

# One-Participant 401(k) Plans

## *Are They More Beneficial for Small Business Owners?*

By Sal Favarolo

Owners of small businesses with no employees, except perhaps a spouse, often use a simplified employee pension (SEP) plan, a business retirement plan that allows for larger contributions than a traditional individual retirement account (IRA). Because of this larger contribution limit and the ease of implementation, tax professionals often recommend SEP plans to such business owners. But many sole proprietors and tax professionals do not realize that another option—the one-participant 401(k) plan (i.e., the “solo-k,” “uni-k,” or “individual 401[k]”)—can allow even larger contributions and, thus, even greater tax deferral.

### Overview of Individual 401(k) Plans

The one-participant 401(k) plan is a traditional 401(k), carrying the same rules and requirements but without the complex administrative responsibilities; however, it covers only a business owner with no employees other than a spouse. A key difference between a one-participant 401(k) and the more familiar SEP is the allowable contribution amount. As with a traditional 401(k) plan, a sole proprietor can make both a salary deferral as the employee and a company contribution as the employer, thus maximizing tax deferrals while simultaneously increasing retirement savings. Under a SEP plan, the maximum contribution is generally limited to the lesser of 25% of the employee’s compensation or \$51,000 (for 2013).

Comparing contributions to a SEP and a one-participant 401(k) plan shows a significant tax deferral advantage, especially when wages are less than \$200,000. In a one-participant 401(k) plan, the owner/employee can elect to defer \$17,500 in 2013 (\$23,000 if age 50 or older). In addition, as the employer, this individual



can make nonelective contributions, up to 25% of compensation; total contributions for a one-participant 401(k) plan, not counting catch-up contributions, cannot exceed \$51,000 for 2013.

The *Exhibit* compares a one-participant 401(k) plan to other popular retirement plans, in terms of contributions, for a married couple (John and Jane) working together; each earns \$100,000 per year. Because John and Jane are 50 years of age, they can also take advantage of the catch-up contribution. The \$48,000 one-participant 401(k) contribution in the exhibit consists of the following: a

\$17,500 employee salary deferral, a \$5,500 catch-up contribution, and an employer match of 25% of compensation or \$25,000.

As shown in the Exhibit, the business owner with \$100,000 in gross wages can contribute nearly twice as much to a one-participant 401(k) plan as to a SEP or profit-sharing plan; in addition, such a business owner can contribute more than twice as much as under a savings incentive match plan for employees (SIMPLE). This can give tax advisors considerable flexibility in structuring and optimizing the manner of compensation.

## Benefits for Business Owners

Tax professionals should consider suggesting one-participant 401(k) plans to business owners with the following goals:

- Allow both employee and employer contributions (and possible tax deductions), thereby maximizing contributions and tax deferral (not permitted in SEP plans)

- Defer more in taxes and save more for retirement than is generally possible through a SEP plan (for gross wages under \$200,000)

- Decide annually whether and how much to contribute based on cash flow (similar to a SEP plan)

- Benefit from catch-up contributions if the business owner is age 50 or older and is self-employed (not permitted in SEP plans)

- Create a participant loan and borrow from the account (not permitted in SEP plans)

- Add a spouse to the plan, which allows business owners to optimize W-2 compensation and possibly lower Federal Insurance Contribution Act (FICA) taxes, while contributing more to the retirement plan for a given level of compensation, as compared to a SEP.

In addition, whereas traditional 401(k) plans often offer participants only a small basket of mutual funds, one-participant 401(k) plans can be operated like a brokerage account, opening up available investment options to individual equities, exchange-traded funds, bonds, and mutual funds.

Other points to consider regarding one-participant 401(k) plans include the following:

- The one-participant 401(k) plan requires adoption of a plan document and selection of a trustee, usually the owner.

- If the plan assets exceed \$250,000, a business owner might have to file IRS Form 5500-EZ, Annual Return of One-Par-

ticipant (Owners and Their Spouses) Retirement Plan.

- In a one-participant 401(k) plan, salary deferrals must be made prospectively. In other words, one may not defer compensation that has already been paid. Thus, timing is important; because incorporated business owners (e.g., C corporations) generally take their compensation throughout the tax year, establishing a one-participant 401(k) plan and making an employee salary deferral earlier in the tax year should be considered. Unincorporated business owners (e.g., sole proprietorships) are usually deemed to receive compensation on the last day of the business's fiscal year, so the timing of establishing a one-participant 401(k) plan and an employee salary deferral selection is less important.

- If a business owner is also employed by another company and participates in its 401(k) plan, that individual should bear in mind that retirement plan contributions are limited by individual, not by plan.

---

Whereas traditional 401(k) plans often offer participants only a small basket of mutual funds, one-participant 401(k) plans can be operated like a brokerage account.

---

### Opening a One-Participant 401(k) Plan

One-participant 401(k) plans can potentially boost retirement savings with their larger allowable contributions. There are several ways to open a one-participant 401(k) plan, but not all investment firms offer this variety of options. Some might not offer the self-directed brokerage account option, and some might only allow business owners to open a plan directly with a mutual fund company. For self-employed small business owners wishing to defer more than \$51,000 per year, the one-person plus 401(k) plan can be combined with a small business defined-benefit retirement plan, which might allow them to double the annual tax deferral amount. As with any other tax strategy, business owners should always consult with their tax advisors before implementing a plan. □

*Sal Favarolo is a financial advisor with Lantern Wealth Advisors LLC, in Melville, N.Y. He can be reached at sfavarolo@lanterninvestments.com.*

## EXHIBIT

### Individual 401(k) Example

The following is a sample 2013 tax table for a husband and wife, both age 50, who work together:

Owner Name	Projected 2013 W-2 Wages	One-Participant 401(k) Plan	Profit-Sharing Plan	Simplified Employee Pension (SEP) Plan	Savings Incentive Match Plan for Employees (SIMPLE) IRA
John Doe	\$100,000	\$48,000	\$25,000	\$25,000	\$17,500
Jane Doe	\$100,000	\$48,000	\$25,000	\$25,000	\$17,500

Source: Ascensus; based on the 2013 tax codes.