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## SIMPLE IRA

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 that allows employees to defer income similar to a 401(k) without the costs.



### **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 such as 401(k)'s. Administrative and legal costs therefore are minimized.

Other key advantages of SIMPLE IRA plans, from an employer's standpoint, is 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.

### **Can the employer adopt less restrictive eligibility requirements?**

Generally, an employer can impose less restrictive requirements if they reduce or eliminate the prior year compensation requirement of \$5,000. For example, an employer could allow participation for all employees that received \$3,000 in the prior year. However, employers cannot add requirements or conditions to a SIMPLE IRA plan.

### **How do SIMPLE IRA Plans work?**

A SIMPLE IRA plan allows employees to make elective contributions to an individual retirement account (IRA)

via payroll deferrals.

Employee contributions must be based on a percentage of their compensation (up to 100%) and cannot exceed \$10,000 in 2006 (\$10,500 in 2007). Catch up contributions for participants aged 50 and over is an additional \$2,500 for 2006 and 2007.

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 no 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, regardless of whether the employee elects to participate.

No more than \$220,000 in 2006 and \$225,000 in 2007 (subject to cost-of-living adjustment) 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 3% matching or 2% nonelective employer contributions can be made to a SIMPLE IRA plan. *All employer contributions are immediately 100% vested to the participant, just like any IRA.*

### **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. Your SIMPLE IRA plan can provide less restrictive eligibility requirements (but not more restrictive ones) by reducing or eliminating the prior year compensation requirements, the current year compensation requirements, or both.

### **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 Social Security, Medicare and FUTA taxes.



### **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.

### **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%.

### **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 the 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 a §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. This includes the safe harbors described above (except that the employer cannot reduce the matching percentage under the matching contribution option below 3%) and the \$10,000 contribution limit in 2006 and \$10,500 in 2007. 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.

### **Can you transfer funds from a SIMPLE IRA to another IRA tax free?**

Amounts can be transferred from one SIMPLE IRA to another SIMPLE IRA in a tax free "trustee-to-trustee transfer."

If the employee is within the 2 year period of when they first became a participant in the plan, and wishes to transfer funds from a SIMPLE IRA to another type of IRA the transfer is not tax free and is not considered a rollover. The transfer is considered to be a distribution from the SIMPLE IRA plan and the 25% penalty applies.

If the employee is beyond the 2 year period of when they first became a participant, the transfer from a SIMPLE IRA to another type of IRA is tax free.

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

The SIMPLE IRA plan replaces the salary reduction simplified employee pensions (SARSEPs) which were available to certain small employers under prior 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. 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.

#### **As an employer, what if the SIMPLE IRA plan fails to meet the requirements?**

Generally speaking, the tax benefit of deducting contributions are lost if the plan fails to meet the SIMPLE IRA requirements set by the Internal Revenue Code. However, tax benefits may be retained if you correct the failure by following an IRS correction program.

#### **When must deposits of employee deferrals be made to be timely?**

You must deposit an employee's deferral in the IRA as soon as possible, but no later than 30 days following the month in which the employee would have otherwise received the money.

#### **When must employer contributions be made to be timely?**

As an employer, you have until the due date, including extensions, of your tax return to deposit matching contributions or nonelective contributions.

#### **Can a SIMPLE IRA plan be maintained on a fiscal year basis?**

No. SIMPLE IRA plans can only be maintained on a calendar year basis (January 1<sup>st</sup> through December 31<sup>st</sup>).

#### **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 days 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 preceding 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 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.

#### **Can a SIMPLE IRA plan be terminated at any time?**

No. Once a SIMPLE IRA plan has started for a year, it must continue for the entire calendar year and must fund all contributions promised in that year. This means that a SIMPLE IRA plan can only be terminated on December 31<sup>st</sup>. The employer must inform their employees of the termination within a reasonable period of time before the 60 day election. The employer is then eligible to establish a different type of qualified plan.

#### **Conclusion**

This information is intended to give you just a few ideas to get you thinking about retirement planning for you and your business. We would like to discuss your situation in detail to see how these plans can be used in your personal situation. Please call to get more details or to schedule a meeting with us.

*Please contact us at 878-1963 to begin today!*

# **ROTH IRA PLANNING**

## **What are the current contribution limits for a Roth IRA?**

The contribution limit is the lesser of earned income or \$4,000 for 2006 and 2007 plus the over age 50 catch-up contribution of \$1,000. Your adjusted gross income, with certain modifications, must be no more than \$150,000 on a joint tax return or \$95,000 on a single person's tax return to make the full \$4,000 contribution. If your adjusted gross income exceeds \$150,000 the amount that you may contribute to a ROTH IRA is reduced. It is completely eliminated at \$160,000 for a joint return and \$110,000 for a single person's return.

## **How do Traditional IRAs and Roth IRAs differ?**

Contributions made to a Traditional IRA are typically tax deductible, however, the distributions are considered income in the year they are withdrawn. Roth IRA contributions are not tax deductible; however, the distributions are tax free if you meet the following two requirements:

1. Five tax years have passed since the first contribution was made.
2. The account owner is at least 59 ½ or the distribution (up to \$10,000) is used for the purchase of a "first" home or is made after the account owners death or disability.

If the first requirement is not met, Roth IRA withdrawals are still tax free to the extent they do not exceed your contributions. The Roth IRA is the only form of retirement savings that provide tax free distributions.

Another difference between Traditional IRAs and Roth IRAs is that Roth IRA owners are not subject to the requirement to take minimum distributions beginning at the age of 70 ½ (minimum distribution rules to apply to the owner's heirs).

Lastly, contributions to Roth IRAs can continue past age 70 ½ as long as the owner has earned income. This is not the case with Traditional IRAs.

## **Can a Traditional IRA be converted to a Roth IRA?**

Converting funds from a Traditional IRA to a Roth IRA is allowed if your adjusted gross income for the year is no more than \$100,000. This income limit is the same whether you file a joint return or a single person return. The conversion triggers taxable income that is normally equal to the amount converted, but then future withdrawals from the Roth IRA are generally tax free.

You should consider the following issues when deciding whether to convert funds to a Roth IRA.

1. How long will the funds remain in the Roth IRA?  
The longer the better
2. How will your tax rate change in the future?  
The lower your tax rate now compared to the expected future tax rate, the better a Roth IRA conversion looks.
3. Can the conversion be undone if necessary?  
A conversion of a Traditional IRA to a Roth IRA can be undone if action is taken prior to the due date of your tax return for the year of conversion.

## **What rules apply to Roth IRA beneficiaries?**

If the owner of a Roth IRA dies, the beneficiary is subject to most of the same rules. For example, the beneficiary cannot make tax free distributions unless the funds have been in the account for a minimum of five years. However, the five year period does not start over if the owner dies. In most cases, the beneficiary is required to begin withdrawing from the Roth IRA the following year of the owner's death. This means that if the funds had not been in the account for five years when you are required to withdraw funds, you should not withdraw more than the original contributions to avoid being taxed on the distribution.

There are several additional rules when the beneficiary of the Roth IRA is a surviving spouse. If the beneficiary is a surviving spouse, the spouse may treat the Roth IRA as their own. This results in the five year period ending at the earlier of the inherited Roth IRA or the spouse's previously existing Roth IRA.

## **How can I start a Roth IRA?**

After you have determined that you are eligible for a Roth IRA and that it is the most appropriate investment for you, it is fairly simple start your Roth IRA. There are several different providers from which you can choose.

Banks and insurance companies typically accept small accounts and are a good starting point for first time investors. Mutual fund companies often give you the flexibility to invest parts of your IRA in different funds. This allows you to create an investment focused on growth, on asset protection, or somewhere in between. Many brokerage firms also offer IRA investments that are often known as "self directed IRAs." This type of investment gives you the opportunity to develop a portfolio that consists of specific investments chosen by you. This may be a good choice for more experienced investors.

## **Can a Roth IRA be combined with a SIMPLE?**

Yes. They can be combined as long as the income thresholds are not exceeded. By combining the two an individual could put aside in excess of \$17,000 per year for retirement.