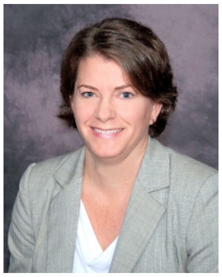
Simple IRA vs 401(k)

RETIREMENT MANAGEMENT SERVICES, LLC
Plan Consulting • Administration • Design

RETIREMENT MANAGEMENT SERVICES, LLC
905 Lily Creek Road Louisville, KY 40243

7/18/2017



Annemarie Keehn, ERPA, QPA, QKA

SIMPLE IRA plans (Savings Incentive Match PLan for Employees) were introduced in 1996 as part of the Small Business Job Protection Act. The purpose of the Simple Plan is to provide small employers with a qualified plan option with fewer administrative responsibilities and lower costs than a traditional 401(k) plan. Although there are benefits to a Simple IRA plan, there are also trade-offs associated with these plans that need to be understood and considered when a small employer is deciding which type of plan to implement OR when a small employer with a Simple IRA is considering "upgrading" to a 401(k) plan.

Simple IRA plans can only be sponsored by employers that have no more than 100 employees earning at least $5,000 in the preceding year. As a small employer grows, it may be forced to switch from a Simple IRA to a 401(k) plan as a result of becoming ineligible for the Simple IRA due to exceeding the "100 employee" threshold. For an employer who is implementing a new plan, it is important to consider whether the anticipated growth of the business might make the business ineligible for a Simple IRA in the near future. If that is the case, it makes more sense to implement a 401(k) plan from the beginning, rather than implementing a Simple IRA and having to terminate it and start over with a 401(k) plan shortly thereafter. There is no limit on the number of employees that the employer can have when sponsoring a 401(k) plan.

Even for employers who have not exceeded the 100 employee limitation, and don't expect to, there may be compelling reasons to consider implementing a 401(k) plan over a Simple IRA plan, or upgrading from a Simple IRA to a 401(k).

Excluding certain groups of employees: Employees who earn at least $5,000 in any 2 previous years and are expected to earn at least $5,000 in the current year must be allowed to participate in the Simple IRA. The only exception to this rule is that union employees and nonresident aliens can be permanently excluded from participation. By contrast, a **401(k) plan may be written to permanently exclude many other groups of employees**. So, if an employer would like to exclude a certain population from the plan (and therefore not be obligated to provide an employer contribution to them) the 401(k) plan provides much more flexibility to do so. 401(k) plans may exclude employees who aren't at least age 21. In addition, they may indefinitely exclude employees who have never worked at least 1,000 hours in a year. Finally, 401(k) plans may be written to exclude certain classes of employees, as long as that exclusion does not result in more than 30% of the employer's population being excluded from the plan. So, employers who want to exclude PRNs, for example, or employees of a certain location, etc. will have much more flexibility to do so in a 401(k) plan.

Employer contributions: Employers who sponsor a Simple IRA are required to contribute either (1) a dollar-for-dollar match on the first 3% of deferrals OR (2) 2% of pay to all eligible employees. *Note, the 3% match may be reduced to 1% in 2 out of every 5 years.* No additional employer contributions may be made to the plan. **In a 401(k) plan, the employer contribution options are more flexible**. If there is good participation from the non-highly paid employees, then it is possible the employer will not be obligated to make any employer contributions to the plan. However, if the participation rate of the non-highly compensated group is low, then in order for the highly compensated employees (defined as owners and family members of owners and those employees earning at least $120,000 per year) to be able to contribute the maximum 401(k) deferrals ($18,000 for 2017), the employer will need to make a "safe harbor" contribution to the plan. The safe harbor contribution can either be (1) a matching contribution formula of 100% of the first 3% of deferrals PLUS 50% of the next 2% of deferrals OR (2) 3% of pay to all eligible employees. In addition, if the Employer has a profitable year and wants to contribute a discretionary profit sharing amount to the employees, that is permissible in the 401(k) plan and the plan document can even be written in such a way that any profit sharing contributions are weighted more heavily toward certain owners or key employees.

Employee contribution limits: The maximum contribution an employee may make to a Simple IRA plan is $12,500, or $15,500 if the employee is at least age 50. The maximum employee contribution to a 401(k) plan is $18,000, or $24,000 if the employee is at least age 50. So a **401(k) plan allows an employee to defer a much larger portion of his pay to the plan.**

Roth deferrals: Employee contributions to a Simple IRA must be made as pre-tax deferrals. In a 401(k) plan, the document may be written to allow employees to contribute all or part of their deferrals on a Roth, after-tax basis. **Roth deferrals are not allowed in a Simple IRA plan**. The benefit of Roth deferrals is that, although the deferral is taxed before it is contributed to the plan, the Roth account (contributions PLUS any earnings) may be distributed completely tax-free after age 59 ½, as long as the first dollar to the Roth contribution account was contributed at least 5 years prior to the distribution.

Employee access to account: Employees may take a distribution at any time from the Simple IRA account (subject to taxes and penalties). This means that each year when the employer makes a contribution to the plan, the employee may choose to withdraw the contribution immediately. The employer has no control over this. In a 401(k) plan, there are restrictions around when an employee may take a withdrawal from the account. The employer can require that the employee only take a withdrawal in the event of a financial emergency or upon attainment of a certain age, like 59 ½ or 65. Restricting employee access to the account helps ensure that the funds will be available for their intended use – in retirement.

Loans: Simple IRA plans cannot allow participant loans. 401(k) plans can be written to allow employees to borrow a portion of their account balance, up to the lesser of 50% or $50,000.

There are many benefits to a 401(k) plan over a Simple IRA. The disadvantage to a 401(k) plan is that it is subject to more nondiscrimination testing, which could make the plan more complex and expensive to maintain. In addition, 401(k) plans must file a Form 5500 with the Department of Labor each year, so there is the expense of preparing that annual filing. But for many employers, the benefits of a 401(k) plan are significant enough to justify the additional administrative expense.

For business owners who are trying to decide which plan is best, it should be understood that under current limitations, **the maximum annual addition (employee plus employer contributions) that the owner under the age of 50 could receive in the Simple IRA plan for the plan year is $25,000** (although to receive that amount, the owner's compensation would need to be at least $416,666). By contrast**, the maximum annual addition an owner under the age of 50 could receive in a 401(k) plan is $54,000**, assuming the owner is willing to contribute to all eligible employees at some minimum level that allows that owner to reach the maximum level.

<u>TERMINATING A SIMPLE IRA PLAN</u>: Employers who have an existing Simple IRA plan who would like to switch to a 401(k) plan can only do so as of the next January 1. However, the important date to remember is November 1, because that is the deadline by which employees must be informed that the Simple IRA plan will be terminated for the upcoming year. A Simple IRA may NOT be terminated in the middle of a plan year and the employer may not maintain a Simple IRA and a 401(k) plan for the same year. So the employer must fund all promised contributions to the Simple IRA for the entire plan year, must inform employees by November 1 that the Simple IRA will be terminated, and then can terminate the Simple IRA as of December 31 and start a new 401(k) plan on January 1. Employees may then take a distribution from the Simple IRA or may roll their Simple IRA account into the new 401(k) plan, provided that the employee was a participant in the Simple IRA for at least 2 years prior to the rollover. Employees who were not participants in the Simple IRA for at least 2 years may NOT roll the Simple IRA balance to the 401(k) plan.