

## One-person 401(k) Plans for Self-employed Individuals

One-person 401(k) plans can provide a valuable source of retirement savings for successful entrepreneurs. Given the right circumstances, such plans allow large contributions on behalf of a business owner and maintain flexibility for making contributions in future years.

For 2010, a business owner can make an elective deferral contribution of up to \$16,500 (add an additional \$5,500 catch-up contribution if he or she is age 50 or older at year-end) plus an employer contribution of up to 20% of self-employment (SE) income or 25% of compensation. In calculating the allowable employer contribution, the owner's SE income or compensation is not reduced by the owner's elective deferral contribution.

The total contributions (elective deferrals of up to \$16,500, plus the employer contribution) cannot exceed the lesser of 100% of the participant's compensation, or \$49,000 for 2010. Catch-up contributions to 401(k) plans of up to \$5,500 can also be made in 2010 for those who have attained at least



age 50 by calendar year-end and are not included in the annual additions limit.

### Example: Maximizing contributions with a one-person 401(k) plan.

Suzanne, age 50, is the sole owner and employee of Training Solutions, a sole proprietorship. Training Solutions is also the sole source of her earned income. Suzanne earns \$162,500 (net of the SE tax deduction) in the current year and wishes to maximize contributions to a retirement account. She believes the business will probably continue to be profitable, but she would like the flexibility of determining on a year-to-year basis how much to contribute. Suzanne does not expect to hire employees and will remain a one-person company.

The following information reflects the maximum amount that can be contributed to a 401(k) plan for Suzanne for 2010.

25% (20% for self-employed individuals)	
profit-sharing contribution ( $\$162,500 \times 20\%$ )	\$32,500
Elective 401(k) deferrals	<u>\$16,500</u>

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Contributions subject to annual addition limit	\$49,000
Catch-up contributions	<u>\$5,500</u>
Total contributions for 2010	<b><u>\$54,500</u></b>

As an additional benefit, a business owner can borrow from his or her 401(k) plan if the plan document so permits. The maximum loan amount is 50% of the account balance or \$50,000, whichever is less.

When the business employs someone other than just the owner, 401(k) contributions may be required for the other employees, in which case the plan would become a standard 401(k) plan with all the resulting complications. However, the plan can exclude from coverage any employee who is under age 21 and any employee who has not worked for at least 1,000 hours during any 12-month period. Because this exclusion rule allows the business owner to avoid covering young and part-time employees, the plan may still qualify as a simple and easy one-person 401(k) arrangement.

Also, if the business's only other employees are the owner's spouse and/or children, a 401(k) plan covering those individuals may be even more attractive than a one-person 401(k) plan, especially for owners hitting the \$49,000 contribution limit.

## Shareholder-to-corporation Leasing Arrangements

Shareholders of closely held C corporations routinely lease real estate, equipment, and other property to their corporate entity. These leases are either held directly by the shareholder or through a separate entity such as a partnership, LLC, or S corporation. Of course, the C corporation could directly purchase the item or lease it from an independent source. However, advantages that can motivate shareholder leasing arrangements include:

1. Avoiding Payroll Taxes. Rental income from real

estate is not subject to social security, Medicare, or self-employment (SE) tax.

2. Avoiding Corporate-level Gain. Corporate capital gains are taxed at ordinary income tax rates as opposed to the more favorable capital gains rates available to shareholders. Therefore, retaining ownership of real estate and other valuable tangible or intangible assets outside the corporation avoids the potential for triggering a gain within the corporation.

3. Retirement Cash Flow. Retaining valuable assets outside a controlled corporation allows the shareholder-lessor to continue to receive lease payments from the corporation, even though the shareholder is no longer actively employed by the corporation.

4. Business Transition. Retaining assets outside the corporation provides a natural segregation between the ownership of the business and the ownership of business assets. This can help transfer ownership and control to a successor by minimizing the value of the corporation (e.g., where the corporation contains only operating assets such as receivables and inventory, with fixed assets retained by the founder).

As you plan your business operations, please keep these potential advantages in mind. It is also important to understand that, as with most areas of tax law, some restrictions and limitations apply to shareholder-to-corporation leasing transactions. Therefore, when contemplating a leasing arrangement with your corporation, please contact us to discuss the details of how these arrangements should be structured.

## Working May Decrease Your Social Security Benefits

Many taxpayers currently underemployed due to recent economic conditions may consider applying for social security retirement benefits earlier than they previously planned to supplement their income.

But, continuing to work while receiving those benefits may cause their benefits to be reduced below the anticipated amount. If you are a social security beneficiary under the full retirement age (currently age 66), an earnings test determines whether your social security retirement benefits will be reduced because you earned more from a job or business than an annual exempt amount (discussed below). A different earnings test applies to individuals entitled to disability benefits.

As a general rule, the earnings test is based on income earned during the year as a whole, without regard to the amount you earned each month. However, in the first year you receive benefits, they are not reduced for any month in which you earn less than one-twelfth of the annual exempt amount.

One of the provisions of the Senior Citizens' Freedom to Work Act is that the social security retirement earnings test is eliminated in the calendar year in which you reach your full benefit retirement age for the month of, and months after, such attainment. In other words, once you reach your full benefit retirement age, there is no longer an earnings test to reduce your social security retirement benefits. However, the earnings test still applies for the years and months before the month you reach your full benefit retirement age.

Social security beneficiaries under the full benefit retirement age who have earnings in excess of the annual exempt amount are subject to a \$1 reduction in benefits for each \$2 earned over the exempt amount (currently \$14,160) for each year before the year during which they reach the full benefit retirement age (see the example). However, in the year beneficiaries reach their full benefit retirement age, earnings above a different annual exempt amount (\$37,680 in 2010) are subject to a \$1 reduction in benefits for each \$3 earned over the exempt amount. Social security benefits are not affected by earned income beginning with the month the beneficiary reaches full benefit retirement age.

You use the first exempt amount (currently \$14,160) from the year you reach age 62 through the year before the year you reach your full benefit retirement age. The second exempt amount (currently \$37,680) is used in the year you reach your full benefit retirement age. (However, social security benefits are not affected by earned income beginning with the month you reach your full benefit retirement age.)

#### **Example: Applying the annual earnings test.**

Charles, age 62 and a commissioned salesperson, currently averages \$2,000 per month in commissions. He has recently experienced a decrease in his income due to lower sales and is considering applying for social security benefits to supplement his reduced income. Charles's social security retirement benefits will be \$1,200 per month, so he expects to receive benefits totaling \$14,400 per year. However, since he will earn \$9,840 over the \$14,160 first exempt amount (\$24,000 - \$14,160), his benefits will initially be reduced by half that amount, or \$4,920. Therefore, he will receive only \$9,480 in social security benefits (\$14,400 - \$4,920). The results would be the same if Charles was self-employed, rather than an employee.

As you plan your retirement, be mindful that, as the example shows, working during retirement may reduce your social security benefits. This, in turn, could have a negative impact on your financial plans.

Please call us if you have questions on the taxability of social security benefits or any other tax planning or compliance issue.

## **Qualified Transportation Fringe Benefits**

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Employers can help employees get to and from work in a tax-favored manner. Within certain monthly dollar limits, employer-provided qualified transportation fringe benefits are exempt from tax. The following fringe benefits are currently available.

**Commuter Transportation.** Transportation provided by or for an employer in a commuter highway vehicle (e.g., vanpool vehicle) qualifies as an excludable transportation fringe benefit. A commuter highway vehicle is one in which (a) there is seating capacity for at least six adults (other than the driver) and (b) at least 80% of the mileage is reasonably expected to be for transporting employees between their residences and their place of work and for trips where at least half the adult seating capacity is occupied by employees. 1003117

**Transit Passes.** These include passes, tokens, vouchers, or similar items that entitle the employee to transportation. They must be for transportation (1) on mass transit facilities (whether or not publicly owned) or (2) provided by a person in the business of transporting people in a vehicle seating at least six adults other than the driver. There are no substantiation requirements for transit passes provided directly by the employer. Also, transit pass reimbursements qualify if a voucher or similar item exchangeable for a transit pass is not readily available.

**Qualified Parking.** This is parking provided on or near the employer's business premises, or on or near a location from which the employee commutes to work by mass transit or hired commuter highway vehicle.

**Bicycle Commuting Reimbursement.** This includes any employer reimbursement of reasonable expenses incurred by the employee for the purchase, improvement, repair, and storage of a bicycle regularly used for commuting from the employee's residence to the place of employment.

Employers can use compensation reduction arrangements for qualified transportation benefits. Under this arrangement, employees will not be taxed solely because they can choose between any qualified transportation fringe benefit and cash compensation. Only employees who choose cash instead of the benefit are taxed.

Please contact us to determine which of these provisions would benefit your business.

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