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401(k) Plans

The Unwatched Solo-K

The 401(k) plan is an available option for sole-proprietors but when left unwatched can be a trap for errors.

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Third-party administrators (TPAs) in the qualified plan arena frequently do not make a practice of handling one-person retirement plans. Like financial advisors, the TPA typically is focused on retirement plans of some size, whether it be small or large market. In an environment where administration fees are already compressed, it can certainly be difficult to charge a fee for administration of a small plan that is considered reasonable by the sponsor and yet sufficient for the practitioner to make a profit.

Financial advisors frequently recommend a 401(k) plan as a good investment vehicle for their sole-proprietor clients to save for retirement. There are advantages for the individual to use the 401(k) plan as opposed to an Individual Retirement Account (IRA) or a Simplified Employee Pension plan (SEP) as the 401(k) allows for larger contributions than an IRA and more flexibility than a SEP. Often the brokerage firm or investment company will even provide a very simplified 401(k) plan document, which can be quickly completed by hand with the answers to just a couple of questions and a client signature, and the plan is ready to take contributions.

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Advantages of 401(k) to an Individual

For many years the 401(k) plan design has been available to a sole-proprietor, and though it has acquired the nickname Solo-K or Uni-K over the years, it is still in all functionality a true 401(k) plan, just generally simplified because there are no employees and therefore no testing required.

The benefit to an individual of using a 401(k) plan as opposed to an IRA is the ability to take advantage of the higher contribution limits so that they can save at a faster rate, as well as the opportunity for the higher tax deduction related to the contribution. For the 2020 plan year, the contribution limit for an IRA is $6,000 with a $1,000 catch-up available to individuals age 50 and older, as opposed to the much higher 401(k) contribution limit of $57,000 plus a $6,500 catchup. Another opportunity within a 401(k) plan that is not available in an IRA, is that one may choose to make a pre-tax or Roth after-tax contribution without regard to Internal Revenue Service (IRS) income limits on the Roth contributions, whereas, the ability to make a Roth contribution to an IRA is phased out at an income of $139,000 for individuals filing taxes as Single and $206,000 for those filing as Married, for the 2020 year.

A 401(k) also has a saving advantage over a SEP. The maximum profit-sharing type contribution in a SEP, or even a traditional profit sharing plan that some might still refer to as a Keogh, is 25 percent of considered compensation. The 401(k) plan requires less compensation to achieve the same total contribution because the salary deferral contribution is contributed outside of that equation. For example, within the 401(k) plan, if an individual over 50 years of age were to defer the maximum $19,500 plus $6,500 catch-up, he/she also would be permitted to make a $37,500 profit sharing contribution (thereby reaching the $57,000 annual addition limit plus the $6,500 catchup). Assuming W-2 compensation for simplicity of calculation, the individual's compensation would only need to be $150,000 in order to make a 25 percent maximum contribution equal to $37,500. Thus, with $150,000 compensation, a maximum contribution of $63,500 is possible. By contrast, within a SEP, the individual would need compensation of $228,000 to calculate a 25 percent contribution equivalent to the maximum annual addition of $57,000. In addition, the SEP has no catch-up provision to take advantage of at age 50. Thus, the 401(k) provides a definite advantage as far as allowing higher total contributions as well as significantly higher contributions at lower levels of income.

Is a Solo-K Always Solo?

As far as the Form 5500 is concerned, a "one-participant plan" is a plan that covers only an individual or an individual and their spouse who wholly own a trade or business. This includes businesses that are incorporated or sole-proprietorships that are not incorporated. Additionally, a "one-participant plan" covers a partnership and their spouses if there are no other employees. So, a "one-participant plan" may cover not only a married couple, but multiple married couples who own and work in the same business.

What Could Possibly Go Wrong?

Form 5500 Filing

I can only imagine how many individual 401(k) plans exist across all of the investment platforms, within brokerage firms in individual accounts and banks. There may be statistics available, but I expect that they would be difficult to quantify because there is no requirement to file a Form 5500 until the assets reach $250,000. Once a plan reaches $250,000 in assets, a Form 5500-EZ must be filed. However, it is not only if the plan reaches $250,000, it is combined plans. So, if a sole-proprietor has a 401(k) and a pension plan, both plans must be looked at in conjunction to see if the $250,000 has been reached.

As you may imagine, there are multiple ways that a plan can run afoul of this rule, particularly when there are multiple partners and spouses under one blanket plan, perhaps using different brokers (because, why not?). What could possibly go wrong, particularly if there is no party responsible for overseeing the administration of the plan (a typical situation for Solo-K accounts)? Quite a few times our practice has been called on to correct multiple years' worth of Form 5500 filings because separate brokerage accounts were created for each spouse, and while internal account systems monitored for the $250,000 level of assets, it may not (and did not) monitor the combined spousal assets. Neither spouse had reached $250,000 but they had both exceeded $125,000 years before and therefore required a Form 5500 years before the balances alerted anyone to look for assistance with Form 5500 preparation. It is not unusual for an individual to open different types of plans with different advisors, a 401(k) here and perhaps a pension there, with one being inactive and unaware that there is a larger balance plan

that creates a Form 5500 filing requirement for both plans if combined they reach the $250,000 level.

Plan Documents

The use of a simplified adoption agreement for the one-person plan document plan is very helpful. The plan does not require the non-discrimination testing like plans with employees, so it is much easier to read through the document and discuss options when the document is limited to only the handful of items that will affect the individual making use of the 401(k) plan. And with only a few options to be decided on, it generally is very easy for a financial advisor to walk through with the client and get up and running. A problem may occur however, when the client is unaware that the plan document itself requires regular maintenance and the financial advisor also is unaware that they should be watching for that maintenance. Particularly if a brokerage firm has stopped sponsoring a plan document somewhere along the way, the document itself may be neglected or forgotten about.

What may create greater havoc is the mobility of the assets. An individual moves the management of their assets, maybe a couple of times, and finds that they no longer have a document, possibly do not even know how long ago they opened that 401(k) plan, and because there is no Form 5500 filing requirement, it is rather difficult to back track. Regardless of whether the plan has one participant or 1,000, to be considered a qualified retirement plan and avoid disqualification of prior year contributions, the plan documents must be up to date. Without someone watching the administration of the plan, the document compliance work can be easily overlooked. In the past year, our practice has had multiple requests to submit missing or never restated one-participant plan documents through the IRS voluntary correction program. All of them had asked for our assistance in terminating the plan to roll over to an IRA and discovered they had no current document.

But We Don't Have Any Employees

Along with plan documentation and Form 5500 issues, perhaps the most frequent problem we run into is when that one-person business gains an employee. Those simplified Solo-K plan documents usually ask for specifics for eligibility. Will your plan have any age or service requirements? The most common answers are no requirements for eligibility, or the maximum permitted by law: one Year of Service and age 21. Either set of answers will work and, depending on the situation, a brand new business for instance, one may prefer the immediate eligibility option. However, immediate eligibility can be a dangerous route to go if the plan sponsor is unaware of what the ramifications may be if they ever hire an employee. It is not unusual for a plan sponsor to go many years with no employees and finally get to the point where they need to hire someone, even if on a part-time basis. Suddenly, because they have a newly eligible plan participant, they no longer have a "one participant plan," and have created plan administration and Form 5500 filing requirements where there may have been none previously. What's worse is the plan sponsor may never let anyone know that they have an employee. They may do their own taxes, so no certified public account (CPA) asks the question about employees or sees payroll information. The sponsor just keeps sending in the same contribution to the financial advisor for deposit, so no one asks the question there. Our practice has assisted with corrections where it was discovered that the sponsor had no idea they should have been making contributions for employees for some years because the plan was set up when there were no employees and no one had asked the question about employees again.

Equally difficult can be the situation when the plan sponsor has been aware that their part-time employees were not eligible for the 401(k) plan that was set up with eligibility of one Year of Service and age 21. The typical situation is a husband and wife making maximum 401(k) deferrals and perhaps a profit-sharing contribution to maximize their total annual benefit. For years the plan goes along and suddenly one of those employees works over 1000 hours and becomes eligible to participate. This past year our practice had a husband/wife plan that required a 17 percent contribution to two employees because they had each worked just 1000 hours the prior year. Unfortunately, it occurred before adding the safe harbor contribution after the fact was possible. It was a surprise because the employees had worked on a special project and never worked over 1000 hours previously but were suddenly plan participants. After working with the accountant, we found it was less expensive for them to make the additional qualified non-elective contribution (QNEC) to two employees and take advantage of the tax benefit than to refund their own collective $50,000 in deferrals.

Who Watches the Solo-K?

In all of the cases above, if these plans had been in an environment where the "one-participant plan" is treated as requiring administration, rather than just an investment vehicle, these situations would have been monitored, and if the problem was not avoided entirely, would have been rectified more quickly. Our practice has made the decision to work with these "one-participant plans" to assist with contribution calculations, monitor assets, and prepare a Form 5500 filing if required, and to prepare and maintain plan documents. Our fees for those plans are not our most profitable, but we have found that the advisors who understand the value of having a TPA work with their clients to ensure that they are in compliance are the same advisors we are comfortable working with for larger plans. The Solo-K is still a 401(k) through and through and should be treated as one to avoid running afoul of IRS and Department of Labor regulations. ■

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