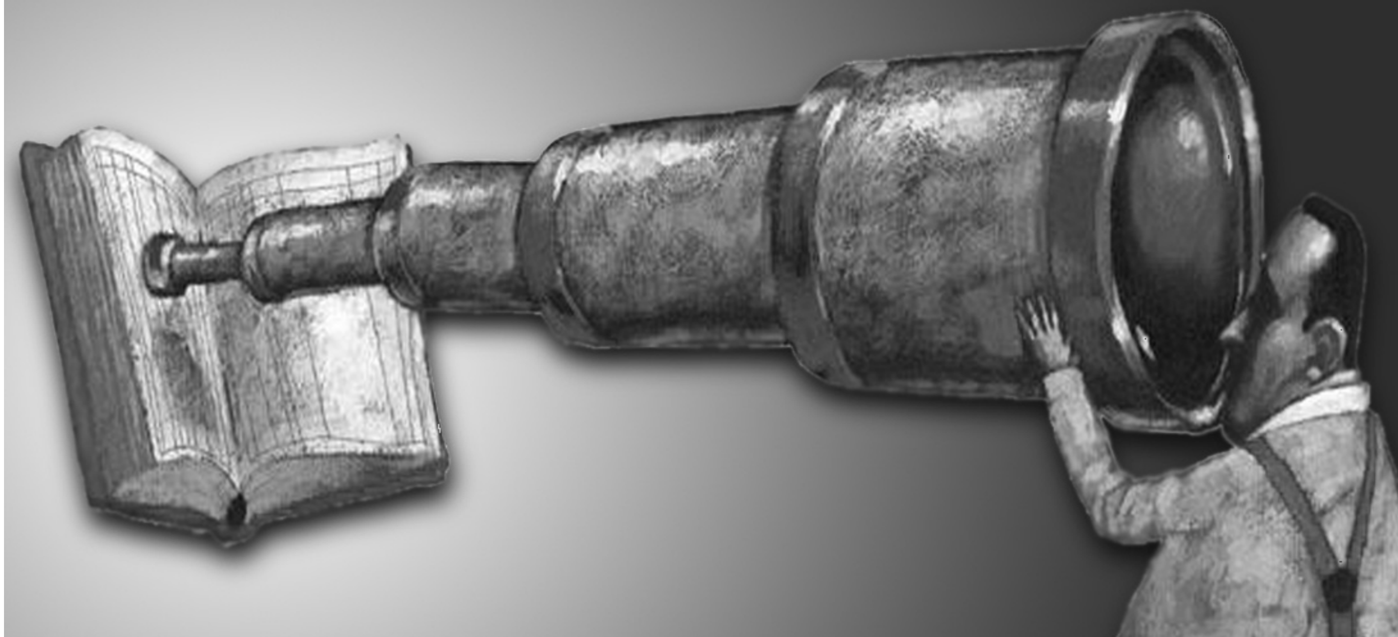
Maximizing Tax Savings with the Owner-Only 401(k)

By Michael Falcon



The 401(k) retirement savings plan has become almost ubiquitous in the corporate world as a way for employees to set aside pre-tax dollars that accumulate tax-deferred monies until the funds are withdrawn for retirement. As a retirement savings vehicle for sole pro prietors, however, the 401(k) has not been an attractive option until recently.

The passage of the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) allows businesses to make tax-deductible profit-sharing contributions of 25% of compensation. In addition, an individual's $13,000 maximum deferral in 2004 ($14,000 in 2005) is no longer included in the calculation of the maximum deductibility. This means that a business owner may now contribute 25% of his compensation as a profit-sharing contribution plus a deferral of $13,000, up to a total of $41,000 (not to exceed 100% of compensation). If the employee will be 50 or older during the year, they are permitted an additional catch-up contribution of $3,000 - bringing their total to $44,000 for 2004.

Easier Administration, Higher Contributions

Prior to the EGTRRA's passage, employer contributions were limited to 15% of total compensation for all eligible participants. In addition, the administration costs and compliance requirements of setting up and running a 401(k) plan for a

sole proprietorship made other options like Simplified Employee Pension (SEP) plans, SIMPLE IRAs (Savings Incentive Match Plan for Employees) or a Keogh look much better by comparison. Now with simplified reporting requirements and contribution limits that in some cases are more than double those of IRAs, SEPs or Keoghs, the Owner-Only 401(k) has become an excellent vehicle for sole proprietors to save substantial amounts of pre-tax dollars for retirement.

An Owner-Only 401(k) is a smart idea for individuals who work as independent contractors and want to defer taxes on as much of their income as possible. Take, for example, a sole proprietor who operates his own technology consulting company and pays himself compensation of $100,000 annually. That income would be taxed on his personal return at his highest marginal rate when he files his IRS Form 1040. With the Owner-Only 401(k), he is able to defer taxes on $38,000 of that income - saving more than $13,000 on this year's taxes. With a SEP plan, he would make an annual employer contribution of $25,000, or 25% of his compensation. With a SIMPLE IRA, he would be limited to just $12,000 in combined salary-deferral and matching employer contributions.

Weighing the Options

Owner-Only 401(k) plans are designed to cover only the owner and his or her spouse. As a sole proprietor, hiring your spouse and paying them a salary does have the advantage of increasing the amount of business income that can be deferred. But if your business is expanding and you plan to add employees in the near future, you would need to convert the plan to a traditional 401(k), meaning more rigorous reporting requirements, including the annual filing of IRS Form 5500 and having to pass nondiscrimination tests, which could limit the contributions made by highly compensated employees. (Note: An Owner-Only 401(k) plan must file Form 5500 when assets of the plan exceed $100,000.)

Also, the Owner-Only 401(k) is best suited for business owners with compensation below $164,000 ($167,000 if age 50 or older). Someone younger than age 50 and earning a steady $200,000 a year, for example, could obtain the same benefits available under an Owner-Only 401(k) with a SEP plan, which is less complicated and less costly to administer. Additionally, SEP plans don't require a summary plan description or annual program administration fees.

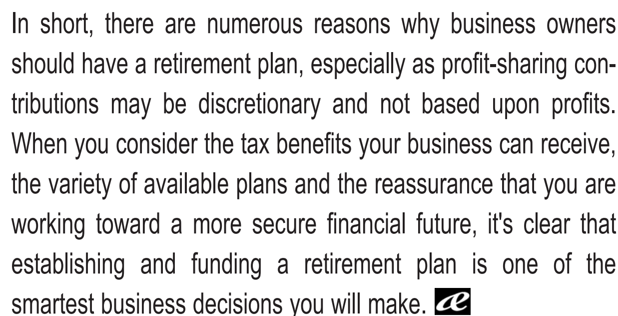
There are numerous factors to consider when choosing a retirement plan for your small business, and one size never fits all. Some of the major factors to be considered are:

- The primary purpose of the plan (either to attract and retain employees or to achieve tax deferrals for the owner).
- Cost sensitivity.
- Desire to make or match employee contributions.
- The age, employment duration and compensation of owners and otherwise eligible employees.

Keeping Tax Considerations Paramount

Regardless of which plan you decide to implement, the tax benefits make the task of saving for retirement much less burdensome. Personal income tax rates are down, but are still as high as 35%, meaning that $35,000 of every extra $100,000 earned goes to taxes instead of being allowed to compound tax-deferred until retirement. The difference over time in retirement account balances can be substantial by using pre-tax dollars.

In short, there are numerous reasons why business owners should have a retirement plan, especially as profit-sharing contributions may be discretionary and not based upon profits. When you consider the tax benefits your business can receive, the variety of available plans and the reassurance that you are working toward a more secure financial future, it's clear that establishing and funding a retirement plan is one of the smartest business decisions you will make.



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