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The Solo 401(k) Death Trap

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This article explains the latest so-called easy solution—the Solo (k) plan. However, it also reminds plan administrators that things can change, and a Solo (k) may cease to be the easy solution it is thought to be.

I like ideas that make maintaining a retirement plan easier. After all, plan sponsors are not in the business of providing benefits to their employees. They are doctors and widget makers and real estate people and the like, and spend the time between seeing clients, performing services, and creating products staying up-to-date with the changes in their own industry. So, wedging understanding retirement plan law into that schedule is difficult at best, and anything that makes that process easier is more than welcome.

However, almost inevitably, things that endeavor to make sponsoring a plan easier have a cost. That cost may be in the form of a benefit that is a little more expensive than it has to be (because the fine-tuning process presumably has a cost that exceeds the potential larger contribution). For example, we could cross-test the plan to reduce the employee contribution, but perhaps the increased contribution is $1,000 and the administrative charge for cross-testing is $1,200. It may be in the form of limiting features that could be available, because administering those features has a cost that is assumed to be greater than the value of those features. For example, we could allow participant loans, but the administrative hassle of maintaining a loan program (additional third-party administrator (TPA) fees and payroll processes) exceeds the perceived value of the feature to the participants. Note that the "cost" of the feature may be financial, such as increased fees or contributions, or something less concrete, such as the amount of learning or additional tasks to be performed by the plan sponsor, or the participants'

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perception of value of the more generous plan versus the more restricted plan—do they even care?

So, whenever a hassle-saving device is designed, the user of that device truly needs to evaluate the cost-benefit exchange to determine if it is a good idea.

Unfortunately, it is very rare for those who design the device to point out to the subscribers what the down sides are. This may be the natural result of salesmanship. (Have you ever had a person at an electronics store tell you why the product available at another store might be a better choice?) It may be because the salesperson offering the product has already done that analysis for the potential client and determined that the cost is "worth it." When a consultant gets information from his/her client and then presents solutions to the client's concerns, the consultant will presumably determine whether the characteristics of the solution benefit the client more than the giveaways that the solution may represent.

The result of all this is that the buyer commonly does not know about the trade-off that this "easy-peasy" solution represents. In truth, it is also common that the salesperson does not know the trade-off, as she/he has never been trained fully on the technical aspects of the product that is being sold.

As a law firm that spends a lot of its time helping plan sponsors whose plans have fallen out of compliance, we are inundated with situations where an unwitting plan sponsor has taken action (or failed to take action) with regard to its plan and now finds itself in trouble. Very rarely does this happen because the plan sponsor knew the rules and didn't care about compliance. Almost always, they knew not what they did.

At one time, the best example of this in the retirement plan area was Simplified Employer Plans (SEPs). The so-called SEP has been embraced by many financial advisors who do relatively little work in the benefits arena as a "great idea" for a small business. There's a two-page form to fill out to establish the plan, you open up an individual retirement account (IRA), life is good. But, often, neither the advisor nor the plan sponsor knows that the plan document must be retained and periodically updated, that the other employees may become eligible at some point in time, that contributions to the SEP give rise to an obligation to contribute on behalf of those eligible workers. When the SEP falls out of compliance, the plan sponsor (and perhaps the financial advisor) both learn about plan corrections and audit closing agreements (along with the costs of making the required correction).

The Solo (k)

Retirement plan administrators with whom I work tell me that a current so-called easy solution that is causing enormous consternation is the owner-only 401(k) plan—the Solo (k).

The idea behind the Solo (k) is that the only employee of the company is the owner-plan sponsor. The sponsor is in a position to save a good chunk of change. Normally, the sponsor's deductible contributions to a defined contribution plan will be limited to 25 percent of compensation, not to exceed the current contribution limit under Internal Revenue Code (Code) Section 415 ($58,000 in 2021). So, for example, if the sponsor has compensation of $150,000, the maximum amount that can be contributed to the plan is $37,500. However, if the sponsor adopts a 401(k) plan, the deduction expands to 25 percent of compensation *plus* the amount that can be deferred to the plan by the participant. So, if we take the sponsor who is making $150,000 per year, and have him defer the maximum of $19,500 (for 2021) to the plan, his maximum deduction goes up to $57,000 (the $19,500 in deferrals plus 25 percent of compensation, and not more than the $58,000 415 limit).

Whenever a 401(k) plan is documented, there are all kinds of options to select among. But, if the only participant is the owner of the company, most of those choices are irrelevant. We don't need to have any eligibility requirements—there's no one else to become eligible. We don't need to worry about vesting—there's no one else who will enter, terminate, and forfeit the employer contribution. No need to design the contribution creatively to avoid excessive employee costs—we don't have any other employees.

As a result, several organizations (again, commonly investment advisors who do not spend a lot of time in the 401(k) space) have designed a plan to operate as a Solo (k). The plan document provides for no eligibility requirements, full and immediate vesting, pro-rata contribution allocations with no service conditions, and normal 401(k) nondiscrimination testing (that will never need to be done, because we have no other participants). The owner can even file the abbreviated Form 5500-EZ (or if the plan assets are less than $250,000, there is no filing at all). Need a TPA? No! There's nothing fancy to be done!

So, for those of you who have or are considering a Solo (k), let this article be the cautionary tale to remind you that things can change, and a Solo (k) may cease to be the bomb-diggity for you it is today.

The Solo (k) Will Cease to Work Well if You Hire Anyone

If the Solo (k) was created and documented in a simplified fashion, it is common that the above assumptions will be drafted into the plan. So, although the plan document was not intended to apply to employees, it most certainly does and hiring someone will throw a monkey wrench into the works. Suddenly, you need to enroll the participant, collect contributions from payroll based on the participant's election, and contribute enough for the participant to meet nondiscrimination rules.

The Immediate Eligibility Default

Immediate eligibility means that the employee enters the plan immediately when s/he walks in the door on the first day.

At a minimum, that means you need to enroll the participant, that is, offer the opportunity to make pre-tax contributions to the plan from payroll. This can be done any time before the first paycheck is issued, and the deferral election will be applicable for the payroll period in which the election is provided.

Alternatively, the plan can be drafted to contain protective provisions that will be helpful if the company expands … at least to give you time to think it through. Eligibility requirements add no "extra work" while the company has no employees, but they can keep any newly hired employees out of the plan for a period that will permit the sponsor to assess what changes are needed to the plan. It is easy to amend a plan to let someone in earlier; it is much more difficult and expensive to deal with a failure to enroll a participant when s/he should have entered the plan.

Employees Mean Nondiscrimination Testing

A small business owner may not know this, but all tax-favored retirement plans require benefits to be provided to a fair cross-section of employees. And, just providing any old benefit is not sufficient; you must provide a benefit that is not discriminatory in favor of the highly compensated employees (HCEs). The law provides processes for proving that your plan is not discriminatory, called (appropriately enough) "nondiscrimination testing."

Once an employee enters the plan, it is not enough that s/he is given the opportunity to defer compensation to the plan. Those deferrals must be within a reasonable range of the rate of contribution (as a percentage of compensation) for the HCEs. If the employee you just hired does not want to defer compensation or if those deferrals are not high enough, the business owner needs to either contribute on behalf of the employee or cut back his/her own deferrals.

It is not just deferrals. If the business owner is using a Solo (k) because s/he wants to contribute 25 percent of compensation in addition to the salary deferral, then the contribution for the employee under the Solo (k) provisions that were likely adopted will also have to be 25 percent of the employee's pay. For a small company, an increase in payroll costs of 25 percent can be daunting.

A plan does not have to default to one level rate of contribution for all employees. Other default provisions leave open myriad options for contributing on behalf of the employee. For example, most plans permit the employer to use the option under which each employee is in his or her own tier, and the company may determine on a discretionary basis how much to contribute for each employee. If an employee is hired, the employer can calculate the minimum amount that must be contributed to keep the plan nondiscriminatory. This minimizes the impact of an employee entering before a redesign can be done.

Small plans with employees tend to be "top heavy." This happens when more than 60 percent of the money in the plan is for the owners and officers. In that case, contributions must be made for the rank-and-file even if they do make deferral elections. A proper plan design uses those top-heavy contributions to also meet nondiscrimination testing, which can minimize its effects.

Vesting

The default Solo (k) plan usually provides for full vesting. Full vesting always applies for the employee's own salary deferrals. But, you can make an employee work for up to six years to earn the right to the full account when s/he leaves the company. If the owner never hires an employee and then leaves the company, the plan will be terminated, and the account will be fully vested. The owner does not need a full vesting provision. But, if the employer hires an employee, that full vesting will apply to the employee's account. Again, why default to a provision that is more generous for an employee than it needs to be?

Solo (k) Plans Are Subject to Documentation Requirements

The law relating to employee benefit plans changes often. The Internal Revenue Service (Service) rules about plan documentation usually require that the written document be kept up to date. When an advisor helps an employer set up a plan and then leaves the client to find its own way through the requirements, it is unlikely that the employer will know when the plan needs to be amended. (The advisor might also fail to tell the employer that any changes in the plan's terms need to be in writing and must meet certain requirements.)

Sponsors need someone around to alert them when the plan needs to be updated. Documentation problems are probably the most discoverable issues on IRS audit; if a plan is missing an amendment or a signature, the IRS will find it.

Conclusion

While simplifying the complexities of a retirement plan is a welcome talent, it is important for both the consultant and the client to understand the limitations of the design. If this part of the process is skipped, it is possible, if not probable, that the plan will drift into noncompliance, to the sponsor's dismay and cost.

If you are using a Solo (k), call an expert when you hire other employees, and retain—from the very beginning—someone to keep the document in compliance with legal changes. If you don't, the problems that arise and their solutions will likely not be simple at all. ■

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