Solo 401(k) Tax Deferral Strategy

Most people are familiar with the 401(k) plans offered by many companies in the United States. These retirement plans are offered by employers to encourage their employees to save for retirement. By deferring some of their compensation to their 401(k) an employee can build a retirement portfolio while receiving immediate and ongoing tax deferral.

A Solo 401(k) is the same as a standard 401(k) except that it is sponsored by a self-employed individual with no other employees. A Solo 401(k) is a very powerful structure that enables a self-employed individual to accomplish goals that are otherwise unattainable by non-business owners. Some of these goals are:

- Contribute up to a maximum of $61,000 ($67,500 if over age 50) instead of the $6,000 ($7,000 if over age 50) maximum available in a Traditional or Roth IRA
- Take out a loan of up to $50,000, tax-free, for any reason
- Reduce income tax bill
- Invest contributions with no taxes due until the funds are withdrawn during retirement

Example:

The following example will illustrate the potential tax savings that a Solo 401(k) can create:

Jeff is a 35-year-old business owner with no employees other than himself. He has a corporation and is a California resident. His compensation from his business in 2020 is $162,000. Let's compare what he will pay in income taxes when he maximizes his Solo 401(k) contributions against not contributing to a Solo 401(k) at all:

	No Solo 401(k) Contribution	Maximum Solo 401(k) Contribution
Total Compensation	174,000	174,000
Solo 401(k) Contribution	0	66,000
Taxable Compensation	174,000	108,000
Federal Income Tax	32,488	16,648
California Income Tax	12,477	6,339
Total Income Tax	**$ 44,965**	**$ 22,987**

Jeff does not owe any income tax on money that he contributes to his Solo 401(k). By maximizing his Solo 401(k) contribution Jeff keeps an extra **$21,978** that he would have otherwise paid in taxes! It's a **49% reduction** in income taxes on Jeff's compensation!

Again, this is a powerful strategy that not everyone can have at their disposal. It takes a special circumstance to reap the full benefits of this strategy: a high-earning business owner with no other employees.

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Roth Solo 401(k) Tax Deferral Strategy

Most people are familiar with the Roth IRAs encouraged by the government of the United States. By contributing some of their compensation to their Roth IRA a person can build a retirement portfolio without worrying about ever paying taxes on the earnings in the account. These retirement plans are available to anyone who makes less than $153,000 ($228,000 if married filing jointly) per year. Most taxpayers earning more than this threshold cannot reap the benefits of tax-free growth.

A Roth Solo 401(k) is the same as a Roth IRA except that it is sponsored by a self-employed individual with no other employees. A Roth Solo 401(k) is a very powerful structure that enables a self-employed individual to receive benefits that are otherwise unattainable by non-business owners. Some of these benefits are:

- High earners are not disqualified (no cap on income!)
- Contribute up to a maximum of $22,500 ($30,000 if over age 50) instead of the $6,500 ($7,500 if over age 50) maximum available in a Roth IRA
- Blend with a 401(k) to shelter up to an additional $43,500 from income taxes immediately
- Take out a loan of up to $50,000, tax-free, for any reason
- Invest contributions with no taxes due EVER AGAIN!

Example:

The following example will illustrate the potential tax savings that a Roth Solo 401(k) can create:

Jeff is a 50-year-old business owner with no employees other than herself. He is a resident of Nevada and his goal is to retire at age 65. He is able to invest $30,000 per year after paying his income taxes. Let's compare what happens when he invests the money in his Roth Solo 401(k) against a standard taxable account. We will assume he earns 8% per year on his investment fund and the long-term capital gain tax rate stays at 23.8%. The investment fund does not pay dividends.

	Roth Solo 401(k)	Taxable Account
Value at Age 65	$879,728	$879,728
Taxes Due Upon Sale	**$0**	**$102,275**

Jeff does not owe any income tax on his assets upon their sale in the Roth Solo 401(k), whereas more than $102,000 is taken away in the taxable account! Don't forget: this simple example refers only to federal income taxes. If Jeff lived in California and he invested in a dividend-yielding investment fund, he would owe even more!

Again, this is a powerful strategy that not everyone can have at their disposal. It takes a special circumstance to reap the full benefits of this strategy: a high-earning business owner with no other employees.

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