Solo 401(k) vs. SEP IRA

Take-Away: Choosing between a solo 401(k) plan and a Simplified Employee Plan, or SEP IRA, depends upon the income and goals of the self-employed individual, along with how much flexibility is desired when making contributions to the retirement plan.

Background: With over 15 million self-employed individuals in this country, who are sometimes called *solopreneurs*, there is a growing interest in retirement savings using a solo 401(k) plan. Included are sole proprietors, consultants, businesses without W-2 employees, or 'freelancers.' However, overlooked in that decision-making process is the option to open a Simplified Employee Plan, or SEP IRA. While each savings vehicle provides the opportunity to contribute up to, and in some instances, more than $70,000 a year towards retirement savings, each option poses its own limitations.

Contributions: Both the solo 401(k) and the SEP IRA have a maximum contribution limit of $70,000 a year(more with the solo 401(k)), but there are differences in how that limit is attained.

401(k): With the 401(k) there is the employee deferral contribution of $23,500 plus $7,500 if the employee is over the age 50 years, , and if the employee is between the ages of 60 to 63 the annual deferral limit is $11,250. The employer's contribution is limited to 25% of employee compensation. Thus, the total limit on employee contributions is $70,000, whichever is *less,* or $77,500 if the participant is over age 50 or $81,250 with catch-up contributions if between the ages 60-63. [If the 401(k) participant is between the ages of 60-63 then the maximum annual contribution to their 401(k) account is $81,250 with their enhanced 'catch-up' contribution under the SECURE 2.0 Act.] It is easier to reach these maximum contribution amounts with the solo 401(k) due to higher contributions through the employee's catch-up contribution opportunities, regardless of the participant's actual earned income for the year.

SEP IRA: With a SEP IRA only the employer contributes to the IRA. There are no employee deferral contributions, which is the major limitation to a SEP IRA. That employer contribution limit is 25% of the employee's compensation, up to $70,000 for the year. If the business's income is variable, it may be more difficult for the self-employed individual to maximize his/her contribution to the SEP IRA. It is more difficult for a self-employed individual to maximize a contribution to a SEP IRA, since the self-employed individual would have to have compensation of $280,000 in a year to be able to receive the $70,000 maximum contribution to his/her SEP IRA. It will be easier to reach the maximum contribution limit with a solo 401(k), especially high earners, because of the flexibility in deferral elections which are not available with a SEP IRA.

Loans: The solo 401(k) plan can be set up to permit loans to the plan participant, up to $50,000. There is no ability to take a loan from a SEP IRA, since it is an IRA from which loans are prohibited.

Hardship Distributions: The solo 401(k) plan can be set up to permit hardship distributions from the 401(k) account. A SEP IRA prohibits hardship withdrawals.

Compliance: There will probably be more expense associated with a solo 401(k) plan.

401(k): This type of qualified retirement plan has more compliance requirements, making it less attractive for a self-employed individual. If there is more than $250,000 in plan assets, the plan will have to pay to have a Form 5500 prepared each year, although in recent years the preparation and filing of that Form has become much more streamlined. Both the employee and employer contributions to the solo 401(k) plan must be established by December 31 of that year. For only employer contributions, the solo 401(k) plan must be established by the tax filing due date, plus extensions, for the business. If income is determined through a K-1 or Schedule C, to include both the employee and the employer contributions the plan must be established by the tax filing due date, plus extensions for the business. If the self-employed business is a sole proprietorship or single member LLC, contributions can typically be made until the employee's tax filing deadline.

SEP IRA: Maintaining a SEP IRA is simple and low maintenance. It is just an IRA established with an IRA custodian. The SEP IRA must be established by the business's tax filing deadline, including extensions for the year the contribution is to be made. As noted, there are no salary deferral contributions made by the employee to the SEP IRA.

Generalizations: The choice between a solo 401(k) plan and a SEP IRA probably comes down to the *solopreneur's* income and how much flexibility is desired.

Solo 401(k): This type of retirement plan is probably a better choice if the goal is to maximize contributions, maintain full control over investment options, and if the self-employed plan sponsor is age 50 years or older he/she can then exploit catch-up contributions. A solo 401(k) plan is probably also valuable with the opportunity to make 'mega backdoor' Roth conversions. Thus, this option will probably be more attractive to those self-employed individuals who want to maximize their income tax deductions.

SEP IRA: This type of retirement plan is probably a better choice if the self-employed individual has fluctuating income. Additionally, it is probably more attractive if there is no intention to make employee deferral contributions. Moreover, it is far simpler to set-up than a solo 401(k) account. The SEP IRA option is probably of more interest to those self-employed individuals who want a simple, low maintenance retirement savings option, or businesses with variable income, or those owners who are under the age 50 and who are ineligible to make catch-up contributions, or who are unlikely to take out a loan against their retirement account

Conclusion: Retirement savings for a self-employed individual can be simple, such as a simple IRA contribution, subject to the annual contribution limits, or more enhanced with a SEP IRA, or much more sophisticated and flexible with a solo 401(k) plan. There are admittedly trade-offs between these options, however, each should be seriously considered if an individual is self-employed.

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