Benefit Insights

dyatech

Delivering benefit solutions through advanced technology and superior service.

A non-technical review of qualified retirement plan legislative and administrative issues

October 2005

The Plain Truth About "Simple" Retirement Plans

The increasing complexities of daily life have left many Americans seeking simpler solutions. As a result, the term "simple," when used with retirement planning, was quickly embraced by the small business community, the same way that "low-fat" became the mantra for weight watchers. The belief was that if it's simpler, it must be better, at least on some levels.

The Simplified Employee Pension (SEP) plan has been around for many years. It offers the flexibility of a profit sharing plan and previously allowed salary deferrals. In recent years Congress created the Savings Incentive Match Plan for Employees (SIMPLE) IRA and 401(k) plans, and thus the simplicity began to get more and more complicated. But more importantly, the simplicity did not keep pace with other advantages afforded to traditional plans. So when an employer searches for the best retirement plan for its employees, the owner may find that the answer is not "simple"!

This newsletter will compare the major differences among the simple and traditional plans.

Availability

Any business, including a non-profit, can adopt a 401(k) profit sharing plan. Such plans allow eligible participants to make salary deferrals and may or may not provide employer matching contributions. In addition, the plan allows the employer to make nonelective contributions which are usually discretionary each year. A plan document must be executed by the last day of the first plan year in order to establish the plan.

A SEP can also be established by any business, although it is more commonly used by small employers. Individual retirement accounts (IRAs) are set up by the employer for each eligible employee to receive contributions. A SEP document can be adopted any time up to the filing due date of the employer's federal tax return, including extensions. The document can be individually designed or the IRS model SEP agreement can be used. SEP contributions are made by the employer and are usually discretionary each year.

A SIMPLE IRA plan can be adopted by any employer with up to 100 employees who each earned $5,000 or more in the previous calendar year. The employer may not maintain another qualified

plan that covers any employee eligible under the SIMPLE IRA plan.

A SIMPLE 401(k) plan is really not a simple plan at all, like the two plans described above. It is more like a watered down safe harbor 401(k) plan, with reduced deferral limits and lower employer contribution requirements, which allow it to eliminate nondiscrimination testing. It is also available to employers with 100 or fewer employees who each earned $5,000 or more in the previous calendar year.

Eligibility

A 401(k) profit sharing plan can omit employees who have not yet attained age 21. In addition, the salary deferral portion of the plan can require up to one full year of service (1,000 hours during a twelve-month period), while all employer contribution portions of the plan (e.g., nonelective and match contributions) can require up to two full years of service, although anything in excess of one year requires 100% immediate vesting.

SEP plans can utilize the same age 21 provision but have very different service requirements. Employees must be included if they earn $450 or more in the current year and performed services for the employer in at least three of the preceding five calendar years.

SIMPLE IRAs must cover all employees who are expected to earn at least $5,000 each from the employer in the current year and who earned at least $5,000 from the employer in any two previous calendar years.

SIMPLE 401(k) plans are governed by the same eligibility provisions as regular 401(k) plans.

Contribution Limitations

The traditional 401(k) profit sharing plan can receive deductible employer contributions up to 25% of all eligible participants' compensation plus employee salary deferrals. Contribution allocations to any one participant are limited to the lesser of 100% of compensation or the annual additions dollar limit ($42,000 for 2005).

For those age 50 and older, the dollar limit is increased by the maximum catch-up contribution which is $4,000 for 2005. Salary deferrals are limited by an annual dollar limit ($14,000 for 2005) plus the catch-up contribution, if applicable.

The SEP deduction and contribution limits are the same as for traditional plans. However, employee salary deferrals are not allowed (salary reduction SEPs adopted prior to 1997 may continue to receive salary deferral contributions).

SIMPLE IRA and SIMPLE 401(k) plans require the employer to match deferrals 100% up to 3% of compensation deferred, or provide a 2% of compensation contribution for all eligible employees. These contributions are slightly lower than those required for safe harbor 401(k) plans, which are either a 3% nonelective contribution or a match equal to 100% of the first 3% deferred, plus 50% of the next 2% deferred. The salary deferral limit for SIMPLE plans is $10,000 as of 2005, plus a $2,000 catch-up contribution for those age 50 and older.

Vesting

Another advantage of the traditional plan is being able to use a vesting schedule. Employer-derived benefits vest over time, typically under a graduated schedule over six or seven years. (Employee contributions are always 100% vested.) When a participant terminates prior to achieving full vesting, the non-vested portion is forfeited and can be used to offset future employer contributions, pay administrative expenses or be allocated to remaining participants.

SEPs, SIMPLE IRAs and SIMPLE 401(k) plans require full and immediate vesting of all contributions. Safe harbor 401(k) contributions are also 100% vested immediately.

Distributions

Most traditional plans require a triggering event for distributions, such as death, disability, termination or hardship. Some profit sharing plans allow in-service distributions after a specified period of time. Distributions from IRAs, including those established under a SEP or SIMPLE IRA plan, can be made at any time determined by the participant. Generally, all taxable distributions prior to age 59½ are subject to a 10% penalty tax. In traditional plans the penalty will not apply for distributions on account of separation from service after age 55. In IRAs, the penalty is waived for certain medical expenses, qualified education expenses and first time home purchases (up to $10,000).

SIMPLE IRAs have an additional distribution restriction. If a taxable distribution occurs within the first two years of the initial contribution, the penalty tax will be increased from 10% to 25%. In addition, rollovers within the first two years can only be made to another SIMPLE IRA plan. Rollovers to any other plan during that period will be considered taxable distributions and be subject to the 25% penalty tax.

Required minimum distributions from IRAs and qualified plans must begin at age 70½. However, traditional plans can permit non-owners (who own 5% or less of the business) who work past age 70½ to delay distributions until their actual retirement.

Analysis

The primary advantages of SEPs and SIMPLE IRA plans are no nondiscrimination testing, no top heavy considerations, no annual Form 5500 filings and a simplified plan document. Account statements must still be provided to participants and contribution calculations must be performed. SIMPLE 401(k) plans can also eliminate nondiscrimination and top heavy testing but they must file 5500s each year.

A major advantage of the traditional profit sharing plan is the broader options for allocating employer contributions. A traditional plan can utilize age-based formulas, including the popular new comparability method, which help to maximize contributions for the owner and minimize contributions for the staff. Here is a prime example:

Janice is 60 years old and owns a business with four other employees. She wants to sponsor a retirement plan with maximum flexibility and maximum contributions for herself. She is considering a SEP plan and a profit sharing plan. The most advantageous SEP allocation formula would be integrated with social security. The profit sharing allocation formula would be new comparability, based on ages and projected benefits. The contribution comparison would be as follows:

Employee	Age	Compen-sation	SEP Contribution	Profit Sharing Contribution
Owner	60	$210,000	$42,000	$42,000
A	35	50,000	8,371	2,500
B	30	40,000	6,697	2,000
C	25	30,000	5,023	1,500
D	21	20,000	3,349	1,000
Total:		$350,000	$65,440	$49,000

The SEP plan would require an additional $16,440 of contributions for the staff to provide the same $42,000 maximum contribution for the owner. In addition, the profit sharing plan could utilize a vesting schedule that might result in forfeitures which could further reduce employer costs.

Now let's assume that the owner's compensation is only $100,000. In that case, salary deferrals would help to maximize the owner's total contri-

bution without increasing contributions for the staff. In addition, since the plan allows deferrals, the owner could make a $4,000 catch-up contribution, bringing her total allocation to $46,000. Here is what the combination of 401(k) and profit sharing contributions might look like:

Employee	Age	Compen-sation	Salary Deferrals	Profit Sharing Contribution	Total Contribution
Owner	60	$100,000	$18,000	$28,000	$46,000
A	35	50,000	?	2,500	2,500
B	30	40,000	?	2,000	2,000
C	25	30,000	?	1,500	1,500
D	21	20,000	?	1,000	1,000
Total:		$240,000		$35,000	$53,000

Employees receive a 5% contribution which is more than enough to meet the 3% safe harbor requirements and avoid deferral nondiscrimination testing. They can also elect to defer into the plan.

Since a new SEP plan cannot accept salary deferrals, it could not compete with the allocations in the above example. The SIMPLE IRA plan would also not be a viable option, even in conjunction with a profit sharing plan, since it has a lower deferral limit ($10,000 plus $2,000 catch-up).

SEP and SIMPLE IRA plans can sometimes eliminate more employees because their service eligibility requirements can exceed one year (see above), but more part-timers can be excluded in traditional plans which can require 1,000 hours of service during a twelve-month period. Also worth noting is that traditional plans can allow participant loans whereas SEPs and SIMPLE IRAs cannot.

Conclusion

When choosing a retirement plan, keep in mind that the simplest solutions are best suited for simple situations. SEP plans may be most appropriate for one-person companies, where the desired contribution can be made with the least amount of administrative work and costs. SIMPLE IRA plans are an easy way for small employers to make salary deferrals available to the staff, where simplicity is traded for reduced deferral limits. But for an employer looking for the full array of options and benefits, the traditional plan is still the best choice.

The information contained in this newsletter is intended to provide general information on matters of interest in the area of qualified retirement plans and is provided with the understanding that our company is not engaged in rendering legal or tax advice. Legal or tax questions should always be referred to a qualified tax advisor such as an attorney or CPA.

©2005 Benefits Insights, Inc. All rights reserved.

805 S. Wheatley, Suite 600, Ridgeland, MS 39157, PH 866-651-4222, FAX 601-914-2329, EMAIL support@dyatech.com