7 Reasons Why You Should Choose a Solo 401k vs. an IRA

A Solo 401(k) Plan is an IRS approved retirement plan, which is suited for business owners who do not have any employees other than themselves and perhaps their spouse. The “one-participant 401(k) Plan” or individual 401(k) Plan is not a new type of plan. It is a traditional 401k Plan covering only one employee. Unlike a Traditional IRA, which only allows an individual to contribute $5500 annually or $6500 if the individual is over the age of 50, a Solo 401k Plan offers the Plan participant the ability to contribute up to $59,000 each year. Before the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) became effective in 2002, there was no compelling reason for an owner-only business to establish a Solo 401(k) Plan because the business owner could generally receive the same benefits by adopting a profit sharing plan or a SEP IRA. After 2002, EGTRRA paved the way for an owner-only business to put more money aside for retirement and to operate a more cost-effective retirement plan than a Traditional IRA or 401(k) Plan.

There are a number of options that are specific to Solo 401k Plans that make the Solo 401k Plan a far more attractive retirement option for a self-employed individual than a Traditional IRA for a self-employed individual.

1. Reach your Maximum Contribution Amount Quicker: A Solo 401(k) Plan includes both an employee and profit sharing contribution option, whereas, a Traditional IRA has a very low annual contribution limit.

Under the 2015 Solo 401(k) contribution rules, a plan participant under the age of 50 can make a maximum employee deferral contribution in the amount of $18,000. That amount can be made in pre-tax or after-tax (Roth). On the profit sharing side, the business can make a 25% (20% in the case of a sole proprietorship or single member LLC) profit sharing contribution up to a combined maximum, including the employee deferral, of $53,000, an increase of $1,000 from 2014.

For plan participants over the age of 50, an individual can make a maximum employee deferral contribution in the amount of $24,000. That amount can be made in pre-tax or after-tax (Roth). On the profit sharing side, the business can make a 25% (20% in the case of a sole proprietorship or single member LLC) profit sharing contribution up to a combined maximum, including the employee deferral, of $59,000, an increase of $1,500 from 2014.

Whereas, a Traditional Self-Directed IRA would only allow an individual with earned income during the year to contribute up to $5500, $6500 if the individual is over the age of 50.

For example, Joe, who is 60 years old, owns 100% of an S Corporation with no full time employees. Joe earned $100,000 in self-employment W-2 wages for 2015. If Joe had a Solo 401(k) Plan established for 2015, Joe would be able to defer approximately $49,000 for 2015 (a $24,000 employee deferral, which could be pre-tax or Roth, and 25% of his compensation giving him $49,000 for the year). Whereas, if Joe established a Traditional Self-Directed IRA, Joe would only be able to defer approximately $6,500 for 2015.

2. No Roth Feature: A Solo 401k Plan can be made in pre-tax or Roth (after-tax) format. Whereas, in the case of a Traditional Self-Directed IRA, contributions can only be made in pre-tax format. In addition, a contribution of $18,000 ($24,00, if the plan participant is over the age of 50) can be made to a Solo 401(k) Roth account.

3. Tax-Free Loan Option: With a Solo 401K Plan, you can borrow up to $50,000 or 50% of your account value, what ever is less. The loan can be used for any purpose. With a Traditional Self-Directed IRA, the IRA holder is not permitted to borrow even $1 dollar from the IRA without triggering a prohibited transaction.

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4. Use Nonrecourse Leverage and Pay No Tax: With a Solo 401(k) Plan, you can make a real estate investment using nonrecourse funds without triggering the Unrelated Debt Financed Income Rules and the Unrelated Business Taxable Income (UBTI or UBIT) tax (IRC 514). However, the nonrecourse leverage exception found in IRC 514 is only applicable to 401(k) qualified retirement plans and does not apply to IRAs. In other words, using a Self-Directed SEP IRA to make a real estate investment (Self Directed Real Estate IRA) involving nonrecourse financing would trigger the UBTI tax.

5. Open the Account at Any Local Bank: With a Solo 401k Plan, the 401k bank account can be opened at any local bank or trust company. However, in the case of a Traditional Self Directed IRA, a special IRA custodian is required to hold the IRA funds.

6. No Need for the Cost of an LLC: With a Solo 401(k) Plan, the plan itself can make real estate and other investments without the need for an LLC, which, depending on the state of formation, could prove costly. Since a 401(k) Plan is a trust, the trustee on behalf of the trust can take title to a real estate asset without the need for an LLC.

7. Better Creditor Protection: In general, a Solo 401(k) Plan offers greater creditor protection than a Traditional IRA. The 2005 Bankruptcy Act generally protects all 401(k) Plan assets from creditor attack in a bankruptcy proceeding. In addition, most states offer greater creditor protection to a Solo 401(k) qualified retirement plan than a Traditional Self-Directed IRA outside of bankruptcy.

The Solo 401k plan is unique and so popular because it is designed explicitly for small, owner-only business. The many features of the Solo 401k plan discussed above is why the Solo 401k Plan or Individual 401k Plan it so appealing and popular among self-employed business owners.