Solo 401(k) vs. SEP IRA

Self-employed people can still save for retirement – and benefit from valuable tax breaks – even if they don't have a job with a 401(k). Whether you're starting your own business, freelancing on the side to earn some extra income or you lost your job and are doing some consulting work, you can save for the future in a tax-advantaged retirement savings plan.

Freelancers who don't have any employees generally have two main options: a simplified employee pension or a solo 401(k). Here's how they both work and how to pick the best plan for you.

With a simplified employee pension, or SEP, freelancers can contribute up to about 20% of their net income from self-employment, up to a maximum of $57,000 in 2020. Your contributions are tax-deductible, and the money grows tax-deferred in the account until you withdraw it in retirement.

A solo 401(k), also called an individual 401(k), lets you save more at lower income levels. Since you're self-employed, you can make contributions as both the employee and the employer. You can contribute up to $19,500 as an employee (or $26,000 if 50 or older), plus about 20% of your net self-employment income as an employer, up to a total of $57,000 for both types of contributions in 2020.

Both accounts let you build tax-advantaged retirement savings, but there are some differences that can give one of the plans an edge.

Benefits of a Solo 401(k)

Higher contribution amounts for lower incomes. If you only earn a few thousand dollars in freelance income for the year, you can contribute much more to a solo 401(k) than you can to a SEP.

You can contribute up to 100% of your self-employed income, with a $19,500 maximum for 2020 (or $26,000 if 50 or older). If you earn more than that, you can also contribute about 20% of your net income from self-employment, as long your combined contributions don't exceed the $57,000 limit. That means if you earned $15,000 from self-employment in 2020, you could contribute about $15,000 to the solo 401(k), but you could only contribute about $3,000 to the SEP.

"The first criteria most people use in choosing between a SEP and a solo 401(k) is how much can I contribute to it?" says Dave Cherill, a certified public accountant in New York and member of the American Institute of CPAs' Personal Financial Planning Executive Committee. "Normally the solo 401(k) allows for a greater contribution, especially in cases where there is limited self-employed income."

The solo 401(k) can also come out ahead if you earn more. Fidelity, which offers both types of plans, has a self-employed plan calculator that compares the maximum contribution amount for a SEP and a solo 401(k) based on your age and your income. If you're a sole proprietor under age 50 whose net business profit for the year is $75,000, for example, you can contribute $13,940 to a SEP IRA or $33,440 to a solo 401(k) (which is $19,500 as the employee plus $13,940 as the employer).

"The solo 401(k) is going to allow larger contributions until income is up to about $300,000," says Michelle Morris, a certified financial planner and enrolled agent in Quincy, Massachusetts. For the specific calculations for self-employed people, see the worksheets in IRS Publication 560, Retirement Plans for Small Business. Your plan administrator can also help you with the calculations.

Catch-up contributions for age 50 and older. You can contribute more to a solo 401(k) as an employee if you're age 50 or older. You can add $6,500 in catch-up contributions, bringing the total of employee contributions to $26,000. The SEP doesn't have catch-up contributions, says Melissa Ridolfi, vice president, retirement and college leadership at Fidelity Investments.

You may have a Roth solo 401(k) option with tax-free withdrawals. Similar to a Roth IRA, your contributions to a Roth solo 401(k) are not tax-deductible, but you can withdraw the money tax-free in retirement. Having a pot of tax-free money to tap in retirement can be particularly helpful if most of your savings is in tax-deferred 401(k)s and traditional IRAs, and if your income is too high to contribute to a Roth IRA – there are no income limits to be able to contribute to a Roth solo 401(k). "I was recently working with a client and showed her that there was about an 11 percentage point bump in her retirement probability of success by saving in the Roth rather than the traditional solo 401(k)," says James Brewer, a certified financial planner and CEO of Envision Wealth Planning in Chicago. The Roth solo 401(k) is even more valuable if tax rates rise in the future. "For people who are getting phased out of the Roth IRA income limits, this gives them greater flexibility," he says.

The contribution rules for the Roth solo 401(k) are tricky: You can only have a Roth solo 401(k) option for the $19,500 in employee contributions (or $26,000 if 50 or older). If you make employer contributions too (the 20% of net income from self-employment), those must be traditional contributions – which are tax-deductible now and then taxable when withdrawn. Not all administrators offer a Roth version of the solo 401(k). Vanguard does, but Fidelity does not, for example. SEPs don't offer a Roth option.

Benefits of a SEP

A SEP is usually easier to set up. It's also more readily available. A SEP is usually available at most brokerage firms, mutual fund companies and banks with the same investing options as IRAs, usually including stocks, bonds, mutual funds, exchange-traded funds and other investments. Fewer financial institutions offer solo 401(k)s, and you need to be careful about fees. Some firms have the same fees and investing choices in their solo 401(k)s as their SEPs, but some solo 401(k)s have extra fees and only offer a handful of mutual funds.

You may also have more paperwork with a solo 401(k) – you have to file IRS Form 5500 each year after the assets in the account reach $250,000.

"The SEP is simply easier from a cost and administrative perspective," says Cherill.

SEP has no extra contribution limits if you max out a 401(k) at another job. With a solo 401(k), you may be limited in the employee's share of the contributions if you max out a 401(k) at another job – the $19,500 limit ($26,000 if 50 or older) applies to both the solo 401(k) and contributions you make to any other 401(k) you may have from another employer. This can limit your solo 401(k) contributions if you have a full-time job with a 401(k) and also do some freelance work on the side. But you can still contribute 20% of net income from self-employment to either a SEP or a solo 401(k), up to the $57,000 total for 2020.

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