# SEP-IRA VS Solo 401K

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If you work as an independent contractor, meaning you get a Form 1099 each pay period instead of a W-2, you're responsible for your own benefits, including a retirement plan. Your two main choices are a SEP-IRA or a Solo 401K. This post will help you decide which to use.

Simplified Employee Pension Individual Retirement Arrangements, or SEP-IRAs allow a sole proprietor to shelter 20% (actually 18.6%, at least until you max out your payroll tax) of your business profit up to $49,000 per year ($50,000 if over 50). The amount placed into a SEP-IRA is 100% tax-deductible. You take this deduction on line 28 of the Form 1040. Whatever amount you put into the SEP-IRA is simply put onto line 28 and becomes an "above the line" (the line is line 38-adjusted gross income) deduction. A SEP-IRA can easily be set up on line with most major brokerage companies, such as Vanguard and funded with a simple electronic funds transfer from your personal or business account. It took me less than 5 minutes. This simplicity is the main advantage over a solo 401K.

Solo or Individual 401Ks were introduced in 2002. Rather than limiting contributions to the usual amount of an employee 401K deferral (currently $16,500 per year), the laws allow you to also put in an employer contribution (really all the same money for a sole proprietor), for a total of up to $49,000 per year, exactly the same as a SEP-IRA. A solo 401K, however, is a more complex beast than a SEP-IRA. You are required to have a plan document, for instance. This isn't a big deal, and the paperwork at most brokerage options walks you through it quickly, but it will take longer than 5 minutes. With that complexity, however, comes a number of options not available in a SEP-IRA.

Advantages of Solo 401K over a SEP-IRA

1) Higher allowable contributions for those making less than $254,460 per year. It turns out you only need $170,840 in income to max out a Solo 401K, but need more than $80,000 more in income to max out a SEP-IRA. Here's a great calculator I found that tells you how much you could put away in each type of plan for your given income.

2) Higher catch-up contributions. After age 50, you can put $50K per year into a SEP-IRA. But you can put $54,500 into a Solo 401K.

3) Loans. You can borrow money from a solo 401K but not a SEP-IRA. You shouldn't borrow from either, but at least the option is there in case of catastrophe.

4) Roth Conversion/Back-door Roth IRAs. SEP-IRAs must be taken into the pro-rata calculation when converting non-deductible IRAs to Roth IRAs. Solo 401Ks are not subject to that rule.

5) Roth Contributions. Inside a Solo 401K, your "employee contributions" (up to $16,500) can be designated as Roth contributions. This not only allows you some tax diversification benefits, but also allows you to save more

money in a tax-protected manner, since after-tax money is worth more than pre-tax money.



6) Asset Protection Benefits. Although most states protect IRAs and 401Ks equally from creditors, at least two (MN and SC) give additional protection to 401Ks over IRAs.

That's a lot of advantages. Yet I have used a SEP-IRA several times and have never opened a Solo 401K. Why is that? I never actually needed any of these advantages. If you're already maxing out an employee 401K at one job (or make more than $254K), don't need a loan, don't want to use Roth options (or convert all your SEP-IRA contributions to a Roth IRA), and are under 50, why not choose the simple and easy option? You can always roll the SEP-IRA over into a solo 401K if you change your mind.