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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, including tax-exempt employers and government entities, which allows employers to make contributions to their employee's retirement funds. 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.

Other key advantages of SIMPLE IRA plans, from an employer's standpoint, are 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. There is also a potential tax credit up to $500 a year for the first three years for the cost of starting a plan.

How do SIMPLE IRA plans work?

A SIMPLE IRA plan allows employees to make elective contributions on a tax-deferred basis to an individual retirement account (IRA) through payroll deductions.

Employee contributions must be based on a percentage of their compensation (up to 100%) and cannot exceed $13,000 in 2019. Catch up contributions for participants age 50 and over allows for an additional $3,000 for 2019.

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 (must be at least 1%), but for no more than 2 out of 5 years.
2. Instead of making matching contributions, your company could elect to make a 2% non-elective contribution on behalf of each employee who earns at least $5,000 in compensation for the year, regardless of whether the employee elects to participate.

No more than $280,000 in 2019 (subject to cost-of-living adjustments for later years) of an employee's compensation can be taken into account in any year under the 2% non-elective contribution formula.

No contributions other than employee elective contributions and required employer 3% matching or 2% non-elective employer contributions can be made to a SIMPLE IRA plan. All employer contributions are immediately 100% vested to the participant, as it is with an IRA.

Employees who participate in another plan from a different employer can participate in two SIMPLE IRA plans in the same year, however the total amount of the salary reduction contributions that an employee can make to all the plans he or she participates in is limited to $19,000 in 2019.

33 Blair Park Rd.
Williston, VT 05495

49 North Main St.
Rutland, VT 05702

info@dh-cpa.com
www.dh-cpa.com

SIMPLE IRA

How is a SIMPLE IRA plan established?

SIMPLE IRAs can be set up with banks, insurance companies, or other qualified financial institutions. The SIMPLE IRA is controlled by the employee and the funds are sent to the financial institution where the SIMPLE IRA is maintained. An existing employer may establish a SIMPLE IRA plan effective as of any date between January 1st and October 1st, 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, it 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 first day of each plan year. For a plan year beginning January 1st (the deadline for such notification would be November 1st of the prior year).

Such communication must include:

1. The employee’s opportunity to make or change a salary reduction choice under the SIMPLE IRA plan;

2. The employees’ ability to select a financial institution that will service as trustee of the employees’ SIMPLE IRA, if applicable;

3. Your decision to make either matching contributions or non-elective contributions;

4. A "Summary Description" of the plan, and

5. Written notice that the employee can transfer his or her balance without cost or penalty if you are using a designated financial institution.

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.

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.

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. There are no age restrictions related to funding a SIMPLE IRA 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 more restrictive requirements or conditions to a SIMPLE IRA plan.

How are contributions to a SIMPLE IRA plan taxed?

Employer contributions to a SIMPLE IRA plan are tax deductible in a given year if they are made by the due date (including extensions) for the company’s federal income tax return for that tax year. Contributions to a SIMPLE IRA account are excludible from employee’s taxable income, and the assets of a SIMPLE IRA account, like those of a qualified retirement plan, grow tax-deferred. However, employee’s 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 non-elective 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. It is the employee’s choice as to the percentage to be taken out of his or her salary. An employer cannot place any restrictions on the amount of the employee’s salary reduction contributions except to the extent required to comply with annual salary reduction 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.

When must employer contributions be made in order to be considered "timely"?

As an employer, you have until the due date, including extensions, of your tax return to deposit matching contributions or non-elective contributions. The employer may deduct all contributions made to an employee's SIMPLE IRA on its tax return.

When must deposits of employee deferrals be made in order to be considered "timely"?

The employer must make salary reduction contributions to the financial institution maintaining the SIMPLE IRA as soon as possible, but no later than 30 days after the last day of the month in which amounts would otherwise have been payable to the employee in cash.

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-deferred basis if the individual first participated in the SIMPLE IRA plan at least two years ago. 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.

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 first became a participant in the plan within the last two years, 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 taxable distribution from the SIMPLE IRA plan and regular income and a 25% penalty applies.

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

Do early withdrawal penalties apply to SIMPLE IRA plans?

Yes. Early withdrawals generally are subject to the 10% early withdrawal penalty tax applicable to IRAs when an employee withdraws funds from his or her SIMPLE IRA account before he or she reaches the age of 59 1/2. 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%.

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.

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 1st through December 31st).

Can SIMPLE IRA plans operate in a §401(k) Plan form?

Yes. Generally, a §401(k) plan is considered to satisfy the special non-discrimination 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 $13,000 contribution limit in 2019. 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 non-elective contribution under the SIMPLE IRA plan.

Can you opt out of a SIMPLE IRA plan?

An employee can not opt out of a SIMPLE IRA plan but can choose to stop making salary contributions to the plan, in which case the employer would also not make any matching contributions for the year.

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. However, if your business established a SARSEP before January 1, 1997, 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. They are limited to employers having 25 or fewer employees, and only are available if 50% or more of eligible employees elect to participate. SIMPLE IRA plans are not subject to these constraints.

The information presented here is intended to give you just a few ideas to get you thinking about retirement planning for you and your business. Davis & Hodgdon Associates CPAs can help you assess your situation in detail to see how these plans can be used in your situation.

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