Solo 401(k)s and the Rule of 55: Does the Answer Lie in 1962?

By Sean Mullaney[1]

Introduction

Solo 401(k)s are unique, particularly when it comes to the distribution phase of retirement planning.

When you or I leave a large employer, we can keep our 401(k) where it is. Not a problem at all, unless we have a very small balance,[2] since our large employer will carry on without us. Thus, the large employer can continue to sponsor the 401(k) plan.

How does it work with a Solo 401(k) for those reporting their self-employment income on a Schedule C? It's clearly not the same. **If we are self-employed and retire, is there an employer remaining to sponsor the Solo 401(k)?**

If there's no employer, that opens up a can of worms. For example, can a retired solopreneur take penalty-free distributions under the Rule of 55 from a Solo 401(k)? I have been concerned about Solo 401(k)s qualifying for the Rule of 55, since the Rule of 55 requires a "separation from service" and thus the possible elimination of the "employer" needed to sponsor the

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[2] 401(k) plans can require departing employees to transfer their 401(k) account out if the account has a relatively low balance. See Milliman Client Action Bulletin, SECURE 2.0: Mandatory cash-out limit increases in 2024, by Nina Lantz, available at https://www.milliman.com/en/insight/client-action-bulletin-secure-2-mandatory-cash-out-limit.

plan. I stated that concern on a 2024 episode of the ChooseFI podcast.[3] I'm not the only one who has stated that it will be challenging for a Solo 401(k) to qualify for the Rule of 55.[4]

Until the research behind this article, I've never done a deep dive to validate or disprove that view, and I'm not aware that anyone else has.

What happens to a Solo 401(k) upon the self-employed sole proprietor's retirement? Is there a time frame in which the Solo 401(k) needs to be transferred to an IRA or other qualified retirement plan? The answers to these questions can help us determine whether a Solo 401(k) qualifies for the Rule of 55.

Roadmap

This article proceeds in five main parts. The first part is a brief timeline of the legislative developments when it comes to qualified plans and self-employed sole proprietors ("**solopreneurs**"). Second is the legislative background on self-employed persons gaining access to qualified plans and the rise of the IRA, 401(k), and Solo 401(k). Third is an analysis of how that history informs the treatment of Solo 401(k)s after a sole proprietor retires and whether the Solo 401(k) qualifies for the Rule of 55. Fourth is a section on relevant tax and retirement planning

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[3] ChooseFI Episode 491, *Answering Your Questions on How to Access Money Before 59.5*, available at https://www.youtube.com/watch?v=hf04Zf1u0xk&t=3040s.

[4] For example, see Mark Nolan's views here (https://www.mysolo401k.net/age-55-rule-taking-money-company-401k-retirement-plan/ and https://mysolo401k.net/mycommunity/forums/discussion/rule-of-55-and-solo-401k-withdrawls/), commentators on the Bogleheads' personal finance forum here (https://www.bogleheads.org/forum/viewtopic.php?t=357990), and a Reddit thread here https://www.reddit.com/r/financialindependence/comments/1agbj5k/rule_of_55_with_solo_401k/. For a more optimistic view as to whether the Rule of 55 could apply to a Solo 401(k), see Eddie Wills here (https://gubmints.com/2017/05/15/retire-early-using-the-solo-401k-parachute/). Many thanks to financial planner Aubrey Williams for bringing this last webpage to my attention.

considerations for solopreneurs. Fifth, I offer proposals as to how the IRS and Treasury can clarify this area of the tax law and make retirement planning for solopreneurs much more certain. Last, I offer a conclusion to the article.

This article has headers stating the following, but it bears repeating and clarifying: this article is not tax advice for any individual or plan. Further, this article deals with an uncertain area of the tax law. This article cannot offer certainty in this area. Rather, it takes an academic approach to assess the possibilities when it comes to the tax treatment of Solo 401(k)s upon the retirement of a solopreneur.

I. Timeline

This article mentions several laws. I'm providing this brief timeline to help orient the reader. I recommend referencing this timeline while reading the body of the article to stay oriented.

1962 Enactment of the Self-Employed Individuals Tax Retirement Act of 1962[5] (hereinafter "**H.R 10**") allowing self-employed individuals to contribute to qualified retirement plans (hereinafter "**qualified plans**").

1974 Enactment of the Employee Retirement Income Security Act of 1974[6] (hereinafter "**ERISA**"). ERISA created the individual retirement account (the "**IRA**") and for the first time provided for a potential rollover of qualified plans to IRAs.

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[5] Public Law 87-792, 76 Stat. 809, available at https://uscode.house.gov/statviewer.htm?volume=76&page=809# and available at https://www.finance.senate.gov/imo/media/doc/ConfRpt87-2411.pdf. See also Teresa C. Campbell, *Self-Employed Individuals Tax Retirement Act of 1962*, 32 Fordham L. Rev. 279 (1963), available at https://ir.lawnet.fordham.edu/cgi/viewcontent.cgi?article=1785&context=flr.

[6] Public Law 93-406, 88 Stat. 829, available at https://www.govinfo.gov/content/pkg/STATUTE-88/pdf/STATUTE-88-Pg829.pdf.

1978 Enactment of the Revenue Act of 1978.[7] This is the act that added the "cash or deferred arrangement" to qualified plans. This is what is generally known as the "**401(k)**" today.

1982 Enactment of the Tax and Equity and Fiscal Responsibility Act of 1982[8] (hereinafter "**TEFRA**"). TEFRA repealed many of the special rules and limitations on qualified plans for the self-employed.

1986 Enactment of the Tax Reform Act of 1986[9] (hereinafter "the **'86 Act**"). The '86 Act introduced today's 72(t) 10% early withdrawal penalty for distributions from retirement accounts prior to the age of 59 ½ and the Rule of 55 exception to that penalty.

II. Statutory Background

A. Qualified Plans

Congress established qualified plans in the 1920s to promote private retirement savings through tax-advantaged accounts.[10] The first qualified plans included profit-sharing plans, stock bonus plans, and pension

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[7] Public Law 95-600, 92 Stat. 2763, available at https://www.govinfo.gov/content/pkg/STATUTE-92/pdf/STATUTE-92-Pg2763.pdf. See Section 135 for the introduction of the cash or deferred arrangement. 92 Stat. 2785.

[8] Public Law 97-248, 96 Stat. 324, available at https://www.govinfo.gov/content/pkg/STATUTE-96/pdf/STATUTE-96-Pg324.pdf. See Section 237 for the repeal of many of the special qualification requirements for qualified plans covering those who were self-employed. 96 Stat. 511.

[9] Public Law 99-514, 100 Stat. 2085, available at https://www.ucop.edu/research-policy-analysis-coordination/_files/Public%20Law%2099-514.pdf. See Section 1123 for the enactment of today's 72(t) early withdrawal penalty and the Rule of 55 exception. 100 Stat. 2472, available at https://uscode.house.gov/statviewer.htm?volume=100&page=2472#.

[10] Campbell, *supra* note 5, at 279 footnote 5 and accompanying text.

plans.[11] Qualified plans offered employees retirement benefits in the form of accounts funded by employers not currently taxed to the employee. Employers got the benefit of an upfront tax deduction for the contributions.

In 1954, qualified plans were codified in the Internal Revenue Code at Section 401.[12] Just as it does today,[13] Section 401(a) in 1954 stated that a trust qualifies as a qualified plan if it is offered by the employer for the exclusive benefit of employees or their beneficiaries.[14]

We see, even back then, a qualified plan required an **employer**. An individual cannot simply establish a qualified plan. One must be an employer to establish a qualified plan.

Qualified plans had a significant drawback going into the year 1962: they were not available to the self-employed.[15]

B. The Self-Employed Gain Access to Qualified Plans

In 1962, Congress enacted H.R. 10, which gave the self-employed access to qualified plans. This win for the self-employed was not a blowout victory. H.R. 10 imposed significant limits on qualified plans of the self-employed. For example, under the then-effective Section 401(d)(4)(B), **self-employed qualified plans could not be withdrawn until the**

[11] Id.

[12] 68A Stat. 134, available at https://uscode.house.gov/statviewer.htm?volume=68A&page=134#.

[13] Available at https://www.law.cornell.edu/uscode/text/26/401.

[14] 68A Stat. 134, available at https://uscode.house.gov/statviewer.htm?volume=68A&page=134#.

[15] Campbell, *supra* note 5, at 279.

solopreneur turned age 59 ½.[16] The only narrow exception was the disability of the owner.

Further, deduction limits were relatively modest. Generally, deductions for contributions to self-employed qualified plans were limited to contributions of the lesser of (i) 10 percent of self-employment income or (ii) $2,500.[17]

Subsections (c)(1), (c)(3), and (c)(4), as enacted in 1962 and largely the same today, provide insights as to who is considered self-employed for qualified plan purposes.

Defining **employee**, Section 401(c)(1) provided, in relevant part, that an employee is anyone with self-employment income and "[t]o the extent provided in regulations prescribed by the Secretary or his delegate, [employee] also includes, for any taxable year, . . . (B) an individual who has been an employee within the meaning of the preceding sentence for any prior taxable year."[18]

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[16] 76 Stat. 813, available at https://uscode.house.gov/statviewer.htm?volume=76&page=813#. See also Campbell, *supra* note 5, at 293, stating "the owner-employee is putting the money he contributes beyond his reach until age fifty-nine and a half" and Frederick W. Joyner, James Pemberton, and William E. Taylor, *The Tax Dilemma of the Self-Employed Professional*, 28 Missouri L. Rev. 161, 201 (1963), stating "that no benefits may be paid to [the owner-employee] prior to age 59 ½ unless he becomes permanently disabled" available at https://scholarship.law.missouri.edu/cgi/viewcontent.cgi?article=1804&context=mlr.

[17] See then-effective Section 404(e), available at https://uscode.house.gov/statviewer.htm?volume=76&page=820#. See also Campbell, *supra* note 5, at 286. According to one inflation calculator, $2,500 in 1962 is worth approximately $26,000 in 2024. https://www.calculator.net/inflation-calculator.html?cstartingamount1=2%2C500&cinmonth1=13&cinyear1=1962&coutmonth1=4&coutyear1=2024&calctype=1&x=Calculate#uscpi.

After H.R. 10, many of the defined contribution self-employed qualified plans were referred to as Keogh plans after one of the authors of H.R. 10, Representative Eugene James Keogh of New York. See Campbell, *supra* note 5 at 284-285 and https://www.investopedia.com/ask/answers/09/retirement-keogh-ira.asp.

[18] 76 Stat. 811, available at https://uscode.house.gov/statviewer.htm?volume=76&page=811#.

Defining **owner-employee**, Section 401(c)(3) provided, in relevant part, that an "'owner-employee' means an employee who (A) owns the entire interest in an unincorporated trade or business, or . . . [t]o the extent provided in regulations prescribed by the Secretary or his delegate, such term also means an individual who has been an owner-employee within the meaning of the preceding sentence."[19]

Defining **employer**, Section 401(c)(4) provided, in relevant part, that "[a]n individual who owns the entire interest in an unincorporated trade or business shall be treated as his own employer."[20]

Under these rules, a retired solopreneur could qualify as being an employer in the current year based on having previously been an employer. That was true under both H.R. 10 and today's rules.

Regulations issued by the Treasury and IRS in 1963 clarified the treatment of self-employed qualified plans during the solopreneur's retirement. Then-effective Treas. Reg. Sec. 1.401-11(e)(2)(ii)[21] provided that the solopreneur must begin taking distributions from the self-employed qualified plan no later than the year they turn age 70 ½.

C. The Introduction of the Traditional IRA

Individuals gained the ability to contribute to a personal retirement account account not linked to a particular employer under ERISA.[22] ERISA established the IRA allowing for individual contributions. IRAs also served

[19] 76 Stat. 812, available at https://uscode.house.gov/statviewer.htm?volume=76&page=812#.

[20] Id.

[21] Available at https://www.govinfo.gov/content/pkg/CFR-2018-title26-vol6/pdf/CFR-2018-title26-vol6-sec1-401-11.pdf.

[22] See footnote 6.

a secondary purpose: to be the retirement home of qualified plans through rollovers.[23]

The original rollover provisions explicitly did not allow self-employed qualified plans to be rolled over to IRAs.[24] This statutory prohibition on rolling over self-employed qualified plans to IRAs lasted until it was repealed by Section 1875(c)(8) of the '86 Act.[25]

Note that ERISA did ease the lock up of self-employed qualified plans by allowing the self-employed to withdraw only up to the amount of employee contributions prior to age 59 ½.[26] Even after this revision to Section 401(d)(4)(B), a retired solopreneur under the age of 59 ½ was required to maintain a self-employed retirement plan with respect to amounts in excess of prior employee contributions.

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[23] Then-effective Section 408(d)(3), 88 Stat. 962, available at https://uscode.house.gov/statviewer.htm?volume=88&page=962#.

[24] Then-effective Section 408(d)(3)(A)(ii), 88 Stat. 962, available at https://uscode.house.gov/statviewer.htm?volume=88&page=962#.

ERISA, a massive, sweeping law change at the time, appears to have contradictory provisions (which ultimately are not impactful to this overall analysis) with respect to rolling over self-employed qualified plans. Then-new Section 408(d)(3) appeared to prohibit rolling such qualified plans to IRAs, while then-new Section 402(a)(5) appeared to only allow such qualified plans to be rolled over to IRAs. The IRS issued Rev. Rul. 78-404 in 1978 allowing a self-employed qualified plan to be rolled into an IRA, leveraging off Section 402(a)(5) and the fact that the particular qualified plan in question had been terminated.

For the then-applicable Section 402(a)(5) language, see 88 Stat. 968-969, available at https://uscode.house.gov/statviewer.htm?volume=88&page=968# and https://uscode.house.gov/statviewer.htm?volume=88&page=969#.

It took until the '86 Act to finally sort this all out with the repeal of the self-employed qualified plan to IRA rollover prohibition in Section 408(d)(3). See 100 Stat. 2895, available at https://uscode.house.gov/statviewer.htm?volume=100&page=2895#.

[25] 100 Stat. 2895, available at https://uscode.house.gov/statviewer.htm?volume=100&page=2895#.

[26] 88 Stat. 957, available at https://uscode.house.gov/statviewer.htm?volume=88&page=957#.

D. 401(k) and the Solo 401(k)

As discussed above, in 1978, Congress added the "cash or deferred arrangement" to qualified plans.[27] These allowed significant deductible employee contributions to qualified plans.[28]

It appears the Solo 401(k), a self-employed qualified plan, was a theoretical possibility for solopreneurs from Section 401(k)'s January 1, 1980 effective date.[29] In practice, self-employed qualified plan contribution limits greatly limited the Solo 401(k)'s implementation until 2002, when the Economic Growth and Tax Relief Reconciliation Act of 2001 greatly increased the Solo 401(k) annual contribution limits.[30]

E. TEFRA Ends the Self-Employed Qualified Plan Trap

Prior to TEFRA, then-effective Section 401(d)(4)(B) trapped amounts inside a self-employed qualified plan until age 59 ½.[31] Withdrawals prior to age 59 ½ were prohibited (in full originally, in part after ERISA[32]).

TEFRA changed that. It entirely repealed the prohibition on pre-age 59 ½ withdrawals from self-employed qualified plans.[33] Interestingly enough, it wasn't TEFRA but rather the '86 Act which repealed then-effective Section

[27] See footnote 7.

[28] In practice, what we often think of as a "401(k)" is a cash or deferred arrangement (employee contributions) added to a profit-sharing plan (employer contributions).

[29] 92 Stat. 2787, available at https://uscode.house.gov/statviewer.htm?volume=92&page=2787#.

[30] Internal Revenue Service, *401(k) Plans for Self-Employed Individuals Fact? Or Fiction?*, available at https://www.irs.gov/pub/irs-tege/forum08_401k.pdf.

[31] 76 Stat. 813, available at https://uscode.house.gov/statviewer.htm?volume=76&page=813#.

[32] See footnote 26 and accompanying text.

[33] See footnote 8.

408(d)(3)'s prohibition on rolling self-employed qualified plans into IRAs.[34]

F. Early Withdrawal Penalty

The '86 Act introduced the 10 percent early withdrawal penalty as we know it today in Section 72(t)(1).[35] This penalty penalizes taxable distributions from qualified plans and IRAs occurring prior to the owner turning age 59 ½.

Along with the penalty came penalty exceptions. The '86 Act introduced the Rule of 55 exception.[36] If an employee separates from service of an employer during the year they turn age 55 or later, distributions from **that employer's qualified plan** (including but not limited to 401(k)s) after the separation from service qualify for an exception from the 10 percent early withdrawal penalty.

Rolling a qualified plan to an IRA blows qualification for the Rule of 55 exception. Once amounts are inside an IRA, distributions would then come from an IRA, not from the qualified plan of the employer the employee separated from. Thus, distributions from an IRA do not qualify for the Rule of 55 early withdrawal penalty exception.

III. Analysis

A. What Does 1962 Tell Us?

The first question to tackle is whether a solopreneur's retirement ceases his or her qualification to hold a Solo 401(k).

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[34] See footnote 25.

[35] See footnote 9.

[36] Id.

I and others have been concerned that once a solopreneur retires, he or she is no longer an "employer" and thus not eligible for a Solo 401(k) or other qualified plan.

A Solo 401(k) is a self-employed qualified plan. Looking back at how self-employed qualified plans were handled at retirement under H.R. 10 will be instructive.

It appears that when self-employment qualified plans were established in 1962, Congress had no concern about this issue. It's clear that self-employed qualified plans could not be withdrawn or otherwise moved prior to age 59 ½. That means the solopreneur's retirement prior to age 59 ½ had no effect on the solopreneur's ability to continue sponsoring the qualified plan.

Here's an example: *In 1963, Hal established a qualified plan for his sole proprietorship. He operated his sole proprietorship until he retired at age 53 in 1969. Under the then-effective Section 401(d)(4)(B), his qualified plan was locked up until he turned 59 ½. Hal's retirement had no bearing on his qualification as an "employer" to sponsor a qualified retirement plan until age 59 ½ and beyond.*

This pre-age 59 ½ lockup of solopreneur retirement plans lasted, at least partially,[37] all the way until TEFRA in 1982. **There's two decades of history demonstrating that a retired solopreneur can and must be an employer for purposes of sponsoring a qualified plan such as a Solo 401(k).**

Here's another example: *In 1963, Steve, a sole proprietor lawyer, established a qualified plan for his sole proprietorship. He contributed to it for 1963 and 1964. In early 1965 he turned age 52 and took a full-time in-house counsel job at Acme Industries, Inc. Under the then-effective Section 401(d)(4)(B), his qualified plan was locked up until he turned 59*

[37] See footnote 26 and accompanying text. ERISA loosened, but did not eliminate, the locking up of self-employed qualified plans prior to the owner turning age 59 ½.

½ in mid-1972. Even after turning 59 ½, under then-effective Treas. Reg. Section 1.401-11(e)(2)(ii),[38] Steve is not required to take a distribution from the qualified plan until the year he turns 70 ½, 1983.

These examples illustrate that a retired solopreneur was required to remain an employer sponsoring the existing qualified plan at least until he or she turned age 59 ½, and was allowed to remain a sponsoring employer until age 70 ½[39] and beyond.

You may wonder how a retired person or a person who gave up self-employment for a full-time W-2 job could be an "employer"? Was it under the old Section 401(d)(4)(B) which imposed the lock-up? Absolutely not.[40] That provision in no way made a retired solopreneur an employer for qualified plan purposes.[41]

In 1962, H.R. 10 defined "employer" for self-employment qualified plan purposes. Then-effective Section 401(c)(4) provided, in relevant part, that "[a]n individual who owns the entire interest in an unincorporated trade or business shall be treated as his **own employer**."[42] *This wording is the exact same today as it was in 1962.*[43]

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[38] Available at https://www.govinfo.gov/content/pkg/CFR-2018-title26-vol6/pdf/CFR-2018-title26-vol6-sec1-401-11.pdf.

[39] When minimum distributions were required.

[40] If former Section 401(d)(4)(B) was the statute making a **retired solopreneur** an "**employer**" for qualified plan purposes, TEFRA would have changed Section 408(d)(3) to allow self-employed qualified plans to be rolled over to IRAs. TEFRA did not do so. The law was not changed to allow self-employed qualified plan rollovers to IRAs until the '86 Act. See footnote 25 and accompanying text.

[41] 76 Stat. 813, available at https://uscode.house.gov/statviewer.htm?volume=76&page=813#.

[42] 76 Stat. 812, available at https://uscode.house.gov/statviewer.htm?volume=76&page=812# (emphasis added).

[43] See https://www.law.cornell.edu/uscode/text/26/401#c_4.

Who owns the entire interest in an unincorporated trade or business? Then-effective 401(c)(3) provided that an "'owner-employee' means an **employee** who (A) owns the entire interest in an unincorporated trade or business" or who previously qualified as an "owner-employee."[44] *This wording is the same today as it was in 1962.*[45]

Who is such an "**employee**"? Then-effective Section 401(c)(1) states that an "employee" for this purpose is anyone with self-employment income during the taxable year or previously qualified as an employee.[46] *This wording has been slightly shifted in the Code's structure but is essentially the same as it was in 1962.*[47]

Thus, **a retired solopreneur** is an employee who **qualifies as an employer for qualified plan purposes** (including Solo 401(k) purposes). This happens because his *previous qualification* as both an employee and an owner-employee is sufficient to qualify him as both an employee and an owner-employee during his retirement.

Those three definitions stated in Sections 401(c)(1), (3), and (4) are essentially the same today as they were in 1962. The differences are that in 401(c)(1) and (3) "Secretary" has replaced "Secretary or his delegate"[48] and the structure, but not the meaning (in this regard), of (c)(1) has changed. Since the Code has stayed the same from 1962 to the present, a retired solopreneur should still be able to qualify as

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[44] 76 Stat. 812, available at https://uscode.house.gov/statviewer.htm?volume=76&page=812# (emphasis added).

[45] See https://www.law.cornell.edu/uscode/text/26/401#c_3. Note that, as discussed below, the delegation to the Secretary of the Treasury has been changed from 1962's "Secretary or his delegate" to today's "Secretary."

[46] 76 Stat. 811, available at https://uscode.house.gov/statviewer.htm?volume=76&page=811#.

[47] See https://www.law.cornell.edu/uscode/text/26/401#c_1.

[48] Section 401(c), available at https://www.law.cornell.edu/uscode/text/26/401#c.

an **employer** for purposes of continuing to sponsor a Solo 401(k) during retirement.

At their creation, self-employed qualified plans were locked up and could not be distributed until age 59 ½. This demonstrates that when self-employed qualified plans were created, retired solopreneurs were considered employers who could still sponsor a qualified plan. Since the relevant provisions in this regard (**Section 401(c)(1), (c)(3), and (c)(4)**) have not materially changed, **it should be true today that a retired solopreneur can sponsor a Solo 401(k) and/or any other self-employed qualified plan.**

Thus, it appears that there is no requirement for a retired solopreneur to rollover a Solo 401(k) to an IRA upon their retirement.

B. Is the Language in Sections 401(c)(1) and (c)(3) Self-Executing?

Both in 1962 and today, the language in Sections 401(c)(1) and (c)(3) contains language clearly indicating that the Secretary of the Treasury can issue regulations governing the provisions.

This raises an issue: are these provisions self-executing? If the IRS and Treasury do not issue regulations, do these two rules have no effect? Today, there are no regulations that appear to operate and/or interpret Sections 401(c)(1) and (c)(3) with respect to treating a retired solopreneur as still being an employee and/or an owner-employee.

In theory, that could mean these rules do not apply unless and until the IRS and Treasury issue such regulations. Considering the apparent absence of those regulations today, it could be the case that a retired solopreneur is not an employer who can sponsor a Solo 401(k).

I believe that these rules are self-executing and thus have effect regardless of the issuance of any regulations. Clearly, the IRS and Treasury are empowered to interpret Sections 401(c)(1) and (c)(3) and likely have wide

latitude to put up guardrails and conditions on taxpayers using those two rules. But I do not believe that IRS and Treasury silence on Sections 401(c)(1) and (c)(3) is equivalent to a veto.

First, we must look at the original statute as I did above. **When H.R. 10 was enacted in 1962, there was no choice and regulations under Sections 401(c)(1) and (c)(3) could not change the result.** Clearly, a retired solopreneur was a sponsor of their qualified plan prior to age 59 ½. No regulation could have changed that. This alone strongly indicates that the original (c)(1) and (c)(3) were self-executing, as are today's equivalent versions, to qualify a retired solopreneur as an **employer** for qualified plan purposes.

Second, it is helpful to look at similar language in the Internal Revenue Code. Under Section 702(a)(7), a partner must take into account his distributive share of the partnership's "other items of income, gain, loss, deduction, or credit, to the extent provided by regulations prescribed by the Secretary."[49] Would the IRS argue that a partner does not have to take into account on his tax return his distributive share of other income unless and until the IRS and Treasury issue regulations?

I think the IRS would, quite logically, argue that Section 702(a)(7) is self-executing and that the IRS and Treasury have latitude to interpret it and provide rules for how partners must report that other income on their tax returns.

Considering that Sections 401(c)(1) and (c)(3) have similar designation language to that of Section 702(a)(7), and the history of Sections 401(c)(1) and (c)(3), it is quite reasonable to conclude that Sections 401(c)(1) and (c)(3) are self-executing.

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[49] Available at https://www.law.cornell.edu/uscode/text/26/702#a_7.

C. The Purpose of Retirement Accounts and the Purpose of Section 401(c)

Any retirement account you can't use to fund retirement isn't much of a retirement account. The concern that solopreneurs cannot continue to hold Solo 401(k)s in retirement starts to dissolve when one realizes that any "Solo 401(k) must be transferred to an IRA at retirement" rule means that a retirement account can't be used for retirement.

You say, "But wait a minute, the Internal Revenue Code is full of technicalities: Why shouldn't the technicality that there's no remaining employer to sponsor the Solo 401(k) govern at a solopreneur's retirement?" I believe the answer is simple: Section 401(c)(1) and (c)(3)'s provisions allowing a retired solopreneur to qualify as an "employee" and "owner-employee." These provisions allow a self-employed person to be considered an employer **after** they cease to be self-employed. Why else are they in the Code other than to address the technicality of a retired solopreneur no longer being an employer in retirement?

D. The Rule of 55

i. Conflict with Section 401?

Now that we have established that it is likely a retired solopreneur qualifies as an employer to sponsor a Solo 401(k), we must ask: could a retired solopreneur qualify for an early withdrawal penalty exception under the Rule of 55 with respect to a distribution from a Solo 401(k)?

At least initially, the answer to this question appears clear cut: the retired solopreneur separated from service from their own employment and has a qualified plan from that employment. Assuming the separation of service occurs during or after the year the retired solopreneur turns age 55, it appears that the retired solopreneur qualifies for the Rule of 55 exception on distributions from the Solo 401(k).

However, some might worry we're speaking out of both sides of our mouths. The Rule of 55 exception requires a "separation from service."[50] Can we claim that for purposes of qualifying as an **employer** we can treat a retired solopreneur as an **employee** (as discussed above) but that for Rule of 55 purposes the same retired solopreneur has "separated from service"?

I believe that we can, for two reasons. First, the question of whether there has been a "separation from service" is a Section 72(t) question. It is not a Section 401(c) question.

The Rule of 55 test is a factual one: has the person separated from the service of the employer? It should not be an obstacle to a solopreneur qualifying for a "separation from service" because, with respect to a separate code Section (401) and a separate issue (being considered an **employer** capable of sponsoring a Solo 401(k)), a retired solopreneur qualifies as an "employee."[51]

Congress's generosity in allowing retired solopreneurs to qualify as employers for qualified plan purposes should not harm the retired solopreneur for the purposes of a separate determination: whether or not the solopreneur has separated from service for Section 72(t) purposes.

Second, Section 401(c)(1) clearly incorporates both the past and present in determining whether someone is an "employee." In theory, someone could have had self-employment income two or three years ago and based on that alone could be an "employee" in the current year under Section 401(c)(1). Section 72(t)(2)(A)(v) has no similar mechanism. That is indicative that the standards to determine "employee" for Section 401(c)(1) purposes are different from the standards used to determine whether a "separation from service" has occurred for Rule of 55 purposes.

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[50] Section 72(t)(2)(A)(v), available at https://www.law.cornell.edu/uscode/text/26/72#t_2_A.

[51] Said differently, Section 72(t)'s factual determination should not be swayed by Section 401(c)(1)'s employee definition.

ii. Rule of 55 Legislative History

The Rule of 55 originated with the Senate Amendment to the '86 Act. The Senate version only allowed qualification for the Rule of 55 if the employee did not own 5 percent or more of the business.[52] After the Senate passed its version of the '86 Act, the different House and Senate versions went to conference. The Conference version (the final version passed into law by both Houses of Congress) kept the Rule of 55 **but dropped from the Rule of 55 the requirement that the employee own less than 5 percent of the business**.[53]

Congress, in passing the '86 Act, considered whether the Rule of 55 should be limited to those who do not own a somewhat controlling stake in the business. The Senate's proposed 5 percent ownership restriction could have locked solopreneurs out of the Rule of 55, since immediately before the separation from service, the solopreneur owned the entire business.

Ultimately, both Houses of Congress rejected that restriction. That judgment from Congress demonstrates that the retired solopreneur's previous entire ownership of the business should not be a bar to Rule of 55 qualification.

E. Why Would the IRS Be Concerned?

Should the IRS be concerned about a retired solopreneur qualifying as an employer for Solo 401(k) purposes?

I don't believe so, for several reasons.

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[52] Conference Report--H. Rept. 99-841, available at https://www.taxnotes.com/research/federal/legislative-documents/public-laws-and-legislative-history/tax-reform-act-of-1986-p.l-99-514/dsps.

[53] Id. See also Joint Committee Report JCS-16-86, available at https://www.taxnotes.com/research/federal/legislative-documents/public-laws-and-legislative-history/tax-reform-act-of-1986-p.l-99-514/ds10.

First, it is abundantly clear that the 88th Congress, the authors of H.R. 10 and the self-employed qualified plan in 1962, had no concern whatsoever with retired solopreneurs sponsoring their own qualified plans. They essentially required it prior to the solopreneur turning age 59 ½.

Second, what advantage do **retired solopreneurs** get from having a Solo 401(k) instead of a traditional IRA? Apart from potential Rule of 55 qualification discussed below, the answer is often practically none from a tax perspective.[54] **Why require an administrative step (a rollover from a Solo 401(k) to an IRA) that does not usually change the taxpayer's position in a meaningful way** apart from special circumstances such as Rule of 55 qualification?

In my book, I discussed that one of the advantages of the Solo 401(k) is that it facilitates the so-called Backdoor Roth IRA.[55] This can be true during the accumulation phase of a solopreneur's career. For most retired solopreneurs, the Backdoor Roth IRA won't be on the table as a planning tactic. Either or both the retired solopreneur will have modest income (and will not need the "Backdoor") or will not have earned income supporting any IRA contribution. The exception would be a situation where the retired solopreneur is married to a working spouse and their combined income is too high to qualify under the Roth IRA contribution income limits. I believe this will apply to a rather small subset of retired

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[54] This is true from a regular income tax perspective, but there may be occasional "play in the joints" when it comes to the 10 percent early withdrawal penalty. See Internal Revenue Service, Retirement topics: Exceptions to tax on early distributions, available at https://www.irs.gov/retirement-plans/plan-participant-employee/retirement-topics-exceptions-to-tax-on-early-distributions. For example, a 53 year old planning on retiring and paying for a child's college tuition from their Solo 401(k) would probably be well advised to roll the Solo 401(k) into an IRA instead of keeping it in a Solo 401(k) to qualify for the 10 percent early withdrawal penalty exception for the payment of qualified higher education expenses. See Section 72(t)(2)(E), (available at https://www.law.cornell.edu/uscode/text/26/72#t_2_E) which allows for the exception from IRAs but not from qualified plans. By contrast, a solopreneur retiring at age 56 looking to fund their living expenses from a Solo 401(k) would likely prefer to keep the money in a Solo 401(k) instead of rolling into an IRA to potentially qualify for the Rule of 55 penalty exception.

[55] Sean Mullaney, Solo 401(k): The Solopreneur's Retirement Account, 2022, pages 32-35.

solopreneurs. Further, the IRS has made informal comments indicating that the Backdoor Roth IRA is generally allowed and is not the most pressing concern from a policy and enforcement perspective.[56]

Third is the issue of timing. I believe the IRS and Treasury do not want to go down the road of "in what time frame must a retired solopreneur roll a Solo 401(k) to an IRA?"

Let's step back: Congress enacted qualified plans, including Solo 401(k)s, to help people retire. It cannot be the case that years of retirement savings are suddenly entirely subject to tax (and a possible 10 percent early withdrawal penalty) because a solopreneur did not execute a "required" Solo 401(k) to IRA rollover within 3 months/6 months/1 year of retirement.

Any rule in this regard is going to be entirely subjective and highly fraught. At what moment in time did the solopreneur retire? In which tax year did it occur? Why would someone who rolled their Solo 401(k) into an IRA 5 ½ months after the end of the last year of self-employment get full tax-free rollover treatment and someone who rolled their Solo 401(k) into an IRA 6 ½ months after that year-end have the entire distribution subject to ordinary income tax and the potential 10 percent early withdrawal penalty?

Congress's overwhelming policy concern with the Solo 401(k) is making tax-advantaged retirement savings available to solopreneurs. Arbitrary rollover rules and deadlines that serve no purpose would threaten that objective through immediate taxation and a potential penalty. My interpretation of the rules finding that retired solopreneurs can continue to sponsor the Solo 401(k)s they built up during their self-employment careers is the statutory interpretation most consistent with clear Congressional intent.

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[56] Benjamin M. Willis and Sean Mullaney, *Backdoor Roth IRAs and the Step Transaction Doctrine*, Tax Notes, May 13, 2019, page 1048.

Fourth, qualification as an "employee" and an "employer" in retirement in no way opens the door to making a Solo 401(k) contribution during one's retirement. All of the applicable limitations will still apply, and a retired solopreneur with $0 self-employment income for the year will not be able to contribute to a Solo 401(k), regardless of being considered an employee and an employer for plan qualification purposes.

What about the Rule of 55? Should the IRS be concerned about retired solopreneurs using the Rule of 55 to escape the 10 percent early withdrawal penalty on Solo 401(k) distributions?

No and Yes.

No in the sense that if a solopreneur has saved enough money in one employer's plan (his/her own) to live off of and separates from service, he or she ought be able to retire in the year they attain age 55 or later and take taxable, penalty free distributions from the Solo 401(k). In this regard, Solo 401(k)s are no different than large employer 401(k)s. Separating from self-employment is no different than separating from W-2 employment at an employer of any size.

Further, in 1986 the 99th Congress considered a business ownership restriction on the Rule of 55 and rejected it. That a retired solopreneur previously owned 100 percent of the business should not matter for Rule of 55 qualification.

Yes in the sense that theoretically taxpayers could engage in stuffing transactions to get significant amounts into Solo 401(k)s through IRA and other qualified plan rollovers to potentially qualify for the Rule of 55 exception. However, I believe that there are ways to curtail this through regulatory and other guidance that I will discuss in the fifth section below.

F. What About S Corporations?

S corporation shareholder-employees can qualify for a Solo 401(k).[57] What I don't believe they qualify for is to shut down the S corporation and keep the Solo 401(k) alive.

When the S corporation shareholder-employee participates in a Solo 401(k), the S corporation sponsors the Solo 401(k). Thus, if the S corporation is liquidated, the Solo 401(k) should be rolled over to an IRA or another qualified plan.[58] This should generally be done prior to the S corporation being liquidated.[59]

An S corporation shareholder-employee, unlike a sole proprietor, does not receive the benefits of Sections 401(c)(1), (c)(3), and/or (c)(4). I'm not aware of any rule that would treat an S corporation and/or the shareholder-employee as an employer sponsor of a qualified plan (including a Solo 401(k)) after the S corporation is liquidated.

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[57] See Internal Revenue Service, One-Participant 401(k) Plans, available at https://www.irs.gov/retirement-plans/one-participant-401k-plans.

[58] Shutting down the Solo 401(k) requires the filing of the Form 5500-EZ.

[59] The policy behind qualified plans is so compelling that one would hope that if an S corporation was liquidated prior to rolling over the Solo 401(k), the IRS would treat the Solo 401(k) as a qualified plan for any time between the liquidation and the rollover to the IRA or other qualified plan. Of course, that is simply a hope and it is very advisable to rollover any Solo 401(k)s sponsored by an S corporation prior to liquidation.

In the S corporation context, we have found an example where a retirement account (a Solo 401(k)) can't be used in retirement. It is because of the confluence of the many tax rules involved in S corporations and Solo 401(k)s. If any member of Congress is reading this, why not change the law to allow S corporation shareholder-employees the benefits of Sections 401(c)(1), (c)(3), and (c)(4) in retirement?

Could the S corporation stay alive for the retired solopreneur to qualify for the Rule of 55 on Solo 401(k) distributions?[60] In most cases I would say no, but it is not impossible. In the case of a S corporation with only the sole owner as the sole employee, it will be tough. Such a shareholder-employee could "retire" but may still remain nominally an officer of the S corporation. Further, the entity likely has some sort of annual entity filing requirements, a Form 1120-S annual tax return, and other administrative tasks. Performing these tasks may mean the employee has not "separated from service" from the S corporation and thus the "retired" shareholder-employee would not qualify for the Rule of 55 exception.

As solopreneurs tackle their "Schedule C versus S corporation" decision,[61] the potential availability of the Rule of 55 exception for Solo 401(k) withdrawals may be a factor for some on the side of Schedule C treatment instead of S corporation treatment.

IV. Tax and Retirement Planning for Solopreneurs

A. Plan Rules

In addition to tax rules, one must always look at the relevant **plan rules** applicable to their particular Solo 401(k) to determine if something is possible. In order to avail oneself of Rule of 55 distributions from a Solo 401(k), the plan rules of the particular provider's plan must allow for partial distributions after the solopreneur's retirement prior to age 59 ½ once the retired solopreneur has reached their 55th birthday year.

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[60] In my home state of California, there's at least one significant drawback of keeping a corporate entity or a limited liability company alive annually: the $800 minimum annual tax on such entities. See https://www.ftb.ca.gov/file/business/types/limited-liability-company/index.html#:~:text=Every%20LLC%20that%20is%20doing,your%20first%2Dyear%20annual%20tax and https://www.ftb.ca.gov/file/business/types/corporations/index.html.

[61] The "Schedule C versus S corporation" decision should consider multiple factors. See Mullaney, *supra* note 55, at 115-116.

A comprehensive review of the plan rules of the various financial institutions' Solo 401(k) plan rules is beyond the scope of this article. It appears from Invesco's Solo 401(k) distribution form that Invesco's plan may allow Rule of 55 distributions from Solo 401(k)s.[62]

For those that may be interested in Rule of 55 distributions from a Solo 401(k) in the future, it can make sense to run the issue by legal counsel and/or the relevant financial institution.

B. Stuffing

I can see it now: "Oh, the Rule of 55 might apply to Solo 401(k)s! Perhaps at age 55 I will drive for Lyft for three months and rollover my old traditional IRA to a Solo 401(k) for my Lyft business."

I worry about such arrangements. Businesses that can be viewed as "born to die" to some degree do not work well with Solo 401(k)s. As I addressed in my book,[63] a Solo 401(k) requires a trade or business. A trade or business needs some level of substance, including operation in a business-like manner and a profit motive.[64]

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[62] See https://www.invesco.com/us-rest/contentdetail?contentId=123f66b451c41410VgnVCM100000c2f1bf0aRCRD&dnsName=us. Consult with your own advisors and with the relevant financial institutions to determine the plan rules at any particular financial institution.

[63] Mullaney, *supra* note 55, at 48-49.

[64] Determining whether there is a qualifying trade or business is a multi-factor analysis. This IRS website lists some relevant factors to consider: Here's how to tell the difference between a hobby and a business for tax purposes, available at https://www.irs.gov/newsroom/heres-how-to-tell-the-difference-between-a-hobby-and-a-business-for-tax-purposes.

The IRS has previously indicated that they are concerned about significant rollover transactions into small business qualified plans.[65] Roll-ins to Solo 401(k)s for marginal "businesses" with an eye toward qualifying for the Rule of 55 are something to generally be avoided, in my opinion.[66]

V. Proposals for the IRS and Treasury

As mentioned earlier, there is significant doubt in the world as to whether a distribution from a Solo 401(k) can qualify for the Rule of 55 exception.[67] I believe that I have made a very credible case that it should.

As a preliminary matter, it's time for the IRS and Treasury to issue definitive guidance on this issue. Obviously, I believe that guidance should align with my views, but even if the IRS and Treasury do not align with my views, guidance from them would be helpful to Solo 401(k) plan participants and plan providers.

It's certainly possible that the IRS and Treasury are concerned that any favorable guidance from them would open the floodgates to inappropriate stuffing transactions to take advantage of the Rule of 55. I believe that the IRS could use a taxpayer favorable mechanism, the safe harbor, to effectively close the floodgates.

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[65] See Internal Revenue Service Memorandum, Guidelines regarding rollovers as business-startups, available at https://www.irs.gov/pub/irs-tege/robs_guidelines.pdf and Internal Revenue Service, Rollovers as Business Start-Ups Compliance Project, available at https://www.irs.gov/retirement-plans/rollovers-as-business-start-ups-compliance-project.

[66] This is particularly true considering that someone looking to retire in their mid-to-late fifties on tax-deferred retirement accounts has a pretty good option in the form of 72(t) payments. In the new 72(t) series of substantially equal periodic payment planning environment, 72(t) payments are a potentially appealing and flexible option. I wrote a detailed blog post about 72(t) payments in early retirement here: https://fitaxguy.com/retire-on-72t-payments/.

[67] See footnotes 3 and 4 and accompanying text.

I recommend the IRS and Treasury issue two regulatory safe harbors. The guidance should state that while the IRS always can examine plan qualification based on all relevant facts and circumstances, the IRS will not challenge Solo 401(k) plan qualification based solely on the use of the Rule of 55 after a rollover contribution to a Solo 401(k) if either of the following is true:

1) At least 30 percent of all contributions to the Solo 401(k) as of the time of the distribution are from annual employee and/or employer contributions (traditional and/or Roth).

2) The Solo 401(k) has received annual employee and/or employer contributions (traditional and/or Roth) totalling at least $5,000 annually for each of at least 3 years prior to the year of the distribution.

The issuance of these safe harbors would protect taxpayers and alert taxpayers that the IRS is aware of the possibility of inappropriately stuffing a Solo 401(k) to allow a Rule of 55 distribution. Taxpayers would be alerted that Solo 401(k) stuffing rollovers risk plan disqualification and immediate taxation (and potential penalty) on the entire amount rolled over into the disqualified Solo 401(k). The safe harbors, while not required for plan qualifications and Rule of 55 qualification, would give taxpayers comfort and would help IRS focus its limited examination resources when it comes to Solo 401(k)s.

Conclusion

Logic tells us that something required by the Internal Revenue Code is possible under the Internal Revenue Code. The repeal of the requirement does not repeal the possibility unless Congress takes a clear step to repeal the possibility.

In 1962, Congress clearly required retired solopreneurs to sponsor their self-employed qualified plans until they turned 59 ½. That requirement lasted for two decades. In 1982, Congress repealed the requirement that

retired solopreneurs continue to sponsor their self-employed qualified plan. But neither then nor later did Congress take action to repeal the possibility of retired solopreneurs sponsoring their self-employed qualified plans, including the Solo 401(k).

Thus, there is strong evidence that Solo 401(k)s indefinitely survive the retirement of a Schedule C solopreneur. This has implications for three groups: financial institutions offering the Solo 401(k), the IRS and Treasury, and solopreneurs.

Financial institutions should review their Solo 401(k) offering with respect to Rule of 55 distributions. Financial institutions should make a well considered decision as to whether their plan will offer Rule of 55 distributions. In their marketing materials, financial institutions should clearly communicate whether Rule of 55 distributions are a possibility from their Solo 401(k). The IRS and Treasury should examine the issues raised in this article and issue definitive guidance as discussed above. For solopreneurs considering retiring during their mid-to-late fifties, now is the time to consider these issues as they do their own planning. Such consideration often should be done in conjunction with professional advisors and their Solo 401(k) plan provider.