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The PRS Report

INSIDE THIS ISSUE:

THE ALLURE OF THE SOLO 401(K) PLAN

The Allure of the Solo 401(k) Plan

How would you or your client like to make a contribution equal to 86% of pay into a qualified plan? A "solo" 401(k) Plan may allow for such high levels of contributions without running afoul of the 25%-of-compensation maximum deductible contribution limit for a defined contribution plan . A "solo" 401(k) Plan is a 401(k) Plan for a business in which the owner is, or the owner and spouse are, the only 1000-hour employees of the company and therefore the only employees eligible to participate in the Plan.

Let's look at an example:

Bob and Joan are husband and wife. Both are semi-retired and over the age of 65. Bob and Joan both draw pensions from their former jobs. Not ready to spend their days playing bridge, pinochle or chasing early-bird specials, Bob did something he had been dreaming about for years. He started a photography business. Bob is an avid photographer and you can find him photographing business gatherings, weddings, bar-mitzvahs and other affairs. Joan is an employee of the business and works more than 1000 hours a year assisting Bob. Joan receives a W-2 Form at the end of the year. Bob has a few other employees besides Joan, all of whom work less than 1000 hours a year.

Bob and Joan have already established a 401(k) plan with PRS. In early December of 2013, Bob and Joan estimate that the business will net roughly $60,000 for 2013. Both Bob and Joan had elected to make the maximum 401(k) contributions for 2013 ($17,500

The Allure of the Solo 401(k) Plan

plus $5,500 as "catch-up" contributions for participants age 50 and over) although payroll has not yet been run for Joan's salary. Since Bob and Joan live off their pensions and Social Security, the goal in setting up the 401(k) Plan was to contribute as much as allowable, thereby lowering their tax burden and saving more for retirement.

What is the minimum salary Joan needs to receive in order for her to defer the maximum allowable 401(k) contribution in 2013? PRS calculates that the minimum salary Joan is required to receive in order to defer $23,000 is approximately $25,000.

That leaves $35,000 which Bob will receive as Net Schedule C earnings, $23,000 of which will be deferred as his maximum 401(k) contribution. That's not the end of the calculations nor the contributions. *An additional feature and allure of the Solo 401(k) Plan is the option to make a Profit Sharing contribution.* After all is said and done, how much more can be contributed as a Profit Sharing contribution? It turns out that the maximum Profit Sharing contribution which can be made based on the numbers detailed in this scenario is $5,834. Of the $5,834, $2,000 is allocated to Joan and the balance $3,834 is allocated to Bob.

The Allure of the Solo 401(k) Plan

Joan's total allocation between 401(k) and Profit Sharing is $25,000 or **100% of her pay.** Bob's total allocation equals $26,834. The total combined allocation for Bob and Joan is $51,834 or a whopping **86% of pay** ($51,834 ÷ $60,000).

There is a segment of the population for whom the Solo 401(k) design fits like a glove. That segment is typically the individual who has a side business not related to his or her main source of income, say a teacher who runs a printing business in his or her spare time. Or, as described above, someone who is close to or at retirement age and is operating a business not necessarily in order to survive. The design works best if the owner is over 50 years old and does not participate in another 401(k) or 403(b) plan.

The Solo 401(k) Plan can be a great vehicle for reducing taxable income while at the same time saving large percentages of pay towards retirement. If you or your client fit the above profile or if you know someone else who does or who could benefit from the design, why not give us a call for more details?

PRS
PENSION REVIEW SERVICES

Pension Review Services
445 Broad Hollow Road Suite 8
Melville, NY 11747
Phone: (631) 465-0850 Fax: (631) 465-0855
www.pensionreviewservices.com
email: info@pensionreviewservices.com
twitter