Retirement Plan Considerations for the Self-Employed

Purposeful retirement planning leads to long-term financial security. For sole practitioners, contractors, the self-employed or small business owners, selecting the right retirement plan can make a significant impact on retirement preparedness. Among the options available, four common choices are the solo 401(k), Simplified Employee Pension (SEP) IRA, Savings Incentive Match Plan for Employees (aka SIMPLE IRA) and cash balance plan. Each of these plans has its own set of advantages and disadvantages, tailored to different needs and circumstances..

Solo 401(k)

A solo 401(k) is also known as an i401(k) and shares some commonalities to a traditional 401(k) with regards to contributions and withdrawal constraints such as maximum annual contributions and limitations on withdrawals prior to age 59 1/2. The solo 401(k) is available to anyone who owns a business or is self-employed with no employees other than a spouse.

PROS

- **Flexible contribution structure:** With the solo 401(k), contributions can be made as both the employee and employer, allowing for potential tax deductions on both fronts. This flexibility is particularly advantageous for maximizing retirement savings and minimizing taxable income.
- **High employer contribution limit:** For 2023, the maximum contribution limit is $66,000 for individuals under 50 years old comprised of $22,500 employee contribution and $43,500 employer contribution. The employer's contribution is limited to 25% of business income. Additionally, those 50 and older can contribute an additional $7,500 as the employee.
- **Possibility for higher contribution at low income levels:** Since the employee contribution is not limited to a percentage of pay, the saver can immediately contribute all their salary to the plan up to the annual maximum. After which, additional contributions are typically completed from the employer's perspective subject to the 25% income limitation.
- **Additional savings potential:** Solo 401(k) plans can be utilized alongside cash balance plans and traditional corporate 401(k) s if the saver has earnings from a qualified side job. While the employee limit of $22,500 per year ($30,000 per year for those 50 and older) is the annual limit across all plans, the employer contribution can be viewed as additional savings potential.
- **Loan options:** Solo 401(k) plans often allow participants to take out loans from the plan, providing a potential source of emergency funding.
- **Roth options**: Roth options are available for those who want both tax-free growth and tax-free withdrawals. Of course, contributions are made with after-tax dollars.

CONS

- **Administrative burden:** While solo 401(k)s can be easy to set up and manage, they do require some administrative responsibilities. Annual reporting and compliance requirements can be more complex than other retirement plans. Beware of IRS Form 5500, which is required for non-ERISA plans and requires special reporting as the plan grows in size (currently required for solo plans with assets exceeding $250,000). Additionally, the information contained in Form 5500 is searchable to the public via an IRS database, so if you value privacy, you may wish to reconsider a solo 401(k).
- **Costs:** Depending on the plan provider and investment options chosen, there might be associated fees and expenses that need to be considered.

SEP IRA

The SEP IRA is a good retirement savings plan for those who are seeking less administrative efforts, have inconsistent but high income or have privacy concerns associated with IRS Form 5500, an annual report detailing a company's employee benefits. The SEP IRA works for sole practitioners as well as small businesses. For 2023, contribution amounts are limited to $66,000 or 25% of business income.

PROS

- **Simplicity:** SEP IRAs are simple to establish and maintain, making them a suitable choice for small business owners who want an easy retirement plan without extensive administrative responsibilities.
- **Flexible contributions:** Employers can contribute up to 25% of an eligible employee's compensation, within certain limits. This flexibility allows businesses to adjust contributions according to financial performance.
- **No ongoing annual funding obligations:** Unlike cash balance plans, SEP IRAs do not require consistent annual contributions. This can be an advantage for businesses with varying income levels.
- **No filing requirements:** There are no IRS Form 5500 filing requirements for SEP IRAs.

CONS

- **Employee participation:** If employees are included, the employer must contribute the same percentage of compensation for each employee, which could become costly for businesses with a larger number of employees.
- **Limited contribution amount for high earners:** For high-income earners, the contribution limit may be reached relatively quickly compared to other plans, potentially limiting their ability to save more for retirement.
- **Limited contribution for low earners:** Limiting contributions to 25% of business income might not maximize contributions relative to a solo 401(k) for low-income businesses. Generally, those with income under ~$90,000 are better off using a solo 401(k) since employee contributions are not limited to 25% of business income.

SIMPLE IRA

A SIMPLE IRA is a good option for small businesses with few employees. This plan type allows a small business to set up and save for their employees' retirement while also allowing for employee contributions. The plan is akin to a traditional retirement plan such as a 401(k) without the onerous reporting requirements. This plan is also a viable option for sole practitioners who are less worried about maximum savings and more concerned with simplicity.

PROS

- **Low effort:** SIMPLE IRA's are straightforward to setup and offer a relatively low ongoing expense commitment.
- **No annual filing requirements:** Similar to SEP IRAs, there are no annual Form 5500 filing requirements.
- **Employees involvement:** with a SIMPLE IRA, employees may share retirement saving responsibility. Employer must contribute up to 3% salary match or make a 2% non-elective contribution. A non-elective contribution is a fully vested employer contribution regardless of whether employee contributes.
- **No discrimination testing requirements:** Discrimination testing is not required unlike traditional 401(k) and cash balance plans. Discrimination testing seeks to ensure that highly compensated employees do not disproportionately benefit.

CONS

- **Inflexible contributions:** Roth options are not available and employer matching is capped at 3% of income.
- **Lower contribution limits:** For 2023, SIMPLE IRAs offer a maximum employee contribution of $15,500 (with a $3,500 catch-up for those > 50 years old) which is significantly lower than other retirement plan options.
- **Loans not available:** A SIMPLE IRA does not allow an employee to borrow from the balance.

The SIMPLE IRA is generally a good option for a small business considering a traditional 401(k) but that wants to avoid administration and keep costs low. Sole practitioners are better off with another plan type.

Cash Balance Plan

A cash balance plan is often referred to as a hybrid plan as there are characteristics consistent with both a defined benefit plan and a defined contribution plan. Per the IRS, a cash balance plan defines the promised benefit in terms of a stated account balance, thus the hybrid notion. This hybrid format allows for potential significant retirement savings and resulting large tax deductions like a defined benefit plan while maintaining the flexibility and transportability of a defined contribution plan. Cash balance plans are available to sole business owners and businesses with multiple employees.

PROS

- **High contribution limits:** Cash balance plans are ideal for small business owners seeking to significantly boost their retirement savings. They have higher contribution limits compared to solo 401(k)s and SEPs and can be particularly advantageous for high-income individuals. For 2023, the maximum cash balance plan contribution is $398,000 for specific age demographics. Most participants in their 50s can contribute between ~$200,000–$300,000 annually. Additionally, a cash balance plan can be paired with a solo 401(k)/401(k)/profit sharing plan for added tax deferred savings.
- **Predictable retirement income:** Unlike a traditional 401(k) or SEP, cash balance plans provide participants with the option for a guaranteed retirement income based on an annuity determined by a fixed account balance.
- **Attracting and retaining employees:** Cash balance plans can be designed to benefit not only the business owner but also key employees, making it an attractive perk for recruiting and retaining top talent.
- **Insured:** Plans are insured by the Pension Benefit Guaranty Corporation (PBGC), a federal government agency that protects defined benefit pension plans.

CONS

- **Complex setup and maintenance:** Cash balance plans are more complex to set up and maintain compared to solo 401(k)s or SEP IRAs. Actuarial calculations, ongoing administration and compliance can require professional assistance and associated expenses.
- **Possible reporting requirements:** Similar to the solo 401(k), cash balance plans may have IRS Form 5500 reporting and disclosure requirements.
- **Required contributions:** The fixed contributions required for employees can be a disadvantage for businesses with fluctuating profits, potentially leading to financial strain during lean years.
- **Investment risk:** The employer bears investment risk for cash balance plans.

In Conclusion

In summary, the choice between a solo 401(k), SEP IRA, SIMPLE IRA or cash balance plan depends on your individual financial situation, business structure, income variability and retirement goals. Solo 401(k)s offer flexibility and high contribution limits for low earners, cash balance plans provide maximum contributions and deductions with predictable retirement income and employee benefits, while SEP IRAs are straightforward and adaptable. Each of these plans work well to enhance retirement savings above and beyond the annual contributory IRA limitations—currently $6,500 or $7,500 for those 50 or older.

As one's employment and business changes over time, it is important to review whether the chosen plan is still the most suitable option. Oftentimes, work and life responsibilities get in the way of annual retirement plan evaluation. Working with an advisor focused on your lifetime goals can help you select the optimal plan to meet your retirement goals.

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