"Solo" 401(k) Plans Offer Big Tax Deductions: Tax-Deferred Investing to the Max

By Jeffrey A. Miller

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Major changes to the tax laws now allow small business owners to establish 401(k) plans more easily than ever before, and benefit from bigger 401(k) plan deductions than they've ever seen. These 401(k) plans have been dubbed "solo" 401(k) plans because of the new rules' popularity among single-owner businesses. Yet, it is possible to have more than one owner and maintain a "solo" 401(k) plan, as noted below.

To obtain the benefits for the 2003 tax year, however, you must act before December 31st. (For more about the types of investment services our investment affiliates offer, please visit http://www.marcjlane.com/decisiontree.htm) In contrast, SEP IRAs can be established at the same time your individual income tax return is filed (i.e., April 15 of the following tax year).

This report highlights some of the significant benefits of a solo 401(k) plan.

A solo 401(k) plan allows a small business owner and his or her family to defer and invest tax-deductible (pre-tax) retirement contributions at a fast rate. The importance of maximizing retirement plan contributions cannot be emphasized enough. Over time, compounding tax-deferred investing can significantly increase one's wealth. (For "A Case For Professional Money Management,"and more about this important aspect of growing wealth, please visit http://www.marcjlane.com/decisiontree.htm)

How you might benefit from a solo 401(k).

Eligibility. While a small business owner could establish a 401(k) plan under prior law, the administrative hassles might have discouraged you from doing so. Recent legislation makes establishing a 401(k) plan much more attractive for small business owners. Now, a business entity whose only eligible participants are business owners, partners, and/or spouses of owners or partners may establish a 401(k) plan easier and with greater deductions than ever before. Children, parents, and grandparents may also participate as long as they earn income from the business. (However, specific plan administrators may have their own guidelines or limitations regarding participants.) Nearly all forms of business entities and ownership are eligible for a Solo 401(k). Sole proprietors, partnerships, corporations (including S-corporations), LLCs, and LLPs may all establish Solo 401(k) plans.

The good news: As long as the eligible 401(k) participants are limited to those mentioned above ("eligible solo participants"), the solo 401(k) will not be subject to all the administrative, recordkeeping, and investment monitoring regulations that traditional 401(k) plans must follow. Full-time employees who are at least age 21 and have one year of service must be offered the opportunity to participate in any 401(k) plan. However, for these purposes, a part-time employee working less than 1,000 hours per year can be disregarded and will not affect the solo 401(k)'s legal compliance. It may be a good idea to set up a solo 401(k) now, even if you may add an employee who is not an eligible solo participant in future years. At that time the solo 401(k) plan can simply be suspended or terminated.

Key benefits. Under the new law, you may deduct up to $40,000 for each participant in a solo 401(k), as explained in more detail below. Even more appealing, if you and your spouse are actively involved in your business and have sufficient business earnings, you and he or she may be able to contribute - - and deduct - - up to $80,000 for retirement.

Another benefit under the new law is that you can reach the maximum deduction of $40,000 at a faster rate than ever before - - with as little as $112,000 of income in 2003. In contrast, at that income level, other retirement plans allow much lower contributions (e.g., a SIMPLE IRA would generally allow about a $11,360 deductible contribution, and a SEP IRA or Profit Sharing Plan would generally allow about a $28,000 deductible contribution. See the comparison chart below.)

If I have a side business, will a solo 401(k) benefit me, even if the business doesn't make much income?

Yes. In fact, a side business is a prime candidate for a solo 401(k). A traditional employee, if he or she has a side business, may now make additional deductible retirement contributions very rapidly via a solo 401(k) plan. With just $20,000 of income, you may be able to deduct up to $17,000 and only pay income taxes on the remaining $3,000. The rapid deductible contribution rate (in this case, 85%) can be very appealing to those wanting to save more for retirement, particularly if the income generated from a side business is not required for their immediate needs. What's more, if the participant is 50 years or older as of January 1st, "catch up" provisions allow even higher contributions for that year ($2,000 in 2003, and increasing by $1,000 each year to a maximum of $5,000 in 2006 and later years).

What other benefits does a solo 401(k) offer?

Solo 401(k) plans also offer several other advantages:

Roll over other plans. Once your 401(k) plan is established, you may roll over other retirement accounts into it.

Loans. You may borrow up to 50% of your account balance (up to a $50,000 loan) and repay it over five years (or over 10 years, if the loan is used for a principal residence).

Brokerage accounts. The plan may include a self-directed brokerage account, allowing maximum investment flexibility.

No tax return. No tax returns for the plan are necessary, as long as assets remain under $100,000.

Simplified tax return. If assets exceed $100,000, a simplified tax return may be filed if the plan covers only you (and your spouse) or one or more partners (and their spouses).

No FICA tax. The employer contribution portion is not subject to FICA (Social Security) or self-employment taxes (but any salary deferral portion is subject to tax. See "Comparison of Contributions" below for description of methods of contribution).

Extended contribution date. Employer contributions may be made after year-end (by your tax return deadline, including extensions). However, salary deferrals must be made by December 31st, and may only be made from income earned after the 401(k) plan is established.

Creditor protection. Retirement assets held in a 401(k) plan are generally protected from the claims of creditors. Creditor protection provides peace of mind that your wealth will continue to build despite any potential hazards on the way to retirement.

(To learn more about some aspects of these advantages of a 401(k) plan, see "Borrowing from Your Retirement Account" please visit http://www.marcjlane.com/LaneReport/0304lr.htm and see "Exactly What Does Marc J. Lane & Company do?" please visit http://www.marcjlane.com/investment/index.html

Comparison of Contributions: Solo 401(k) vs. Other Plans

Recent legislation increased the maximum deductible contribution under many retirement plans to 25% of compensation, up to a maximum contribution of $40,000. Since a 401(k) plan, uniquely, has two methods of contribution (i.e., an employee salary deferral and an employer contribution), it is able to take advantage of these new limits and defer retirement contributions at a very rapid rate.

For 2003, the maximum salary deferral generally allowed is $12,000 per participant (unless the participant is at least 50 years old, as noted earlier). Additional contributions may be made by the employer; however, employer contributions must be made for each eligible participant and at the same rate (i.e., 25% of compensation). Salary deferrals are ignored when determining "compensation" for purposes of computing the employer contribution. Therefore, the contribution rate (i.e., 25%) is applied toward the participant's compensation before salary deferral. However, the "compensation" amount used in the calculation is less for unincorporated businesses than for corporations because of a reduction for self-employment taxes.

The chart below compares the maximum contributions available in 2003 for several popular retirement plans. The chart presumes that the business is incorporated, and reflects both the maximum employee and employer contribution components.

Comparison of Retirement Plans: Maximum Contributions (2003)

Business Owner Wages for 2003 SIMPLE IRA SEP IRA SOLO 401(k) $ 20,000 $ 8,600 $ 5,000 $17,000 $ 40,000 $ 9,200 $10,000 $22,000 $ 60,000 $ 9,800 $15,000 $27,000 $ 80,000 $10,400 $20,000 $32,000 $100,000 $11,000 $25,000 $37,000 *$112,000 * $11,360 $28,000 * $40,000 * $120,000 $11,600 $30,000 $40,000 $140,000 $12,200 $35,000 $40,000 $160,000 $12,800 $40,000 $40,000

Maximizing Your Solo 401(k): A "Side Business" Example

Bill is an employee of a corporation at which he has been contributing the maximum amount to that company's 401(k) plan (currently, $12,000). With the stock market's bear market from 2000 to 2002, he knows he either needs to contribute more toward retirement savings or get by with less income in his retirement years. (Note: Bill will probably opt to contribute more toward retirement savings since he is not a $20 million lottery winner) (To see "Case Studies," please visit http://www.marcjlane.com/Studies/casestudies.html)

Bill is also the sole shareholder of a corporation that he created five years ago for a side business. That business currently generates $40,000 of income, and since it is a side business, Bill doesn't need the income to support his family's routine expenses. If Bill establishes a solo 401(k) for the corporation, he can contribute $22,000 toward his retirement in 2003:

Salary deferral (maximum) $12,000 Employer contribution (25% of $40,000) $10,000 TOTAL solo 401(k) contributions $22,000

With these additional contributions, Bill can nearly triple the total amount he contributed to retirement plans in 2002 (i.e., $12,000 in 2002 with his primary corporate job, and $34,000 in 2003 with both his primary job and his side business). Bill will only pay income taxes on the remaining $18,000 of the $40,000 of income earned from his side business.

However, Bill can do better. If Bill's wife, Betty, is involved with the business and earns a salary of $10,000, she can contribute her full compensation as salary deferral. The total contributions for Bill and Betty would be calculated as follows:

Salary deferral (Bill) $12,000 Salary deferral (Betty) $10,000 Employer contribution - Bill (25% of $30,000) $ 7,500 Employer contribution - Betty (25% of $10,000) $ 2,500 TOTAL solo 401(k) contributions $32,000

Bill and Betty will now pay income taxes only on the remaining $8,000 (20%) of income generated from their side business and they'll avoid current income taxes on $32,000 (80%) of the business income. Combined, they will contribute $44,000 toward retirement in 2003 ($32,000 from the side business and $12,000 from Bill's primary job)!

Conclusion

A solo 401(k) plan now offers small business owners a practical way to rapidly contribute toward retirement, reduce taxes, consolidate retirement plans, and provide liquidity via 401(k) plan loans, if necessary. While everyone may not qualify for a solo 401(k), those that do enjoy the benefits of the plan for years to come. If you have questions, or if we can install a solo 401(k) plan for your business, please let us know and we'll be happy to help you. ______________________________

Retirement planning is an important part of your overall financial plan. How often should you review your financial goals? To learn more see "Start 2003 With a Review of Your Financial Goals and Strategies." please visit http://www.marcjlane.com/LaneReport/0301LR.htm

Interested in tax-focused planning? We can help. To learn more see "Wealth Retention Through Tax-Focused Planning: The Next Financial Challenge." please visit http://www.marcjlane.com/LaneReport/0207LR.htm

When should someone consider professional money management for a retirement - - or other investment - - account? To learn more see "A Case For Professional Money Management." please visit http://www.marcjlane.com/LaneReport/0204LR.htm

For additional information, please call (800) 372-1040 or send an e-mail to success@marcjlane.com