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## SIMPLE IRA Plans

Many small employers can now offer a retirement plan to their employees at a relatively low cost. A SIMPLE - Savings Incentive Match Plan for Employees - is an easy-to-administer retirement savings arrangement for you and your employees.



### What is a SIMPLE IRA plan and what are its advantages?

A SIMPLE IRA plan is a type of simplified retirement plan for small businesses. Because of its streamlined features, it is not subject to the complex qualification requirements associated with tax-qualified retirement plans. Administrative and legal costs therefore are minimized.

Other key advantages of SIMPLE IRA plans from an employer's standpoint include that they are subject to simplified reporting requirements and that the employer (and any other plan fiduciary) will not be subject to fiduciary liability resulting from the employee or the employee's beneficiary exercising control (direction) over the assets in his or her SIMPLE IRA account.

### Who can adopt a SIMPLE IRA plan?

Your business is eligible to adopt a SIMPLE IRA plan if it employs 100 or fewer employees who earned at least \$5,000 in compensation for the preceding year and it does not maintain another employer-sponsored retirement plan. If your business is eligible to establish a SIMPLE IRA plan but later becomes ineligible, your company will have a two-year grace period during which it may continue to maintain the plan.



### How do SIMPLE IRA plans work?

A SIMPLE IRA plan allows employees to make elective contributions to an individual retirement account (IRA). Employee contributions must be based on a percentage of their compensation and

cannot exceed \$6,000 per year (as indexed for inflation). As an employer, your business would have to satisfy one of two contribution formulas:

(1) Under the matching contribution formula, your company generally would be required to match employee contributions dollar-for-dollar up to 3% of each participating employee's compensation. A special rule allows you to elect a lower percentage for more than two out of five years.

(2) Instead of making matching contributions, your company could elect to make a 2% nonelective contribution on behalf of each eligible employee who earns at least \$5,000 in compensation for the year.

No more than \$160,000 of an employee's compensation can be taken into account in any year under the 2% nonelective contribution formula.

No contributions other than employee elective contributions and required employer matching or 2% of nonelective employer contributions can be made to a SIMPLE IRA plan. **All employer contributions are 100% vested to the participant.**

### Who is eligible to participate in a SIMPLE IRA plan?

Generally, each of your employees who received at least \$5,000 in compensation from your company during **any** two prior years, and who can reasonably be expected to receive at least \$5,000 in compensation during the current year, must be eligible to participate in the SIMPLE IRA plan. Self-employed individuals also can participate.

### **How are contributions to a SIMPLE IRA plan taxed?**

Employer contributions to a SIMPLE IRA plan are tax deductible in a given year only if they are made by the due date (including extensions) for your company's federal income tax return. Contributions to a SIMPLE IRA account are excludible from employees' taxable income, and the assets of a SIMPLE IRA account, like those of a qualified retirement plan, grow tax-free. However, employee contributions are subject to FICA.

### **How are distributions from a SIMPLE IRA plan taxed?**

Distributions from a SIMPLE IRA plan generally are taxed under the rules applicable to IRAs, and tax-free rollovers can be made from one SIMPLE IRA account to another. A SIMPLE IRA account can be rolled over to an IRA on a tax-free basis after a two-year period has expired since the individual first became a participant in the SIMPLE IRA plan. If an employee is no longer participating in a SIMPLE IRA plan (*e.g.*, the employee has terminated employment) and two years have passed since the employee first participated in the SIMPLE IRA plan, the employee's SIMPLE account is treated as an IRA.

### **Do early withdrawal penalties apply to SIMPLE IRA plans?**

Yes. Early withdrawals by an employee from his or her SIMPLE IRA account generally are subject to the 10% early withdrawal penalty tax applicable to IRAs. However, if the withdrawals are made during the two-year period beginning on the date that the employee first became a participant in the SIMPLE IRA plan, the penalty tax increases to 25%.

### **Are employer contributions to a SIMPLE IRA plan subject to employment taxes?**

No. Neither employer matching nor nonelective contributions to a SIMPLE IRA account are subject to employment taxes when made.

### **What rules apply to employees' elections to contribute to a SIMPLE IRA plan?**

An eligible employee can elect, within the 60-day period before the beginning of any year (or the 60-

day period before first becoming eligible to participate), to participate in the employer's SIMPLE IRA plan and to modify any previous elections regarding the amount of contributions. As an employer, you are required to contribute employees' elective deferrals to the employee's SIMPLE IRA account within 30 days after the end of the month to which the contributions relate. Employees must be allowed to terminate participation in the plan at any time during the year. A SIMPLE IRA plan can provide that an employee who terminates participation cannot resume participation until the following year. A SIMPLE IRA plan also can permit an individual to make other changes to his or her salary reduction contribution election during the year. Your company may designate a SIMPLE account trustee to which contributions on behalf of eligible employees are made.

### **Can SIMPLE IRA plans operate in §401(k) plan form?**

Yes. Generally, a §401(k) plan is considered to satisfy the special nondiscrimination tests applicable to employee deferrals and employer matching contributions if the plan satisfies the contribution requirements applicable to SIMPLE IRA plans, including the safe harbors described above (except that the employer cannot reduce the matching percentage under the matching contribution option below 3%) and the \$6,000 contribution limit. For a §401(k) plan to qualify under the SIMPLE IRA plan rules, the employer cannot maintain another qualified retirement plan for the year or make general profit sharing contributions other than the 2% employer nonelective contribution under the SIMPLE IRA plan.

### **What if your business currently maintains a SARSEP?**

The SIMPLE IRA plan replaces the salary reduction simplified employee pensions (SARSEPs) which are available to certain small employers under current law. If your business established a SARSEP before January 1, 1997, however, it can continue to make contributions under the SARSEP rules, and employees hired after December 31, 1996, can become participants in such a preexisting SARSEP and be covered under the old rules. A business, however, cannot establish a new SARSEP after December 31, 1996. Further, since a SARSEP is a type of employer-sponsored retirement plan, an employer cannot

maintain both a SARSEP and a SIMPLE IRA plan.

SARSEPs, like SIMPLE IRA plans, are subject to simplified qualification, administration, and reporting requirements. Even if your business currently maintains a SARSEP, however, you may want to consider switching to a SIMPLE IRA plan, depending on the circumstances. For instance, although it is possible under certain limited circumstances for SARSEPs to permit a greater level of employee deferrals than SIMPLE IRA plans (this ultimately will cease to be the case as the \$6,000 employee contribution limit is indexed for inflation), SARSEPs are subject to special nondiscrimination testing, are limited to employers having 25 or fewer eligible employees, and only are available if 50% or more of eligible employees elect to participate. SIMPLE IRA plans are not subject to these constraints.

### **How is a SIMPLE IRA plan established?**

An existing employer may establish a SIMPLE IRA Plan effective as of any date between January 1 and October 1, providing that the employer (or any predecessor employer) did not previously maintain a SIMPLE IRA Plan. If the employer is new and comes into existence only after October 1st of any given year, he may set up a SIMPLE IRA Plan for that year as soon as “administratively feasible”, even if the effective date is later than October 1st.

A number of decisions must be made and communicated to employees at least 60 prior to the 1st of each plan year. For a plan year beginning January 1st, the deadline for such notifications would be November 1st of the prior year.

Employees must be given 60 days prior to the first day of each plan year to consider whether or not they want to participate in the SIMPLE IRA Plan - or would like to make a change in their prior salary reduction agreements.

Immediately prior to this 60-day election period, the employer must provide each eligible employee with formal notification regarding his opportunity to enter into a salary reduction agreement or to modify a prior agreement. This notification must also specify whether the employer will make a matching or nonelective contribution to the plan for the coming plan year - and what level of employer matching

contribution, if any, he will provide.

In addition, the employer must provide every eligible employee with a **Summary Description** of the plan prior to the 60-day election period preceeding each plan year.

For employers who set up their SIMPLE IRA plans using IRS Form 5304-SIMPLE or 5305-SIMPLE, these government forms include a Model Notification to Eligible Employees and a Model Salary Reduction Agreement. In addition, pages 1 and 2 of these IRS forms packages can be copied and distributed as the **Summary Description** for the SIMPLE IRA Plan, providing they are supplemented with an outline of the Trustee’s procedures for withdrawals and transfers from the SIMPLE IRA’s established under the plan.

