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Solo-k Plans – What Could Go Wrong?

Over the years, EJReynolds has discussed the merits of a "Solo-k Plan", or a 401(k) plan that covers only owners and their spouses. This plan design is a useful tool for getting the maximum deduction for a business owner to save for retirement. However, this article focuses on the responsibilities involved in maintaining such a plan as well as the potential problems that may arise as the business matures. In fact, the Internal Revenue Service announced recently that the Service's TE/GE (Tax Exempt and Government Entities) division has identified one-participant 401(k) plans as among its current audit initiatives. On the IRS website post announcing the initiative, TE/GE states: ***"the focus of this strategy is to review one-participant 401(k) plans to determine if there are operational or qualification failures, income and excise tax adjustments, or plan document violations. The treatment stream for this strategy is examinations."***

As previously stated, a Solo-k Plan is a traditional 401(k) plan covering a business owner or owners with no employees, or those persons and their spouses. Solo-k Plans are subject to the same rules and requirements as any other 401(k) plan; however, because no common law employees participate, there is no concern regarding ADP/ACP testing, top-heavy rules, minimum coverage requirements or, in general, most of the requirements of Title I of ERISA.

The following are the most common Solo-k compliance issues. If you have clients with a Solo-k Plan design, you may want to discuss these issues before the IRS audits them while you can still take steps to correct any compliance failures using several IRS and Department of Labor correction methods. Taking steps now to correct any compliance failures through use of the Employee Plans Compliance Resolution System (EPCRS) and the Delinquent Filer Voluntary Compliance Program (DFVCP), where applicable, can avoid substantial penalties if an IRS audit does occur.

Upon audit, the IRS penalties usually start with plan disqualification and the negotiations begin from there.

1. Plan Document Errors: The Solo-k plan *is* a 401(k) plan, and subject to the written document requirements like all other plans. This means that the plan document must periodically be restated to comply with the law just like any other plan sponsor, meeting the adoption deadlines for pre-approved plan cycles and any required interim amendments. For instance, the Cycle 3 Restatement deadline fell on July 31, 2022, meaning that all Solo-k Plans must have been restated on to a Pre-Approved Cycle 3 Document by that date. Once the language comes out for the SECURE Act and CARES Act amendments, Solo-k Plans must adopt those as well. Failure to meet these requirements result in a document failure, a qualification issue. This may be corrected easily under EPCRS, but only if determined prior to an audit.

2. Form 5500 Reporting Failures: Solo-k Plans are exempt from filing Form 5500-EZ so long as plan assets remain under $250,000. If plan assets exceed this threshold and a Form 5500-EZ is not filed, significant penalties could be assessed by the IRS and by the Department of Labor. The SECURE Act of 2019 increased the penalties for late filings from $25 to $250 per day. Filing the late forms under the Department of Labor Penalty Relief Program for Form 5500-EZ for Late Filers is a way to avoid penalties. This is like the DFVCP for small plan filers in that the user fee is capped at $1,500, but each year has a $500 fee assessed.

3. Exceeding Contribution and Deduction Limits: Since there are two sources of contributions in a Solo-k Plan (employee contributions and employer contributions), it is important that each source contribution is limited to the appropriate dollar amount. Employee 401(k) salary deferrals cannot exceed the 401(k) dollar limit ($23,500 in 2025, plus $7,500 for those 50 and older). Obviously, the employee must have enough earned income to support the 401(k) contribution that is made. The maximum total allocation to an employee is the lesser of 100% of compensation or $70,000 (in 2025) or a total of $77,500 for an individual over age 50 deferring the maximum catch-up contribution of $7,500 (in 2025). What derails many Solo-k Plans, however, is that the employer deduction is limited to a total of 25% of eligible plan compensation. An owner with a W-2 of $40,000 may be able to defer $23,500 as an employee contribution, but the employer contribution would be limited to $10,000. Failure to observe any of these dollar limits could be picked up easily on audit.

4. Exclusion of Common Law Employees: One of the most frequent errors with a Solo-k Plan is that they lose their solo status when the business sponsoring them hires employees. Although the plan may be written to exclude employees with less than a year of service and require a minimum number of hours for eligibility (generally, this cannot exceed 1,000 hours), if no one is monitoring the plan, employees may become eligible. This can trigger application of minimum coverage, nondiscrimination, and top heavy rules, as well as ERISA reporting and disclosure requirements, regardless of the assets. Business owners need to also realize that the Solo-k Plan is only ***for owners and their spouses.*** The hiring of an owner's ***child*** will cause the plan to be subject to all the above rules. Testing is not an issue as the child is considered Key and Highly Compensated, however the plan would be required to file a Form 5500-SF, and is no longer allowed to file the shorter, Form 5500-EZ. Having the rank and file employees paid under a leasing arrangement or PEO would cause the same rules to apply as there is a co-employment relationship to the employees under the PEO. Failure to meet requirements under any of these sets of rules would bring joy to an IRS Agent in an audit setting.

5. Exclusion of other Companies, especially in Controlled or Affiliated Service Groups:
The Controlled and Affiliated Service Group rules were designed years ago to ensure that an employer does not establish one company for the owners with rich benefits and a separate company for the employees with no benefits. Employees of other commonly owned businesses would be eligible for benefits under the (formerly) Solo Plan.

We have always tried to stress that the field of retirement plans is complicated. Without proper supervision, a plan can quickly become a liability to any employer. Spending a few dollars annually to ensure compliance can certainly save future headaches when the plan spins out of control. Too often, we have come into situations where the client just made contributions without looking at the proper limitations or never filed the tax returns when required. Some advisors just take the money and run, leaving the taxpayer uneducated and responsible for penalties when the problems arise. Since the IRS has specifically listed these plans as a target for their future examinations (audits), it is imperative that you look at any plans that may need a review of their procedures.

Let EJReynolds help you look better to your clients before the IRS looks at them.

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