

## **401(k) Plans: Learning to Fly Solo**

For years, 401(k) plans were used almost exclusively by mid- to large-sized companies. But smaller companies and self-employed individuals are increasingly taking advantage of this popular type of retirement plan as a result of reduced administrative costs and other changes.

In fact, "solo 401(k) plans" have a distinct advantage over many other plans. Key point: A small-business owner can benefit from both "employee" and "employer" contributions. Therefore, the owner may save more for retirement than he or she could normally save with a qualified plan.

Background: The tax law imposes certain limits on qualified retirement plan contributions and benefits. The limits are adjusted on an annual basis. For 2011, the limit for an employer's deductible contribution to a defined contribution plan like a Simplified Employee Pension (SEP) is generally the lesser of 25% of compensation or \$49,000 (\$54,500 for a participant age 50 or older). The maximum compensation that may be taken into account for this purpose is \$245,000.

With a 401(k) plan, an employee may also choose to defer part of his salary to the account. The salary deferral limit for 2011 is \$16,500 (\$22,000 for a participant age 50 or older). In addition, the employer may make a contribution on the employee's behalf, subject to the limits for defined contribution plans. The same rules for deductible contributions by employers continue to apply.

However, due to a recent tax law change, elective deferrals to a solo 401(k) do not count toward the 25%-of-compensation cap (although the annual dollar limit still applies). Thus, a small-business owner may be able to reap even greater savings.

Hypothetical example: John Q. Public is self-employed and younger than age 50. He earns \$100,000 of compensation per year. If John sets up a SEP (Simplified Employee Pension) IRA for his small incorporated company, the maximum deductible amount he can contribute to the plan in 2011 is \$25,000 (the lesser of 25% of compensation or \$49,000).

But suppose John establishes a solo 401(k) instead of a SEP. In that case, he can defer \$16,500 to his account in addition to the maximum \$25,000 employer contribution. That results in a total contribution of \$41,500, which is still well below the \$49,000 limit. Because John is the only employee of the company, he does not have to make any other contributions. In other words, John can contribute an extra amount year-in and year-out. The eventual savings, when compounding of earnings is figured in, can easily reach seven figures.

A solo 401(k) may also enable participants to borrow against their accounts or take hardship withdrawals if necessary. Funds from another qualified plan of a prior employer can be rolled over into the solo 401(k) for convenience.

Finally, be aware that contributions are discretionary. If the business is not faring well, solo 401(k) contributions can be reduced or skipped entirely until the business gets back on its feet.

This option should be carefully considered for certain situations. Make an informed decision.