Flying Solo? Navigate 401(k) Rules

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If you are a sole proprietor, you have more retirement plan options now than you did in the not-so-distant past. For example, you can participate in a 401(k) plan much like the CEO of a major corporation. Many of the obstacles to this arrangement, including high costs for administering this type of plan, no longer stand in your way.

With a "solo 401(k) plan," you can make contributions on your own behalf, up to the allowable tax law limits. Furthermore, these contributions can be combined with contributions by your employer—namely, yourself. Thus, you may be able to save a substantial sum for retirement in a relatively short period of time.

The IRS recently announced the new limits for qualified retirement plans for 2014. Many of the inflation-indexed limits are unchanged or are only slightly higher than they were in 2013.

The maximum deductible contribution allowed to a defined contribution plan in 2014 is the lesser of 25% of compensation or $52,000. The maximum compensation that may be taken into account for these purposes in 2014 is $260,000. For individuals who are not incorporated, the 25% cap is replaced by a limit of 20% of self-employment income.

In addition, a dollar limit applies to 401(k) elective deferrals. For 2014, an employee can defer up to $17,500 of compensation to his or her account, plus a "catch-up contribution" of $5,500 is allowed if the employee is aged 50 or older. Thus, an employee participating in a 401(k) plan can make elective deferrals within these annual limits. Plus, the company may match a portion of the contributions (usually, up to a set percentage of the participant's compensation).

Although the basic rules for defined contribution plans still apply, there is a distinct advantage for sole proprietors. Notably, elective deferrals to a solo 401(k) plan do not count toward the percentage cap on overall contributions, although they do count toward the dollar cap. So you can combine contributions for possibly even greater retirement savings.

For example, if your annual self-employment income is $100,000 and you are aged 50 or older, you are able to defer the maximum $23,000 to your account in 2014 and combine it with a deductible employer contribution of $25,000 (25% of $100,000). The total contribution is $48,000 ($23,000 $25,000)—still within the allowable tax law limits.

Generally, the contributions to a solo 401(k) plan grow tax-deferred until you are ready to retire. At that time, distributions are taxed at ordinary income rates. Alternatively, you may roll over part or all of your account to an IRA without paying current tax.

A spouse on the payroll is eligible for the same contributions as the sole employee. If you add other employees, they must be covered under the regular 401(k) rules. Also, you will likely incur some administrative costs.

This is not for everyone. Keep an eye open for other alternatives for self-employed individuals, such as Simplified Employee Pensions (SEPs), Savings Incentive Match Plans for Employees (SIMPLEs) or traditional Keogh plans. Be sure to investigate all the possibilities.

Consult your Henry & Horne, LLP professional tax advisers with respect to your situation.

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