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Individual 401(k) Plans

As Benjamin Franklin famously said, "In this world nothing can be said to be certain, except death and taxes." Fortunately, for most us, we can control how we plan for the certainty of those taxes, and we can implement various strategies to reduce the burden of paying them.

For those of you who operate as a sole-proprietor or S corporation owner with no employees, there is an important retirement planning opportunity that may be beneficial. You will likely recognize the Simplified Employee Pension or SEP IRA; however, the lesser known individual 401(k) or solo 401(k) may be a better retirement plan and tax deduction vehicle for self-employed business owners. As a caveat, there are aspects of individual 401(k) plans which we will not delve into within the confines of this article.

The individual 401(k) covers a business owner with no employees and his or her spouse, and may be implemented by S corps, single-member LLCs, and sole proprietors. The real benefit of the individual 401(k) is the business owner's ability to contribute both as the employer and an employee. The plan follows the same rules and guidelines as a traditional 401(k), but the individual 401(k) is not governed by ERISA legislation and does not require non-discrimination testing as there are no employees. Like a traditional 401(K), an individual plan allows for elective deferrals up to 100% of compensation (earned income relative to the self-employed) up to the annual contribution limit. For 2019, an individual may defer up to $19,000 of salary and $25,000 if age 50 or over with the catch-up provision. Additionally, employer non-elective contributions, or profit sharing contributions, can be made up to 25% of compensation. For those filing as self-employed on schedule C, the profit sharing contribution is a maximum of 20% and requires a bit more math to calculate the allowable amount. The maximum contribution to an individual 401(k) is $56,000 for 2019, not including the $6,000 catch-up provision.

For example, let's focus on a business owner operating as an S corporation, age 52, who earns $100,000 in W2 wages from his or her company in 2019. This example will really highlight the superiority of the individual 401(K) over a SEP IRA in certain situations. Our business owner defers $25,000 of his or her salary ($19,000 plus catch-up of $6,000) and makes a 25% profit sharing contribution for total contribution of $50,000 - an astonishing 50% of her W2 income. Keep in mind, by operating as an S corporation, the business owner can access additional income via a distribution from the company. By comparison, an S corporation owner making a SEP IRA contribution could only make a total contribution of $25,000. The SEP IRA does not allow for the salary deferral component only the 25% profit sharing contribution.

One drawback to the individual 401(k) is the plan must be established for the tax year in which contributions will be made. At this point in 2019, it is too late to create an individual 401(k) for 2018. However, there is an easy work-around for this situation. A SEP IRA can be established any time up until one's tax filing deadline including valid extensions. To capture a tax deduction for 2018, business owners can establish a SEP IRA and make a contribution. At the same time, the business owner may set up an individual 401(k) for 2019 and subsequently initiate a rollover of the SEP IRA funds.

As you can see, the individual 401(k) provides unique tax advantages for individuals operating a business with no employees. We hope you've found this information useful and welcome the opportunity to answer any questions you may have. As with any tax related issue, please be sure to consult your tax advisor.

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Jason serves as a Client Advisor for Naples Global Advisors. He is responsible for client service and working with individuals and families to assist with their financial planning and investment management needs including: asset allocation analysis, retirement cash flow analysis, insurance and annuity analysis, estate planning, and tax planning. In 2011, Jason obtained his CFP® (Certified Financial Planner) designation by completing an in-depth two-year program of study in financial planning, insurance, investments and retirement plans, tax, and estate planning. Jason has 15 year's experience serving as a financial advisor and providing financial planning for high net worth clientele.