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Individual 401(k) Plan

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What is it?

An individual 401(k) plan is really nothing more than a combined profit-sharing plan and 401(k) plan implemented by a self-employed individual or small business owner with no full-time employees (unless the full-time employee is the owner's spouse).

Self-employed individuals and small businesses have, for some time, been able to establish both a profit-sharing plan and a 401(k) plan. Prior to the enactment of the Economic Growth and Tax Relief Reconciliation Act of 2001 ("2001 Tax Act"), however, establishing both plans had little relative appeal. Self-employed individuals and small businesses adopting employer-sponsored retirement plans largely focused on simplified employee pensions (SEPs) or savings incentive match plans for employees (SIMPLE) IRA plans. These plans generally offered benefits somewhat comparable to those offered by profit-sharing plans and 401(k) plans, but without the associated administrative costs. Additionally, self-employed individuals and small business owners who established profit-sharing plans received little in the way of additional benefit from utilizing a 401(k) plan as well.

Changes made by the 2001 Tax Act, though, have made 401(k) plans much more appealing to self-employed individuals and small business owners. In fact, when combined with a profit-sharing plan, 401(k) plans can allow for significant tax-deferred contributions.

Tip: Individual 401(k) plans are often referred to by other names, including solo 401(k)s, employer-only 401(k)s, single participant 401(k)s, and mini 401(k)s.

When can it be used?

Any nongovernmental organization is eligible to establish a 401(k) plan. However, only self-employed individuals or businesses (including partnerships) with no full time common law employees can adopt an individual 401(k) plan as described here. The fact that you, as a business owner, employ your spouse does not prevent you from adopting an individual 401(k) plan. The fact that you have one or more part-time employees who work fewer than 1,000 hours a year (and therefore can be excluded from participation in the plan) also may not prevent you from adopting an individual 401(k) plan.

Caution: If you have any (nonspouse) full-time employees age 21 or older (or part-timers working more than 1,000 hours a year), you will generally be required to allow them to participate in the plan. In this case, you can still adopt a 401(k) plan, but it will not be an individual 401(k) plan as described here.

Tip: One reason that you can generally adopt an individual 401(k) plan even though you employ your spouse has to do with nondiscrimination testing. You, as the business owner, are considered a highly compensated participant. Your spouse, because of special attribution rules, is also considered a highly compensated participant. A plan that covers only you and your spouse, then, includes only highly

compensated participants. Because only highly compensated employees participate in the plan (since the plan covers only you and possibly your spouse) an individual 401(k) is not subject to nondiscrimination testing. This greatly simplifies administration of the plan. Were the plan to include any non-highly-compensated employees, nondiscrimination rules would apply and the overall simplicity of the plan would be defeated. In addition, a plan that covers only you (or you and your spouse) is exempt from the complicated requirements of the Employee Retirement Income Security Act of 1974 (ERISA).

How does it work?

Compensation deferral

As with any 401(k) plan you, as an owner-employee, are able to defer up to $17,500 in compensation in 2014 (unchanged from 2013). If you are age 50 or older, you are able to make an additional "catch-up" contribution of up to $5,500 in 2013 and 2014. These limits are adjusted for inflation each year.

You can also designate all or part of your elective deferrals as Roth 401(k) contributions.

Profit-sharing contribution

The 2001 Tax Act increased the maximum deductible amount an employer could contribute to a profit-sharing plan from 15 percent to 25 percent of total eligible compensation under the plan. Significantly, the 2001 Tax Act also provided that compensation deferred as part of a 401(k) plan does not count toward the 25 percent limit. Therefore you, as an owner-employee, can defer the maximum amount of compensation under the 401(k) plan, and still contribute up to 25 percent of total compensation to the profit-sharing plan on your own behalf.

Tip: In calculating total eligible compensation under the plan, the maximum compensation that can be considered for any single individual is $260,000 in 2014 ($255,000 in 2013).

Tip: If the business is unincorporated, individual 401(k) plan compensation is based upon net earned income. This means that self-employed individuals must deduct one-half of their self-employment tax as well as any plan contributions to determine their compensation base. Effectively, this means that an unincorporated business with one owner-employee can deduct contributions of up to 20 percent of the owner-employee's earnings after the deduction for one-half of self-employment tax.

Example(s): 30-year old Jack is the sole owner of a small corporation, and he had annual pretax compensation of $50,000 in 2014. Since he has no employees, he is the only participant in his business's 401(k) plan. Under current tax law, Jack's plan account can receive a tax-deductible business contribution of $12,500 (25 percent of $50,000), plus a 401(k) employee elective deferral contribution of $17,500 in 2014. This combination results in a total contribution of $30,000, well within Jack's 2014 annual additions limitation of $50,000 (the lesser of $52,000 or 100 percent of his pretax compensation).

Now assume the same facts as above, except that Jack is a sole proprietor instead of the sole owner of a corporation. In this case, Jack's plan account can receive a total contribution of up to $26,793 for 2014--a $9,293 tax-deductible business contribution (20 percent of Jack's net earnings after the deduction for one-half of self-employment tax--see 1040 Schedule SE), plus a 401(k) elective deferral contribution of $17,500.

Annual addition (415(c)) limit

The 2001 Tax Act also increased the maximum amount that a participant can receive in the form of combined employee deferrals and employer contributions to the lesser of 100 percent of compensation or $52,000 (in 2014). This means that the total of your compensation deferral and profit-sharing contribution cannot exceed $52,000 in 2014.

Technical Note: If the business is unincorporated, the 100 percent of compensation limit must be adjusted. In general, the owner employee's profit-sharing contribution can't exceed 50 percent of his or her earnings reduced by the deduction for one-half of self-employment tax, and further reduced by the owner employee's elective deferrals.

The $52,000 contribution limit (for 2014) does not apply to catch-up contributions made by individuals age 50 or older. These individuals may exceed the dollar limit (but not the 100 percent of compensation limit) by an amount equal to their allowable catch-up contribution (e.g., $5,500 in 2014).

Advantages to consider

A qualifying self-employed individual or small business owner seeking to put aside the maximum amount of funds for retirement on a tax-deferred basis really can't do much better than an individual 401(k). Moreover, given the flexibility of being able to determine each year how much to contribute (or whether to contribute at all), an individual 401(k) becomes a very powerful retirement savings vehicle. An individual 401(k) may be particularly appealing to individuals who have full-time careers, but have their own sideline businesses. Such individuals could potentially contribute a large portion, if not all, of the sideline business earnings into an individual 401(k).

Caution: An individual already participating in an employer-sponsored retirement plan must be careful. Compensation deferrals and total amounts received under the plans must be coordinated. Consult a retirement plan professional.

Additionally, like all 401(k) plans, individual 401(k) plans can allow loans, and may allow hardship withdrawals (withdrawals made prior to age 59½ may be subject to a 10 percent federal penalty tax). You can also roll over funds to your individual 401(k) plan from a former employer's 401(k) plan and from other types of retirement arrangements, including IRAs, SEP and Keogh plans, and governmental Section 457(b) plans.

Disadvantages to consider

Like a regular 401(k) plan, an individual 401(k) plan must follow certain requirements under the Internal Revenue Code (IRC). Since you are generally the only participant in an individual 401(k) plan, meeting these requirements isn't nearly as difficult as with plans that have multiple participants. Additionally, individual 401(k) providers will typically bundle the product with administrative support. However, there is still a cost associated with establishing a individual 401(k), as well as a cost relating to the plan's ongoing administration.

Another issue to consider is whether an individual 401(k) will meet your future needs. If your business grows and you hire a full-time employee who is not your spouse, that employee will generally need to be covered by your retirement plan. If that happens, you're no longer dealing with an individual 401(k), but a full-blown qualified plan subject to all coverage and discrimination rules.

In addition, since an individual 401(k) plan is a one-participant plan, many providers offer a relatively limited selection of investment alternatives. However, as individual 401(k)s gain in popularity, more investment options should become available.

One final issue to consider is creditor protection. You individual 401(k) plan assets are generally fully protected from your creditors under federal law if you declare bankruptcy. However, since your plan isn't subject to ERISA, whether your plan's assets will be protected from your creditors outside of bankruptcy will be determined by the laws of your particular state. (By contrast, assets in 401(k) plans covered by ERISA are generally fully protected from participants' creditors, inside or outside of bankruptcy (some exceptions apply).)