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Tax Newsletter

Flying Solo With a 401(k) Plan
Retirement savings for small businesses

For decades, the retirement plan options for small businesses were more limited than those for big corporate entities, but not anymore. **Prime example:** In the past, S corporation owners and self-employed individuals may have been discouraged from using 401(k) plans due to high administrative fees. Now you can generally set up and operate a "solo 401(k) plan" at a reasonable cost.

Background: With a solo 401(k), a business owner effectively wears two hats—one as employee and another as employer. Contributions can be made in both capacities within tax law limits indexed annually for inflation.

- As the employee, you can make elective deferrals equal to 100% of your compensation ("earned income" for a self-employed individual), up to the annual contribution limit. For 2020, the limit is $19,500, plus you can add another $6,500 if you are age 50 or older.

- As the employer, you can make nonelective contributions up to 25% of compensation. (Special rules apply to self-employed individuals.) For 2020, the total contributions to a participant's account cannot exceed the lesser of this amount or $57,000, the same as other defined contribution plans.

This unique one-two punch enables you to save a sizable amount for retirement even if you are getting a late start.

Say that you are age 55 and earn $100,000 in compensation from your S corporation each year. As an employee, you may choose to defer the maximum $26,000 to your solo 401(k) plan in 2020, on top of employer contributions of $25,000. As a result, your total contributions amount to $51,000—or more than half your salary.

Important: You must make a special computation to find the maximum amount of elective deferrals and nonelective contributions if you are a self-employed individual. In figuring the contribution, your compensation is your "earned income." This is defined as net earnings from self-employment after deducting one-half of your self-employment tax and contributions for yourself. Rely on your financial and tax advisors for guidance.

What about the strict testing requirements for 401(k) plans? This can be a headache for traditional 401(k) plans, but it is usually less of a hassle for solo plans.

Notably, a business owner with no other employees does not need to perform any nondiscrimination testing for the plan, because there are no employees who might be receiving disparate benefits.

If you employ other workers and they meet the plan eligibility requirements, however, you must include these workers in the plan and their elective deferrals are subject to nondiscrimination testing (unless the 401(k) plan is a safe- harbor plan or another plan exempt from testing).

Of course, a solo 401(k) isn't the only game in town. Other types of qualified retirement plans—such as a Simplified Employee Pension (SEP) or a Savings Incentive Match Plan for Employees (SIMPLE)—offer comparable benefits within generous limits. But a solo 401(k) may offer the flexibility you need by combining employee and employer contributions.

Practical advice: Investigate alternatives like SEPs and SIMPLEs and compare your findings. Depending on your situation, you may decide to strike out on your own with a solo 401(k).

New Payroll Tax Twists in 2020
Complications under executive order

In August, President Trump signed an executive order creating a "payroll tax holiday" for employees, effective on September 1. But the celebration may be short-lived. Absent any further developments, the deferred tax will become due in 2021, when withholding is scheduled to increase.

Background: Employees must meet federal payroll tax obligations during the course of the year. First, an employee owes Social Security tax of 6.2% on wages up to an annual "wage base" ($137,700 for 2020). Any amount above the wage base is not subject to the Social Security tax.

Second, an employee must pay a 1.45% Medicare tax on all wages. There is no annual dollar limit on the Medicare portion of tax. (An employer must pay its share of payroll tax at the same rates.)

Employers are responsible for withholding the tax owed by employees and depositing it with the IRS. But the executive order on payroll tax deferrals creates some new wrinkles.

How it works: For employees who earn less than $4,000 in a biweekly payroll period paid from September 1 through December 31, the Social Security tax that would normally be due is deferred. Similarly, if an employer uses a weekly pay period, the deferral applies to an employee earning less than $2,000 per week.

If your employer has opted to implement this change, you have probably noticed an increase in take-home pay. This will continue through the rest of the year. Employers are not required to do this.

But the payroll tax deferral does not permanently relieve obligations for paying the deferred Social Security tax. As things stand now, employees will face increased withholding in 2021 to make up for any shortage. If you are not prepared for this change, it might cause some financial hardship. Due to the complexity of this provision, most employers are not offering their employees the choice of taking advantage of the payroll tax deferral or bypassing it.

Note that the executive order holds employers, not individual employees, responsible for paying the deferred amounts to the IRS by April 30, 2021. The deferral may cause other complications for employers if an employee quits or retires before 2021 or if workers are seasonal. Thus, the payroll tax holiday could trigger some additional scrambling in 2021.

Reminder: Do not confuse the new payroll tax deferral for *employees* with the deferral for *employers* included in the Coronavirus Aid, Relief, and Economic Security (CARES) Act.

Under the CARES Act provision, an employer can defer the 6.2% Social Security tax it owes for March 27, 2020 through December 31, 2020. Half of the deferred amount is due at the end of 2021 and the other half must be paid by the end of 2022.

Final words: The IRS is expected to issue more guidance on this matter. Other changes could be in the works following the election. We will keep you posted on any important new developments.

Latching Onto a Dependent Care Credit
Key tax rules for working parents

It is not unusual for both parents of young children to have full-time jobs to support the family. So they have to hire someone to watch the kids while they are at work. This can be problematic now that many youngsters are learning remotely or going to school on a hybrid schedule. Depending on your situation, you could incur additional expenses you had not anticipated at the start of the year.

At least you may be able to salvage a dependent care credit—frequently referred to as the "child care credit"—to offset part of the cost. What's more, the credit may cover more expenses than parents think. It is not just for daycare centers and nursery schools.

Background: For starters, the dependent care credit can be claimed by a couple or single parent that pays to care for a child under age 13 in order to be "gainfully employed." It is equal to 35% of the qualified expenses for a taxpayer with an adjusted gross income (AGI) of $15,000 or less. This amount is reduced by one percent for each $2,000 that AGI increases, hitting a floor of 20% for an AGI of $43,000 or more.

This credit is available for the first $3,000 of qualified expenses for one child; $6,000 for two or more children. As a result, if your AGI exceeds $43,000, the maximum credit that you can claim is either $600 or $1,200, respectively. **Reminder**: A tax credit reduces your tax liability on a dollar-for-dollar basis.

In the past, the dependent care credit was often associated with out-of-home expenses of parents who drop off their kids on their way to work, but in-home costs may qualify, too. For example, the cost of a babysitter who comes to the home is a qualified expense, even if the babysitter is a close relative like your parent or in-law. But the relative cannot be someone that qualifies as your tax dependent, such as a teenaged child who you pay to watch a younger sibling.

The credit may even apply to wages paid to a nanny or housekeeper who does other work around the home. But no credit is available for a chauffeur or a gardener.

Note that the cost of summer day camp qualifies for the credit, but overnight camp does not. The day camp may be a specialty camp geared to activities like athletics or a specific academic discipline.

Finally, there is one other important restriction you should note. The qualified dependent care expenses for a couple cannot exceed the annual earnings of the lower-paid spouse. For example, if one spouse works part-time and earns $5,000 in 2020, the maximum credit for a couple with an AGI above $43,000 and two kids is $1,000 (20% of $5,000). If you are returning to a physical work location away from home or otherwise qualify, keep these tax rules in mind.

Don't Be Tricked By Spoofers

Have you been targeted by someone who is "spoofing?" This occurs when you are sent an email that appears to be from someone you know. Therefore, you are likely to open it up to see what John or Jane has to say.

But beware: This is just another variation of a phishing scam. If you subsequently click on a link or respond, your personal information may be compromised. Be especially suspicious about communications from people who do not normally send you emails. Confirm the communication is legit before you react.

Facts and Figures
Timely point of particular interest

Tax Repercussions—The fate of the "net investment income tax" (NIIT) may up to the U.S. Supreme Court. **Reason:** The NIIT was initially authorized by the Affordable Care Act (ACA). Now the top court in the land has decided to review whether the individual healthcare mandate in the ACA is constitutional, the latest challenge to the law. If the Court ultimately strikes down the ACA, the NIIT might go with it. The ruling is expected to be issued by June.