Converting a SIMPLE IRA to 401(k) Midyear

RETIREMENT MANAGEMENT SERVICES, LLC
Plan Consulting • Administration • Design

RETIREMENT MANAGEMENT SERVICES, LLC
905 Lily Creek Road Louisville, KY 40243
10/4/2023

Although SIMPLE IRAs may initially be the best fit for certain small businesses, they may not continue to be the best fit over time. In general, a 401(k) plan is the better choice when higher contribution limits or a more flexible plan design is needed. For example, SIMPLE IRAs cannot allow discretionary contributions and the contribution limit is much smaller. If flexible design features and higher contribution limits are unnecessary, then a SIMPLE IRA can be an excellent alternative due to its ease of administration and low costs. However, it is not uncommon for employees or prospective employees to view SIMPLE IRAs as inferior to 401(k) plans. This feeling can sometimes be overcome with education, but employee perception is also something to consider when choosing between a SIMPLE IRA and 401(k) plan.

Current SIMPLE IRA rules will not allow an employer to maintain another plan during the same year because of the exclusive plan rule. In order to change from a SIMPLE to 401(k), the plan sponsor has to notify the participants prior to November 2 that this will be the last year for the SIMPLE and that it will be replaced by a 401(k) plan.

SECURE 2.0 changed this rule. Starting in 2024, a SIMPLE IRA can be replaced with a safe harbor 401(k) plan mid-year. The replacement plan can be either a traditional safe harbor plan or a Qualified Automatic Contribution Arrangement (QACA) safe harbor 401(k) plan. The replacement safe harbor/QACA 401(k) plans must be effective as of the termination date of the SIMPLE IRA.

Contributions will be restricted to an aggregate elective deferral limit (including catch-up contributions) during the replacement year. The limit is based on the number of days covered in each plan. For example, if the replacement is done on June 1, 2024, the 2024 elective deferral limit – contributed to either the SIMPLE IRA or 401(k) plan – would be determined by taking the number of days covered in the SIMPLE IRA multiplied by its contribution limit (152/365) x 15,500 (19,000 including catch-up) = $6,454.79 ($7,912.33) and adding the number of days covered in the 401(k)-plan multiplied by its contribution limit (213/365) x 22,500 (30,000 including catch-up) = $13,130.14 ($17,506.85) for a total deferral contribution of $19,584.93 (25,419.18). This is using 2023 limits for illustrative purposes since the 2024 limits have not been announced.

The SECURE 2.0 Act also fixed the issue that SIMPLE IRA participants cannot roll over assets from their SIMPLE IRAs to another plan within the first two years of participation without incurring a 25 percent penalty and will also allow transfer money to a replacement plan that is not a SIMPLE IRA in certain circumstances. If an employer terminates a SIMPLE IRA plan and establishes a 401(k) plan (or, for rollover purposes, a 403(b) plan), rollovers between the SIMPLE IRA to the new 401(k) plan are allowed if the rolled amount is subject to 401(k) distribution restrictions (e.g., age 59 ½, death, severance of employment, hardship, etc.).

We are still waiting for additional guidance from the IRS on mid-year replacements, such as whether there will be a notice requirement to employees. With a little knowledge and planning, the decision to use a SIMPLE IRA or replace it with a 401(k) plan can be smooth and stress-free.

RMS
RETIREMENT MANAGEMENT SERVICES, LLC

Retirement Management Services, LLC
905 Lily Creek Road
Louisville, KY 40243

www.consultRMS.com Phone: 502-429-0767