THE IRS MAY BE COMING AFTER YOUR SOLO 401(K) PLAN

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If you sponsor a solo 401(k) plan, beware!

The IRS recently announced that it is targeting several employer plan areas for stepped-up auditing. One of those areas is solo 401(k) plans.

The fact that solo plans made the list is a signal that the IRS believes there are widespread compliance issues with these plans. While solo 401(k) plans don't have as many rules to follow as employer-based 401(k) plans, there are still several requirements. The IRS announcement should be a warning to business owners with solo plans to make sure they are obeying those rules.

These are the areas that the IRS will likely be looking at:

Have you hired employees? If you have any employees (besides your spouse), you can't have a solo 401(k). Hiring an employee would cause the plan to become a standard 401(k) and lose the administrative benefits of a true "solo(k)." Be aware that the definition of "employee" has recently expanded to include part-time workers. Previously, someone was not an employee if she did not work at least 1,000 hours in a 12-month period or was under age 21. Starting this year, someone who has worked at least 500 hours in three consecutive years and is age 21 or older by the end of the three-year period is considered an employee. (However, years before 2021 don't have to be counted for the three-consecutive-year rule.) Keep in mind that, if your business must be aggregated with another business under IRS common control rules, the "no-employee" rule applies across both businesses.

Have you exceeded contribution limits? If you have a solo 401(k), you wear two hats – an employer and an employee. The good news is this allows you to make both elective deferrals and deductible employer contributions. The bad news is you must worry about *three different* contribution limits, First, annual elective deferrals can't exceed a dollar amount -- $19,500 for 2021 ($26,000 if age 50 or older). Remember that this deferral limit is per person (not per plan). So, if you have a solo 401(k) for your side job and a traditional 401(k) in your regular job, the most you can defer between both plans is $19,500 (or $26,000). Second, yearly employer contributions are limited to an amount that is normally 20% of adjusted net earnings. Finally, there's an overall annual limit on combined contributions. For 2021, that limit is $58,000 (or $64,500 if the $6,500 catch-up deferral was made).

Are you filing Form 5500-EZ when required? Once solo plan assets reach $250,000, an annual Form 5500-EZ must be filed.

Is your plan document in order? Every solo 401(k) plan has an official plan document which sets forth the provisions of the plan. Make sure you are operating the plan *exactly* in sync with what the plan document says. Also, documents must be updated periodically to account for tax law changes. Make sure yours is up-to-date.

Doing your own compliance audit (with the help of a knowledgeable financial advisor) before the IRS comes knocking could save you a significant amount of money and aggravation.