income tax unless you withdraw money from the account.

What can the business contribute to the plan?
Your business can make tax-deductible contributions to your account – up to 25% of your wages, or 20% of net self-employment earnings. There is an overall dollar limit for the combined contributions you and the business can make each year.

Does the business have to be a corporation in order to have a 401(k) plan?
No. Both incorporated and unincorporated businesses can set up a solo 401(k) plan. Even if you are self-employed, you are still considered an employee of the business.

Can you borrow from a solo 401(k)?
Yes. That is another benefit to an individual 401(k); you have access to the money you've invested. While borrowing against SEPs or SIMPLEs is never allowed, 401(k) plans allow you to borrow as much as 50% of the balance in your account, up to $50,000.

If you have retirement money in other plans, can it be rolled over into your solo 401(k) plan?
Yes. You have the option of rolling over money from other eligible retirement accounts into your 401(k) account. Doing so may make it easier for you to track investment returns.

Are there disadvantages to a solo 401(k) plan?
Yes. Perhaps the main problem is that if your business grows and you hire employees, your 401(k) plan must also cover them. Your plan is then subject to all the complex rules and costly administration of a regular 401(k) plan. Because nondiscrimination rules would no longer allow you to make large contributions just for yourself, the main benefit of having a solo 401(k) would be lost.

In certain situations, a solo 401(k) plan is an excellent way to cut current income taxes while putting away large amounts for a business owner's retirement. Before making any decisions, investigate not only a solo 401(k), but also other retirement plan options available to you.

Feel free to contact our office if you have any questions about individual 401(k) plans or any other accounting needs.