The retirement plan strategy small-business owners need to know about

Business, Strategy

This article is part of the from tax and legal expert Mark J. Kohler.

Entrepreneurs are gravely mistaken if they think an IRA or SEP are the only strategies for tax-deferred retirement planning. The 401(k), historically only reserved for large companies and their employees, has evolved to be one of the most creative and flexible retirement vehicles for small-business owners.

Here are a few key points about the 401(k) you need to know that could save you thousands and require your action before Dec. 31.

Why a 401(k) vs. a SEP IRA?

The SEP IRA is a super-charged IRA account that runs off of IRA rules, while the Solo 401(k) is an employer-based retirement plan used solely for the business owner(s) when they have no employees. The 401(k) has several features that are either similar or far superior to that of the SEP. Here are a few of the similarities and differences:

- Both a SEP IRA and a Solo 401(k) can be self-directed and invested into real estate, private company stock or precious metals. Under a SEP IRA, you will have a self-directed IRA custodian. However, under a Solo 401(k), you can serve as your own trustee and administrator, saving you administrative costs and giving you more control of your investment choices.
- Under a SEP you can contribute up to 25 percent of your salary or self-employment income. However, with a Solo 401(k), gives you a much more cost-efficient contribution strategy. You can contribute $18, 000 ($24, 000 if you are 50 and over), plus 25 percent of your salary or

self-employment income. This creates tremendous tax savings when you couple your 401(k) with an S-Corp. You can keep your FICA amounts much lower and still put away the same amount as a SEP with tax efficiency.

- All SEP contributions are traditional dollars and all funds in a SEP must be traditional dollars. However, through a Solo 401(k) business owners can have a traditional account and a ROTH account within the same plan. You can also convert traditional sums over to Roth as well within the 401(k) plan and not having to take a distribution from the SEP first.

The Power of the Solo 401(k)

First, keep in mind that the Solo 401(k) is only available to self-employed persons, while a standard 401(k) would include multiple employees. It is called a " Solo" 401(k) plan because only the business owner and his or her spouse can participate in the plan.

Next, the primary reason why a business owner would choose the 401(k) is because they want to put away more tax-deferred dollars, whether in a ROTH or for a tax deduction.

Here’s what it comes down to: If you want to put away around $5, 000 a year, stick to an IRA. If you want to put away around $10, 000 to $15, 000, use the SEP. If you want to put away more than $20, 000, utilize a combo strategy of the Solo 401(k) with an S-Corp. The tax efficiency is amazing and you can sock away those big dollars you are envisioning and also self-direct the funds on the backside.

Setting up the 401(k)

If you want to take advantage of a 401(k) tax deduction in 2016, even if you make the contribution and " match" later next year, you must set up the 401(k) *this* year. Moreover, you must plan sponsors -- companies that help you establish your 401(k) are going to file your paperwork in early December. Don't wait until the last minute. A lot of sponsors will turn you away and suggest you wait until 2017 if you call them around Christmastime.

The cost to set up a 401(k) will vary based on whether it’s a " Solo 401(k)" or a " traditional plan" because you have other employees besides you and your spouse. Prices can range from about $1, 250 to $3, 000. Some companies may assist you in setting up a lower cost 401(k), but your investment options will be limited to their portfolio of funds, so you want to be careful when you sign up and confirm how much flexibility you have in your investment choices.

Takeaway: Consider a 401(k) plan and get it set up before Dec. 31 if you want the deduction in 2016.

How much should I contribute?

For S-Corporation owners, you have some critical decisions you need to make before year-end. Others can wait until next year. The first is how muchmoneyyou want to contribute to the 401(k).

The second decision is if and how much you should contribute to the spouse’s 401(k). The same deadline being that you need to report this on his or her W-2 in early January. I typically recommend you never put your spouse on payroll unless you are going to contribute to his or her 401(k).

Why issue a W-2 to the spouse and incur the cost of FICA, if you aren’t going to contribute to the 401(k)? It doesn’t make sense even for social security benefit reasons. Now if you are going to contribute to the spouse’s 401(k), I strongly recommend you " back into" the amount of payroll necessary for the 401(k) contribution. For example, if you are going to contribute $18, 000, then the payroll amount will be around $21, 000 (to cover FICA) and you keep the cost of doing the " contribution" to the least amount possible. The company match amount can be decided upon next year before filing the tax return.

Takeaway: Only put your spouse on payroll if you’re going to contribute to his or her 401(k) this year.

Should I be my own trustee for the 401(k)?

Yes, you can probably set up a 401(k) before year-end on the cheap if you give up control to a broker-dealer offering you limited investment options. You can guarantee there will be some management fees buried in the 401(k) as well.

However, if you want to self-direct the funds, and/or play a more active role in the management of the 401(k), I strongly recommend you serve as trustee. This allows you to self-administer your 401(k) plan, under the guidance of a law firm or third-party administrator (TPA) that keeps you out of harm's way of committing a prohibited transaction.

When it comes to investing the money in your 401(k) or other retirement accounts, don’t feel trapped into using one of the menu options you get from your financial advisor -- you don’t have to settle for a select group of mutual funds when investing your retirement money.

Instead, you can self-direct your IRA into all kinds of legal investments, including small companies, real estate, loans or precious metals.

The most popular self-directed retirement account investments include rental real estate, secured real estate loans to others, small-business stock or LLC interest, and precious metals such as gold or silver.

In sum, if you want to make a significant contribution to a retirement account before year-end, you need to act now. The deadline is approaching fast and if you don’t use the 401(k), you will either be limited to $5, 000 to

$6, 000 with an IRA or paying a lot in self-employment tax (FICA) to make a large contribution to a SEP. The 401(k) could be the difference in thousands of taxes you may pay next year.

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