

New One Man 401(k) Plan a Big Winner

BY AL MATHEWS

The passage of the Economic Growth and Tax Relief Reconciliation Act of 2001 resulted in the transformation of the 401(k) plan into an excellent retirement program for small businesses that employ only an owner and possibly their spouse.

Individual business owners may now make an annual contribution of up to \$41,000 to a 401(k) plan and only pay about \$200 per year in administration expenses.

At most compensation levels, the contribution amount allowed under a 401(k) plan for an individual business owner is greater than that permitted by many other retirement plans including Profit Sharing, Money Purchase Pension, SEP and SIMPLE IRA plans.

The reason for the low cost of administration is that there is minimal compliance testing and no nondiscrimination testing. The Department of Labor requires only the short Form 5500 EZ for plans with assets over \$100,000. Otherwise, no annual reporting is required.

The emergence of the One Man 401(k) Plan is due to two significant tax changes in the Act. The first tax change is that salary deferrals no longer count toward the employer contribution amount in terms of the maximum allowable contribution. The second change is that the maximum employer contribution that can be deducted as a business expense has increased from 15% to 25% of eligible compensation, or earned income in the case of a sole proprietor.

These two changes allow an individual business owner to contribute the maximum allowable salary deferral amount, \$13,000 in 2004, and make an additional employer contribution up to the 25% limit.

The annual overall maximum contribution of \$41,000 for an individual to a 401(k) plan includes salary deferrals and employer contributions. In addition, the Act established “catch-up” contributions for plan participants age 50 and over. These catch-up contributions, up to \$3,000 in 2004, are made in the form of salary deferrals and

are not subject to plan contribution limits.

A caveat for the individual business owner



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considering a 401(k) plan: If the business expands and employees are added who become eligible for the plan, then the additional cost of administration may make the plan less appealing.

If you have employees who are working more than 1000 hours in a plan year they are generally eligible to participate in a 401(k) plan. When this occurs, the administration and government reporting of the plan change. For example, the plan becomes “top-heavy” and a 3%

of compensation contribution is required to be made on behalf of the employees. In addition, nondiscrimination testing of the salary deferral component of the plan is required and the owner may be limited in what he can contribute as a salary deferral. The Department of Labor regular Form 5500 is also required.

However, for the individual business owner with a spouse and perhaps some part-time employees, the newly enhanced 401(k) plan with its high contribution limits and low cost of administration, is quickly becoming the retirement plan of choice.