Solo 401(k) Rules

January 18, 2024

Take-Away: There is no rush to open a *solo* 401(k) account by the end of 2023. But there may still be a deadline.

Background: A *solo* 401(k) plan is a great way to save for retirement by a self-employed business owner who has no employees other than his or her spouse. The business owner is treated as both the employer and the employee-participant for purposes of making contributions to the qualified *solo* 401(k) plan.

> Example: Rex is self-employed. As an employee of his own business Rex can make elective deferrals of up to $30,000 in 2023 since Rex is over the age 50. As the employer, Rex can also make additional contributions up to 20% of Rex's adjusted net earnings to Rex's 401(k) account. There is an overall limit on the combined elective deferrals and employer contributions; for 2023 that maximum amount is $73,500 (considering Rex's additional catch-up contribution of $7,500.) This maximum contribution amount is much greater than if Rex had used a SIMPLE IRA or SEP IRA for his business and retirement plan contributions.

SECURE Act 2.0: An important, but often overlooked, change to *solo* 401(k) plans was created by the SECURE Act 2.0. This change closed a loophole in the SECURE Act. When *solo* 401(k) plans first started, the new plan had to be in place by the end of the calendar year. The SECURE Act changed that rule by permitting the business owner to retroactively create a *solo* 401(k) plan if it was created and funded prior to the due date for a corporate income tax return in the following year (including extensions.) The problem with the SECURE Act change was that the extended deadline was only available for employer contributions, not elective deferrals made by the employee. In short, a sole proprietor could open a *solo* 401(k) plan in 2023 retroactively effective for 2022, but only if the plan had just employer contributions, but no employee elective deferrals. The SECURE Act 2.0 changed this last limitation to allow sole proprietors to establish a retroactive *solo* 401(k) plan with both employer contributions and employee elective deferrals.

Deadline: The deadline to adopt a new *solo* 401(k) plan after its first year with both employer contributions and employee elective deferrals is the due date of the individual's income tax return without extensions for the prior year.

> Example: Betty is a sole proprietor of a clothing alteration business. In February 2024 Betty learns of the opportunity to create a *solo* 401(k) plan from her trust advisor. Betty wants to set up a new *solo* 401(k) plan retroactive to 2023. If the plan is opened by April 15, 2024 (Betty's business's 2023 tax filing deadline without extensions), Betty could fund her *solo* 401(k) plan with both 2023 employer contributions and her own employee elective deferrals.

Conclusion: Self-employed individuals should look into establishing a *solo* 401(k) account due to the much larger contributions that can be made to their account and because of the fact that the contributions can be made retroactive to the prior calendar year providing a great deal of flexibility in saving for retirement.