January 22, 2020

To our valued clients and friends:

Have you procrastinated about setting up a tax-advantaged retirement plan for your small business? If the answer is yes, you are not alone.

Still, this is not a good situation. You are paying income taxes that could easily be avoided. So consider setting up a plan to position yourself for future tax savings.

For owners of profitable one-person business operations, a relatively new retirement plan alternative is the solo 401(k).

The main solo 401(k) advantage is potentially much larger annual deductible contributions to the owner's account—that is, your account. Good!

Solo 401(k) Account Contributions

With a solo 401(k), annual deductible contributions to the business owner's account can be composed of two different parts.

First Part: Elective Deferral Contributions

For 2020, you can contribute to your solo 401(k) account up to $19,500 of

- your corporate salary if you are employed by your own C or S corporation, or
- your net self-employment income if you operate as a sole proprietor or as a single-member LLC that's treated as a sole proprietorship for tax purposes.

The contribution limit is $26,000 if you will be 50 or older as of December 31, 2020. The $26,000 figure includes an extra $6,500 catch-up contribution allowed for older 401(k) plan participants.

This first part, called an "elective deferral contribution," is made by you as the covered employee or business owner.

- With a corporate solo 401(k), your elective deferral contribution is funded with salary reduction amounts withheld from your company paychecks and contributed to your account.

- With a solo 401(k) set up for a sole proprietorship or a single-member LLC, you simply pay the elective deferral contribution amount into your account.

Second Part: Employer Contributions

On top of your elective deferral contribution, the solo 401(k) arrangement permits an additional contribution of up to 25 percent of your corporate salary or 20 percent of your net self-employment income.

This additional pay-in is called an "employer contribution." For purposes of calculating the employer contribution, your compensation or net self-employment income is not reduced by your elective deferral contribution.

- With a corporate plan, your corporation makes the employer contribution on your behalf.
- With a plan set up for a sole proprietorship or a single-member LLC, you are effectively treated as your own employer. Therefore, you make the employer contribution on your own behalf.

Combined Contribution Limits

For 2020, the combined elective deferral and employer contributions cannot exceed

- $57,000 (or $63,500 if you will be age 50 or older as of December 31, 2020), or
- 100 percent of your corporate salary or net self-employment income.

For purposes of the second limitation, net self-employment income equals the net profit shown on Schedule C, E, or F for the business in question minus the deduction for 50 percent of self-employment tax attributable to that business.

Key point. Traditional defined contribution arrangements, such as SEPs (simplified employee pensions), Keogh plans, and profit-sharing plans, are subject to a $57,000 contribution cap for 2020, regardless of your age.

Example 1: Corporate Solo 401(k) Plan

Lisa, age 40, is the only employee of her corporation (it makes no difference if the corporation is a C or an S corporation).

In 2020, the corporation pays Lisa an $80,000 salary.

The maximum deductible contribution to a solo 401(k) plan set up for Lisa's benefit is $39,500. That amount is composed of

1. Lisa's $19,500 elective deferral contribution, which reduces her taxable salary to $60,500, plus

2. a $20,000 employer contribution made by the corporation (25 percent x $80,000 salary), which has no effect on her taxable salary.

The $39,500 amount is well above the $20,000 contribution maximum that would apply with a traditional corporate defined contribution plan (25 percent x $80,000). The $19,500 difference is due to the solo 401(k) elective deferral contribution privilege.

Variation. Now assume Lisa will be age 50 or older as of December 31, 2020.

In this variation, the maximum contribution to Lisa's solo 401(k) account is $46,000, which consists of

1. a $26,000 elective deferral contribution (including the $6,500 extra catch-up contribution), plus
2. a $20,000 employer contribution (25 percent x $80,000).

That's much more than the $20,000 contribution maximum that would apply with a traditional corporate defined contribution plan (25 percent x $80,000). The $26,000 difference is due to the solo 401(k) elective deferral contribution privilege.

Example 2: Self-Employed Solo 401(k) Plan

Larry, age 40, operates his cable installation, maintenance, and repair business as a sole proprietorship (or as a single-member LLC treated as a sole proprietorship for tax purposes).

In 2020, Larry has net self-employment income of $80,000 (after subtracting 50 percent of his self-employment tax bill).

The maximum deductible contribution to a solo 401(k) plan set up for Larry's benefit is $35,500. That amount is composed of

1. a $19,500 elective deferral contribution, plus
2. a $16,000 employer contribution (20 percent x $80,000 of self-employment income).

The $35,500 amount is well above the $16,000 contribution maximum that would apply with a traditional self-employed plan set up for Larry's benefit (20 percent x $80,000). The $19,500 difference is due to the solo 401(k) elective deferral contribution privilege.

Variation. Now assume Larry will be age 50 or older as of December 31, 2020.

In this variation, the maximum contribution to Larry's solo 401(k) account is $42,000, which consists of

1. a $26,000 elective deferral contribution (including the $6,500 extra "catch-up" contribution), plus
2. a $16,000 employer contribution (20 percent x $80,000).

That's much more than the $16,000 contribution maximum that would apply with a traditional self-employed defined contribution plan (20 percent x $80,000). The $26,000 difference is due to the solo 401(k) elective deferral contribution privilege.

As you can see, in the right circumstances, the 401(k) can make for a great retirement plan. If you would like to discuss the 401(k) with me, please call us at 859-441-2020 or contact us on line at www.ahm-cpa.com.

Sincerely,

Anneken, Huey & Moser, PLLC