



ASK THE LAWYER

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NEW AFFORDABLE RETIREMENT PLANS FOR SMALL AND FAMILY-OWNED BUSINESSES

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We all know how important retirement planning is for our financial future. A qualified retirement plan not only provides financial security, but also offers attractive tax benefits while helping to attract and retain quality employees. The high costs of setting up and administering a 401(k) have made these plans unappealing to self-employed individuals and small family-operated businesses.

Recent pension reform legislation has created new retirement vehicles to help small-business owners shelter a significantly greater portion of their income from taxation that they were previously unable to do with conventional business retirement plans.

Unlike a traditional 401(k), these plans are designed specifically for small and self-employed businesses. Financial service providers refer to these new plans as the Uni-K, the Self-Employed 401(k), the Mini-401(k) and the Solo 401(k).

These plans may be adopted by sole-proprietorships and small businesses (including partnerships, S-Corporations, LLCs and LLPs), provided the only eligible plan participants are the business owners and their family.

What makes a Solo 401(k) simpler?

A Solo 401(k) covers the business owners who are also the only employees; therefore, the complex 401(k) rules on coverage and nondiscrimination don't come into play. Further, these plans are less complex, and less costly to manage than traditional 401(k) plans. In fact, some financial administrators charge a very low annual fee to administer the plans.

Who is eligible to participate in a Solo 401(k)?

The Solo 401(k) may be adopted by businesses whose only eligible persons are the business owners. Although specific plan administrators may have their own guidelines or limitations regarding participants in a Solo 401(k), generally your family members, including spouses, children, parents and grandparents may also participate if they earn income from the business.

What other advantages are there to a Solo 401(k)?

Depending on your earnings, you may be able to contribute more to a Solo 401(k) than to another retirement plan.

There are two components to a Solo 401(k) plan: salary deferral contributions and profit sharing contributions. For example, in 2004 a small-business owner can make a salary deferral contribution of 100% of compensation, not to exceed \$13,000. The business could make a profit sharing contribution for the same participant of up to 25% of compensation, not to exceed \$41,000. As with traditional 401(k) plans, there are limits on the total amount contributed, and catch-up contributions are allowed for participants age 50 and over. By allowing higher contributions than other plans, such as SIMPLEs and SEPs, these 401(k)s may give you more opportunity to cut your taxes while building a bigger retirement nest egg.

The calculation of the profit sharing contribution is a little more involved for a sole-proprietorship than it is for a small corporation; however, the IRS provides a step-by-step formula in publication 560, which is available at www.irs.gov.

Are these contributions tax-deductible?

Salary deferral contributions or elective deferrals are excluded from taxable income rather than being deducted from it. Your contributions are subject to Social Security tax, but they won't be subject to income tax until you withdraw money from the account. The profit sharing contributions are generally tax-deductible by the business.

Are loans available from a Solo 401(k)?

Another benefit to a Solo 401(k) is that you have access to the money you have invested. While borrowing against SEPs or SIMPLEs isn't allowed, the Solo 401(k) plans allow you to borrow as much as 50% of the balance in your account, up to \$50,000.

While you can borrow against your account at any time, you cannot withdraw from it penalty-free until you're retired or become disabled. However, there are provisions for withdrawals for severe hardship but it's subject to an IRS penalty. When one stops working for the business, or if the plan is terminated, one can move their savings into another retirement plan without paying the IRS penalty.

Are rollovers allowed into a Solo 401(k)?

Yes, if you have money in another retirement plan, you have the option of rolling over money from other eligible retirement accounts into your 401(k) account. Doing so may

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make it easier for you to track investment returns.

What are the disadvantages to a Solo 401(k)?

Perhaps the main problem is that if your business grows and you hire employees, your 401(k) plan must also cover them. Your plan then is subject to all the complex rules and costly administration of a regular 401(k) plan. The main benefit of having a Solo 401(k) plan would be lost because nondiscrimination rules would no longer allow you to make large contributions just for yourself.

Conclusion

A Solo 401(k) is especially appealing for the self-employed and other small businesses that employ no full-time employees except the owners and their immediate family members. This type of plan typically works well for participants who make \$40,000-200,000 per year. Before you elect a Solo 401(k), be sure you don't intend to add full-time permanent employees in the near future.

There is a great deal of information on the Internet about these plans to allow employers to become familiar with the specifics. One such Web site is www.401khelpcenter.com. As usual, one should contact their counsel, financial advisor and/or accountant before taking any action. □

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