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Solo 401(k) Plans: A Quick Fix-It Guide

by William D. Jewett on February 14, 2025

"Solo 401(k)" is a marketing term used for a 401(k) plan that is adopted by a sole proprietor or an incorporated business with no employees other than the owner. These plans offer a greater retirement savings opportunity compared to other individual accounts such as IRAs. If the business owner's spouse is an employee, a solo 401(k) can cover the spouse as well as the owner. However, a solo 401(k) cannot be used if the business has one or more employees other than (i) employees under age 21, (ii) employees who do not have either 1,000 hours of service during a one-year period or 500 hours of service in each of two consecutive years, and (iii) non-resident aliens, all of whom can be excluded from participating.[1]

The compliance burden associated with a solo 401(k) is relatively light but is not to be minimized. Solo 401(k) plans are not subject to Title I of the Employee Retirement Income Security Act of 1974, as amended (ERISA), but they are subject to the federal tax rules that apply to other 401(k) plans, including the ERISA-like prohibited transaction rules in section 4975 of the Internal Revenue Code ("Code"). A solo 401(k) also must file an annual report on Form 5500-EZ if the plan has assets exceeding $250,000 at year-end.

Things can go wrong in operating a solo 401(k), just as things can go wrong in any 401(k) plan. Some of the basic items in the IRS 401(k) Plan Fix-It Guide are therefore relevant to a solo 401(k), including the need to keep the plan up to date with changes in law and to follow the terms of the plan. But certain issues are more likely to arise in operating a solo 401(k). Here are three somewhat thorny compliance challenges a solo 401(k) may face.

Issue #1: A Non-Excludable Employee Is Hired. A business owner who expects to hire one or more non-spouse, non-excludable employees would do well not to adopt a solo 401(k). If a solo 401(k) is adopted and non-spouse, non-excludable employees are hired, the plan would no longer qualify as a solo 401(k). Unless the plan is terminated or frozen, it will have to be brought into compliance with a variety of rules that apply to 401(k) plans with more than one participant. These rules include nondiscrimination requirements that apply to contributions made by or for highly compensated employees and to the availability of plan features. The applicability of these rules could be delayed until completion of any

[1] Some will remember that retirement plans for the self-employed used to be called "Keogh" plans, after the Congressman who sponsored the law that made them possible, or "H.R. 10" plans, after the law. These terms are no longer commonly used.

initial waiting period for plan participation, generally not to exceed one year of service. In addition, ERISA requirements for the timing of contributions, the selection of investments and service providers, and other fiduciary considerations, including a surety bond, will apply. Finally, the annual report that once was submitted on the easy Form 5500-EZ must now be submitted on the short-form Form 5500-SF.

Issue #2: Contributions Exceed IRS Limits. Contributions to a solo 401(k), just like a regular 401(k) plan, are constrained by several annually-adjusted maximum contribution limits: the limit on employee salary deferrals ($23,500 for 2025, but higher for participants age 50 or older), the limit on employer contributions (only deductible up to 25% of compensation), and the overall limit on annual additions to a participant's account (the lesser of 100% of compensation or $70,000, for 2025, and, again, higher for participants age 50 or older). For a solo 401(k) maintained for the owner of a business that is not treated as a corporation for tax purposes, "compensation" means "earned income," which has a technical definition in the Code, and that's one place where problems might arise. In general, earned income means net earnings from self-employment—which itself has a technical definition requiring netting out deductions for business expenses—in a business for which personal services of the taxpayer are a material income-producing factor, determined after deductions taken for one-half of employment taxes and for employer contributions to a solo 401(k).

If excess deferrals are made for a calendar year, they must be removed from the plan, with any related earnings, by April 15 of the following year, as described more fully in our post on correcting excess deferrals in 401(k) plans. If the limit on annual additions is exceeded, elective deferrals must be distributed to participants on a taxable basis until the limit is satisfied. If the limit is still exceeded after all elective deferrals have been distributed, any remaining contributions must be forfeited to the extent necessary to satisfy the limit. The forfeitures must be used to reduce employer contributions for a participating spouse, if any, in the same year and for the sole proprietor and a participating spouse, if any, in the succeeding year. While these forfeitures remain, no contributions may be made to the solo 401(k) other than elective deferrals.

Issue #3: The Prohibited Transaction Rules Apply. Section 4975 of the Code prohibits certain types of transactions with the income or assets of retirement plans, including a solo 401(k) plan, in ways that closely resemble the prohibited transaction rules under ERISA. This means that even though ERISA does not apply to a solo 401(k), certain concepts familiar from ERISA will apply, such as the requirement that service providers be paid no more than reasonable compensation—although certain related ERISA rules will not apply, such as those requiring specific disclosures intended to ensure compensation is reasonable. The key prohibitions to keep in mind are (i) a prohibition on several types of transactions (such as loans, leases, and sales of plan assets) with "disqualified persons," which include, among others, fiduciaries, service providers, the employer, any owner of the employer, and any family member of any of these, and (ii) a prohibition on a fiduciary dealing with the income or assets of the plan in his or her own interest or for his or her own account. For example, a decision by the owner to invest in the owner's business or a family business is generally prohibited.

For plans that are subject to ERISA, certain prohibited transactions can be corrected under the Department of Labor's Voluntary Fiduciary Correction Program (VFCP), including the purchase of assets from parties in interest, the sale of assets to parties in interest, and the purchase or sale of assets at more or less than fair market value. But a solo 401(k) is not subject to ERISA and, therefore, would seem to be ineligible for VFCP unless a decision is made to hire a non-spouse W-2 employee who would join the plan, making it subject to ERISA. Unless an exemption applies, the penalty for a prohibited transaction is 15% of the amount involved for each year or partial year in the taxable period for which the transaction is in place, and if the transaction is not corrected within the taxable period when the IRS assesses a 15% penalty, the penalty increases to 100%.

Please contact a member of our Employee Benefits & Executive Compensation Group with any questions about potential compliance issues involving a solo 401(k).

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