



YOUR MONEY:

Retirement Plan Options For The Self-Employed: Solo 401(k)s vs. SEPs

Utilize retirement plans to secure your financial future and gain tax advantages.

November 2007, by Guy McPhail

(Part three of a series on retirement planning. In previous installments of this series we examined [defined benefit plans](#) and [matching and Safe Harbor 401\(k\)s](#). This month we take a look at Solo 401(k)s and SEPs.)

Experts estimate that Americans will need 60 to 80 percent of their pre-retirement income to maintain their current standard of living when they stop working. If you are the sole owner of a small business, pension plans are a great way to build wealth to ensure that you can retire comfortably. They are also great tax-saving tools that can benefit your business today.

The two most common retirement plans available to the sole owner are the more traditional SEP (Simplified Employee Pension plan) and the Solo (Self-Employed) 401(k) that was introduced in 2001 under the Economic Growth and Tax Relief Reconciliation Act (EGTRRA).

Deciding which retirement plan is right for you can be confusing. Which would be better for you: a SEP or a Solo 401(k)?

The Solo 401(k)

The Solo 401(k) is a plan designed to accept employee salary deferral contributions plus a profit sharing portion. (See [part two of this series](#).)

This means for 2007, the Solo 401(k) allows a self-employed person to make a contribution of 25 percent of earned income (net profit from your Schedule C minus one-half of self-employment tax minus the contribution), plus salary deferrals of \$15,500 with a maximum contribution not to exceed \$45,000. Individuals 50 and older can make an additional \$5,000 catch-up contribution and invest a maximum \$50,000.

The SEP

The SEP, on the other hand, only allows you to contribute the profit sharing portion. The Internal Revenue Code for 2007 allows the same maximum contribution of \$45,000 or \$50,000 for those 50 and older. Let's look at some examples to clarify the differences between these plans.

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Jane is 54 years old and runs a one-person business, a one member LLC consulting firm. This is how the contributions to her Solo 401k Plan could look if she has \$100,000 in profits in 2007:

Maximum Profit Sharing Contribution	\$18,587
Maximum salary deferral to 401(k)	\$15,500
Maximum catch-up deferral to 401(k)	<u>\$5,000</u>
Total	\$39,087

If Jane had a SEP the maximum contribution to her 2007 pension would be \$18,587, which only includes the profit sharing portion.

The above example is for a single owner who is either a sole proprietor or single member LLC.

If Jane had an incorporated business, the numbers would change slightly because the self-employment taxes would be paid by the corporation in her W-2. She could contribute the following to her Solo 401(k):

Profit Sharing (25% of \$100,000)	\$25,000
Salary Deferral Contribution to 401(k)	\$15,500
Catch-up contribution to 401(k)	<u>\$5,000</u>
Total	\$45,500

If Jane's incorporated business sets up a SEP only the profit sharing portion, or \$25,000 in this case, could be contributed to her pension plan.

So, the bottom line is those of you who are savvy will set up the Solo 401(k) to take advantage of every tax break available, and create the greatest amount of wealth. You also will not have to worry about future years when cash might be tight, because you will not have to contribute the maximums, or anything at all, if you so choose. In other words, the Solo 401(k) lets you make larger contributions in profitable years while giving you the freedom not to make lower contributions in less profitable years or when cash flow is tighter.

If you wish to contribute more than 25 percent of earned income then a Solo 401(k) is *definitely* for you. Otherwise, a SEP may be sufficient. As you start nearing \$225,000 of earned income the difference between one plan type and the other shrinks because, in both cases, you're approaching the contribution maximums. Setting up a Solo 401(k) is generally a little more expensive and requires slightly more paperwork than a SEP. However, the benefit almost always outweighs the small cost difference.

It's important to note that you must set up a Solo 401(k) by December 31st of this year. A SEP can be set up after year-end and before you file even if you request extensions.

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