Newly introduced individual 401k and reengineered solo defined benefit plans have the potential to dramatically change the retirement plan landscape, and the trend toward their use has just begun. Investment management firms and banks need to take note as these programs are positioned to dramatically increase the amount of individual’s tax deferred wealth and shift the type of vehicle used to do it. While these programs are an immediate offshoot from tax law changes back in 2001, which increased deductible limits of retirement plan contributions to 100% of income, implementation is now just picking up. We believe the current lack of popularity has nothing to do with any program limitations or costs, but mainly due to the lack of information available for consumers and tax professionals. But, for those who are now using these plans, they are like a “kid in a candy store” when it comes to the amount they can save and the tax strategies they are implementing. And, one of the more interesting effects of the birth of individual 401k that we see in our practice, is that business owners are significantly changing the way they manage their growth and staffing in an effort to preserve their high contributions.

Individual 401k Plans – A Simple Approach for Significant Wealth Accumulation

With the term individual 401k, you might assume these plans are only for business owners who are self-employed. How then can this plan in itself have such a significant impact across all investors? Well, anyone can be a sole proprietor, even if you are already employed….just go out and cut your neighbor’s grass for payment and report it. Of course, there is more to it than that, but this thought hopefully will make it intriguing for everyone to take note. Let’s say you do start a business, even if it is just a moonlighting effort. If you have positive profits as a sole proprietor or reported W-2 earnings as a corporation, you can contribute using an Individual 401k plan. Then, if you are married, you can always hire your spouse, which has the potential of doubling your retirement plan contribution limits.

As baby boomers leave corporate America to start side businesses, the individual 401k plan can be very helpful, not only to consolidate all retirement holdings, but to continue contributions to a 401k which is a familiar plan. The most common user of an individual 401k we see are those fitting this profile, often surprising themselves by making twice as much as they did during their employment years and needing a tax hedge. The others are workers who want to use an individual 401k to borrow from their retirement holdings when starting their businesses. The third are individuals whose employers don’t offer enough retirement benefits, and they start a side business to use the individual 401k structure. In other words, anyone can have an individual 401k.

Individual 401k Features

Let’s start by providing the highlights of an individual 401k. Don’t be confused, these are 401k plans just like those offered by corporations. The difference is that now the business owner is not only the plan administrator, but often the only participant. Because they are designed for these owner benefiting situations, they do not require all the expensive
administration normally imposed on 401k sponsors, and therefore are little work and low cost (as low as $15 per year by some leading investment firms).

The three key features of an individual 401k are:

- **Higher Allowable Contribution at Lower Levels of Income.** The individual 401k allows for the employer 25% profit sharing contribution, as well as a $15,500 employee deferral, with both amounts maxing out at a $45,500 (for 2007) or 100% of income. So if you report $15,500 of personal income from a business, either on a W-2 or through self-employed earnings, you can actually contribute up to the full $15,500. Beyond that level of income, you can then put additional profit sharing away.

Let's say you are a self-employed individual with an income of $50,000 (in this example, you pay yourself on a W-2 basis in a corporate structure). Here's what you would be allowed to put into the various plans for 2007:

- Individual 401k: $28,000
- SEP: $12,500
- IRA: $4,000
- SimpleIRA: $12,000

*The individual 401k plan wins hands down.*

- **Flexibility to roll over all types of plans into the Individual 401k.** The ability to consolidate all of your qualified retirement plan holdings including IRAs, 401k, SEPs, SimpleIRAs, 403b, helps you simplify your records, which is a big trend today, and potentially save you fees.

- **Loan Feature.** Individual 401k plans allow participants the option to take a loan out against their holdings, up to 50% of their balance to a $50,000 maximum loan. You pay your plan back with the set interest. SEPs, SimpleIRAs and IRAs do not offer this feature. The borrowing option allows participants to tap into their retirement a little early, or help hedge a high tax year during retirement. We also see participants borrowing to fund that year’s contribution; in essence taking a current tax deduction, but funding it over five years. The strategies are quite novel.

**Qualifying for an Individual 401k**

Companies who can have an individual 401k plan are owner-only businesses, with partners, spouses, children or parents employed. Part-time employees can be excluded from the plan, and independent contractors are not included. So, what this means today is that many business owners who can benefit from the high allowable contribution are thinking twice about their own firm’s growth, keeping their workforce to part-time status, and outsourcing as much as possible. While this was probably not the intended outcome of the tax law change, it is tough for owners to give up a sizable retirement plan contribution once they are use to the tax savings and wealth accumulation.

While it hardly seems it can get any better for business owners using the individual 401k strategies, adding on a solo defined benefit plan just makes having your own business even better. While it is usually beneficial to maximize your use of an individual 401k from an ease and cost standpoint, users who want more should consider a defined benefit plan.
Defined Benefit Plans – While Costly for Large Employers can be a Significant Benefit for Small Business Owners

No doubt, pension plans are expensive for corporations with aging workforces. The reason is that actuarial assumptions used in these types of plans, and the mathematics at work, require increasingly higher contributions as employees age beyond the 40-year old mark. But the same age-based formula that works against large businesses creates a huge benefit for small businesses to use a defined benefit plan. The amount a business owner can contribute to their own pension plan can be substantial and can work to significantly reduce income tax burdens for many high earners during their working years. Defined benefit contributions can go all the way up to $180,000 for a business owner. When combined with the individual 401k, the contribution can go even further, maxing at 100% of income (special calculation of defined income is done). In a combined strategy, business owners choose to contribute to the defined benefit plan versus contributing through the profit sharing component of the individual 401k, since simply stated, only one of the contributions is allowed. (A match up to a limit and employee deferral is still allowed in the 401k.)

For husband and wife teams or partnerships, and if the workforce can be managed to employees who are either very young or do not have to be included in the plan (part-time or independent contractors), the combined defined benefit contribution can be up to $360,000 for a full tax deduction. Then the additional contribution to an individual 401k can be up to $31,000 (with just the combined employee deferral amount). Some high earners can reduce their tax bills to just their self-employment tax burden. It is a pretty dramatic strategy. The retirement plan investment portfolio build-up can be significant when this much is contributed each year. While not everyone can afford to stuff this much into a plan, the trade off is pretty tough. Don’t do it, and pay Uncle Sam a hefty tax deposit, or do it and pay significantly less in taxes and accumulate sizable funds for retirement. Different assumptions for retirement age can change the required contribution into a defined benefit plan, so some fine-tuning can be done to reach your target contribution. It is important to remember that defined benefit plans are a commitment, and they must be funded each year until your plan is terminated, so understanding the impact and rules is important. Defined benefit portfolios are managed as a separate investment pool under the company’s direction, so having the watchful eye of a good administrator and investment manager is important, but they really are very straight forward.

While 401k and defined benefit strategies have been around for a long time, the new twist on these plans makes them an important part of the retirement landscape today. It seems likely these strategies will run the traditional IRAs, SEPs and SimpleIRAs out of business for those who can take advantage of these plans. Seek out investment professionals and tax professionals who are knowledgeable about these programs and reap the potential rewards.

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