**Chapter 9**

**Other Qualified Defined Contribution Plans**

**Q. 9.01: What is a SIMPLE IRA?**

A SIMPLE IRA is established under Code Section 408(p) and technically is not a qualified plan, but a type of individual retirement account (IRA). Eligibility to sponsor a SIMPLE IRA is limited to an employer with no more than 100 employees who received at least $5,000 of compensation from the employer in the preceding year. If an employer adopts a SIMPLE IRA and in a subsequent year cannot satisfy the 100-employee rule (i.e., the employer has more than 100 employees), under some circumstances, a two-year grace period is provided, allowing the employer to continue the SIMPLE IRA for two years.[[1]](#footnote-1) For purposes of the 100-employee limitation, all employees employed at any time during the calendar year are taken into account, regardless of whether they are eligible to participate in the SIMPLE IRA plan.[[2]](#footnote-2)

The term “employer” includes all employers of a controlled group under Code Sections 414(b), 414(c), and 414(m)(4)(B).[[3]](#footnote-3) For example, two companies (even in different industries) owned by the same person must be aggregated in determining whether the 100-employee requirement is satisfied.

An employer that adopts a SIMPLE IRA may not maintain any other “qualified plan” for which contributions are made or benefits accrued (defined benefit plan) beginning or ending in the year the SIMPLE plan is maintained.[[4]](#footnote-4)

**Practice Point: *.***A newly established SIMPLE IRA may be adopted effective on any date between January 1 and October 1 if the employer did not sponsor a SIMPLE plan previously. A newly formed employer may establish the plan as soon as administratively feasible after coming into existence. The employer may use Form 5305-SIMPLE to adopt the plan with a “designated financial institution” or Form 5304-SIMPLE to adopt the plan if each employee selects his or her own financial institution. Neither of these forms have to be filed with the IRS.

**Example1** An adopting employer sponsors a profit sharing plan that is maintained on the same fiscal year as the employer’s tax year, July 1 to June 30. If the employer makes any contribution to the plan for the plan year beginning July 1, 2013, and ending June 30, 2014, that same employer may not adopt a SIMPLE IRA for calendar year 2013 or calendar year 2014 (all SIMPLE plans are maintained on a calendar year).

The term “qualified plan” refers to any qualified retirement plan (under Code Section 401(a)), qualified annuity plan, governmental plan, tax-sheltered annuity, or simplified employee pension plan.[[5]](#footnote-5)

**Q. 9.02: Who are eligible employees for purposes of a SIMPLE IRA?**

Employees of an eligible employer are eligible to make elective deferrals in a SIMPLE IRA if they:[[6]](#footnote-6)

1. received at least $5,000 in compensation from the employer during any two preceding years, and
2. are reasonably expected to receive at least $5,000 in compensation during the current year.

**Practice Point:** It is important to note that employee eligibility for a SIMPLE IRA does not allow for a minimum service requirement or a minimum age, e.g., 1,000 hours of service and age twenty-one*.*

An employer may impose less restrictive eligibility requirements by eliminating or reducing the prior-year compensation requirements, current-year compensation requirements, or both. For example, an employer can allow participation for employees who received $3,500 in compensation during any preceding calendar year or for all employees regardless of compensation.

**Q. 9.03: What notice requirements apply to a SIMPLE IRA?**

The employer must notify each eligible employee of his or her option to make a deferral election or to modify an existing election. Notification must occur sixty days before the beginning of the plan year, or sixty days before the first day the employee is eligible if the effective date of the plan is not the first day of the plan year (plan adopted during the year). During the sixty-day election period, employees have the right to modify their salary reduction agreements without restrictions. This notice must include the summary description provided by the trustee of the employee’s SIMPLE IRA account (see Q 9.05).[[7]](#footnote-7)

As in the case of qualified plans, union employees and nonresident aliens may be excluded from participation in the SIMPLE IRA; however, it appears that union employees must be counted as employees of the employer for purposes of the 100-employee requirement.[[8]](#footnote-8) This has the effect of preventing an employer from adopting a SIMPLE IRA for its nonunion employees if the total of union and nonunion employees is more than 100, even though there are fewer than 100 nonunion employees.

SIMPLE plans eliminate the need to satisfy the nondiscrimination tests common to 401(k) plans, the ADP and ACP tests (see Chapter 6). SIMPLE plans also do not have to satisfy minimum contributions if the plan is top-heavy (see Chapter 5).[[9]](#footnote-9) In exchange for the reduced testing and elimination of top-heavy rules, the amount that can be deferred pre-tax by each employee is limited to $12,000 for 2014[[10]](#footnote-10) and thereafter adjusted in $500 increments for the cost of living, compared to the $17,500 (for 2014) that can be deferred to a traditional or safe harbor 401(k).

**Practice Point:** An employee who participates in a SIMPLE IRA is considered an active participant subject to the limitations on deductions to IRA accounts.[[11]](#footnote-11)

**Q. 9.04: What employer contributions may be made to a SIMPLE IRA?**

The employer may not make any contributions to the plan other than those that are specifically allowed. The Small Business Job Protection Act (SBJPA) provides for two types of employer contributions—a matching contribution and a nonelective contribution—both of which must be immediately vested.

The matching contribution is equal to 100 percent of the employee’s deferral up to 3 percent of compensation.[[12]](#footnote-12) One of the advantages of the SIMPLE IRA compared to the SIMPLE 401(k) is the ability to reduce the matching contribution in any two of the five years ending in the current year. The reduced match cannot be any lower than 100 percent of the employee’s deferral, up to 1 percent of compensation.[[13]](#footnote-13)

**Practice Point:** The employer, for the first two plan years, can reduce the match to 1 percent. For a new plan that has not been in effect for five years, it is assumed that prior years’ match was 3 percent.

As an alternative, the employer may make a nonelective contribution of 2 percent of compensation to all employees who are eligible to participate and have compensation of at least $5,000 for the year.[[14]](#footnote-14) Whichever employer contribution is chosen, the employer must notify the employee within a reasonable period before the sixty-day election period. This notice is also required if the employer elects to make a reduced match for any year.

In a case in which an employee does not make an elective deferral and the employer is making a nonelective contribution rather than a matching contribution, it is possible that the employee will not choose a financial institution in which to open his or her account in a timely manner. For that eligible employee, the employer may execute the necessary documents to establish a SIMPLE IRA on the employee’s behalf with a financial institution selected by the employer.[[15]](#footnote-15)

An interesting variation in the application of these two types of employer contributions allows the matching contribution to be based on total compensation while the elective employer contribution of 2 percent is applied to compensation as limited by Code Section 401(a)(17) (i.e., $260,000 for the year 2014).[[16]](#footnote-16) Table 9-1 illustrates the result of this quirk in a small business. In all cases, the matching contribution is 100 percent of the employee’s deferrals, up to 3 percent of compensation.

**Table 9-1**

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
|  | **Salary** |  **Deferral** | **Traditional401(k)** | **SIMPLEIRA** | **SIMPLE401(k)** |
| **Matching contribution** | $275,000 | $12,000 | $ 7,800  | $ 8,250 | $ 7,800  |
| **Employer elective contribution** | $275,000 | $12,000 | $ 5,200 | $ 5,200 |  $ 5,200 |

Because there is no limit on compensation, the match in the SIMPLE IRA is higher. Remember the match is made “. . . in an amount equal to so much of the amount the employee elects under clause (i)(I) [the amount of the elective deferral] as does not exceed the applicable percentage [3 percent] of compensation for the year”.[[17]](#footnote-17)

In the SIMPLE IRA, the deferral is $12,000, so the match is $8,250 because it is no more than 3 percent of the employee’s compensation of $275,000 and no more than 100 percent of the employee’s deferral. In the other types of 401(k) plans, compensation that may be taken into account is limited to $260,000; the 3 percent, the applicable percentage, is applied to the compensation as limited. The elective employer contribution must, however, be based on compensation up to $260,000 (for the year 2014).

Suppose the SIMPLE IRA contribution is compared to the maximum deferral in a traditional 401(k):

**Table 9-2**

|  |  |  |  |
| --- | --- | --- | --- |
|  |  |  **SIMPLE IRA** | **Traditional 401(k)** |
|  | **Salary** | **Deferral\*** | **Match** | **Deferral\*** | **Match** |
| **Owner** | $275,000 | $ 12,000 | $  8,250 | $17,500 | $ 7,800  |
| **Spouse** | $   8,000 | $ 8,000 | $    240 | $  7,760 | $   240 |
| **Total contribution:** |  |  | **$28,490** |  | **$33,300**  |
| \*Although the maximum deferral by statute is 100 percent, as a practical matter, sufficient funds must be retained as compensation to pay applicable payroll taxes, e.g., FICA. In addition the Code Section 415 limit of the lesser of 100 percent of compensation or $52,000 (for 2014) limits the deferral for the spouse in the traditional 401(k) plan. |

The SIMPLE IRA total contribution for the owner is lower than the traditional 401(k) contribution by $5,050. However, the SIMPLE IRA is less costly to establish because it does not require a plan document but only the appropriate IRS forms to adopt. On the other hand, the traditional 401(k) is also a profit sharing plan that would allow for additional profit sharing contributions. In this case, a deductible profit sharing contribution could be made in the traditional 401(k) plan of up to $26,700 ($52,000 – $17,500 – $7,800). A profit sharing contribution cannot be made for the spouse because the annual additions limit is at the maximum, i.e., the lesser of 100 percent of compensation or $52,000, with the deferral and match) whereas the SIMPLE IRA is limited to the deferrals and match only.[[18]](#footnote-18)

**Practice Point:** Even though the limit on deductible contributions in a profit sharing plan is 25 percent of compensation, which in this case would be $67,000 [($260,000 + $8,000) x 0.25] plus deferrals, the annual additions limit for each participant is the lesser of 100 percent of compensation or $52,000, which includes employee deferrals and all employer contributions, resulting in a limit on the profit sharing contribution of $26,700.

**Q. 9.05: How is a SIMPLE IRA administered?**

Because a SIMPLE IRA is not a qualified plan under Code Section 401(a), separate administrative requirements govern the operation of the plan. The first set of guidelines applies to the employer, who must:

1. Make the elective salary deferral contributions not later than thirty days following the last day of the month in which the deferrals were made.[[19]](#footnote-19) The US Department of Labor (DOL) has indicated that, under SIMPLE IRA plans, salary reduction contributions must be made to the SIMPLE IRAs as of the earliest date on which the contributions can reasonably be segregated from the employer’s general assets, but in no event later than the thirty-day deadline.
2. Make the matching contribution or the nonelective employer contribution not later than the time required to file the employer’s tax return for the year, including extensions.[[20]](#footnote-20)
3. Allow an employee to terminate withholding of salary deferrals at any time during the year. If terminated, the employer may prohibit the employee from reactivating his or her deferrals until the beginning of the following plan year.[[21]](#footnote-21)
4. Allow each eligible employee to elect to participate in or modify his or her election during the sixty-day period before the beginning of the plan year or before the first day the employee is eligible to participate.[[22]](#footnote-22)

A SIMPLE IRA is not required to file Form 5500, Annual Return/Report of Employee Benefit Plan, as are plans qualified under Code Section 401(a). In addition, the employer is not subject to fiduciary liability resulting from the employee exercising control over the assets in the SIMPLE account. The employee will be treated as exercising control over the assets in his or her account at the earlier of:

1. an affirmative election with respect to the initial investment of any contributions,
2. a rollover contribution to another SIMPLE account or IRA; or
3. one year after the SIMPLE account is established.[[23]](#footnote-23)

Regarding the SIMPLE IRA accounts, the sixty-day election notice must also disclose the employee’s ability to select the financial institution that will serve as the trustee for the employee’s SIMPLE IRA account.[[24]](#footnote-24) If several employees are participating and each chooses a different trustee, a separate check must be sent to each trustee for that employee’s deferrals. This could create quite an administrative cost and burden for the employer. To avoid this problem, the employer may require that all contributions be made to a specific financial institution, a “designated financial institution.”[[25]](#footnote-25) To qualify, the financial institution must:

1. Agree that if a participant requests, his or her contribution must be transferred without cost or penalty to another SIMPLE IRA account at a different financial institution of his or her choice, and
2. Provide each participant with written notification describing the procedure under which that transfer will be executed.[[26]](#footnote-26)

**Practice Point**: Certain financial institution products, such as front- or back-loaded mutual funds, variable or fixed annuities with surrender charges, and certificates of deposits with surrender penalties, may not be eligible for use as SIMPLE IRA accounts. Check with the financial institution to determine whether it has the appropriate products that satisfy this requirement.

To avoid open-ended employee transfer of accounts, the employer can limit the time available for these transfers to the sixty-day election period before the plan year.[[27]](#footnote-27)

In addition to employer reporting and compliance guidelines, the trustee of the SIMPLE IRA account (usually the financial institution holding the account) must provide the employer with a “summary description,” which includes the following:[[28]](#footnote-28)

1. the name and address of the employer and trustee,
2. the requirements for eligibility in the SIMPLE IRA,
3. the benefits provided with respect to the plan,
4. the time and method of making elections to participate, and
5. the procedures for, and effects of, withdrawals from the plan.

In addition, the trustee is required to report information with respect to the minimum amount required to be distributed (the required minimum distribution or RMD, see Chapter 15) from the IRA for each calendar year to individuals as well as the applicable federal tax forms and accompanying instructions.

The trustee of a SIMPLE IRA must provide the summary description to the employer early enough to allow the employer to meet its notification obligation to employees. If the employer fails to provide the notice to employees of their opportunity to participate in or modify the amount of their deferrals, or if the trustee fails to provide reports as indicated previously to the IRS (by January 31 for the prior year), statements of closing balances and account activity to participants (within thirty days after the end of the calendar year),[[29]](#footnote-29) or the summary description to the employer, the defaulting party, the trustee, is subject to a $50 per day penalty for each of the notices that has not been provided.[[30]](#footnote-30)

**Q. 9.06: What special rules apply to distributions from a SIMPLE IRA?**

Distributions from SIMPLE IRAs may be rolled over to another SIMPLE IRA[[31]](#footnote-31) at any time or to an individual IRA after a two-year period has expired from the date of the employee’s initial participation.[[32]](#footnote-32) During the first two years of participation in the SIMPLE IRA, early withdrawals are subject to a 25 percent penalty rather than the normal 10 percent penalty.[[33]](#footnote-33)

A SIMPLE IRA can be converted to a Roth IRA on the same terms as the conversion of a traditional IRA, with the following exception. Because an amount distributed from a SIMPLE IRA during the two-year period that begins on the date the individual first participated in any SIMPLE IRA is subject to further restrictions on distributions, the SIMPLE IRA cannot be converted to a Roth IRA during that two-year period.[[34]](#footnote-34)

Notwithstanding the penalties on early distributions, one of the disadvantages of a SIMPLE IRA is that amounts held in the plan may be withdrawn by the employee at any time. The employer cannot require an employee to retain any portion of the contributions in his or her SIMPLE IRA account, or otherwise impose any withdrawal restrictions. This tends to defeat the purpose of an employer-sponsored retirement plan, i.e., to accumulate funds for retirement and to retain employees.

**Q. 9.07: What is a SEP IRA?**

A SEP is intended as an alternative to qualified plans, particularly for small businesses. Other than the maximum limits on the amount of contributions, all the IRA rules apply to SEPs because a SEP is an IRA established and maintained by the employee to which an employer contributes.

The ease of administering these plans and the complete discretion given to the employer in deciding whether to make an annual contribution are features that are especially attractive. An employer may deduct contributions paid to a SEP in an amount not in excess of 25 percent of the compensation paid to employees during the calendar year ending with or within the tax year (this is the same deduction basis as for profit sharing plans) . In applying the 25 percent ceiling on the employer’s deduction for SEP contributions, the annual compensation of each employee that is taken into account under the plan for any year can be no more than $260,000 for the year 2014.

**Q. 9.08: Which employees are eligible to participate in a SEP IRA?**

Participation requirements for SEPs differ from qualified plans discussed in Chapter 2. Eligibility requirements to participate in a SEP are limited to an employee who has attained age twenty-one, has performed service for the employer during at least three of the immediately preceding five years, and has received at least $550 in compensation from the employer for the year. The plan may exclude union employees and nonresident aliens. In addition, contributions may not discriminate in favor of highly compensated employees. The ability to require one year of service and full-time employment, i.e., 1,000 hours annually, does not apply to SEPs, making it necessary to include both full-time and part-time employees.

Many small employers that sponsor a SEP do not apply the eligibility rules correctly. Consider this example.

**Example** *Dr. Jonathan Jones began his private practice on January 1, 2014. At the same time, he adopted a SEP plan with his broker, signed the necessary IRS forms, and made a contribution for that year. On July 15, 2014, he hired a receptionist. He told the receptionist that she would be eligible to participate in his SEP in 2017, the third anniversary of her date of hire. This is not consistent with the requirements that the plan treat all employees the same. If Dr. Jones participated immediately, his employees must also participate immediately, requiring a contribution for his receptionist in 2014.*

**Q. 9.09: How is a SEP established?**

A SEP is established by the employer completing IRS Form 5305-SEP, which sets forth eligibility requirements. The instructions to this form state, “This agreement is considered adopted when:

* IRAs have been established for all your eligible employees;
* You have completed all blanks on the agreement form without modification; and
* You have given all your eligible employees the following information:
1. A copy of Form 5305-SEP
2. A statement that traditional IRAs other than the traditional IRAs into which employer SEP contributions will be made may provide different rates of return and different terms concerning, among other things, transfers and withdrawals of funds from the IRAs.
3. A statement that, in addition to the information provided to an employee at the time the employee becomes eligible to participate, the administrator of the SEP must furnish each participant, within 30 days of the effective date of any amendment to the SEP, a copy of the amendment and a written explanation of its effects.
4. A statement that the administrator will give written notification to each participant of any employer contributions made under the SEP to that participant’s IRA by the later of January 31 of the year following the year for which a contribution is made or 30 days after the contribution is made.

Form 5305-SEP also sets forth the required disclosure to be made by the financial institution holding the funds. This disclosure must be made in plain, nontechnical language including an annual statement allowing the participants to evaluate the performance of their accounts.

**Q. 9.10: What rules apply to contributions to a SEP?**

Contributions made by the employer to SEPs must bear a uniform relationship to total compensation, i.e., the same percentage for each employee. Social Security integration, also referred to as permitted disparity, may also be used in allocating the contribution (see Chapter 7).

Because a SEP is really an employee IRA that the employer contributes to, the employee *must* have the right to withdraw funds from the SEP account at his discretion. This means that all contributions made by the employer are immediately vested rather than vested over several years as in a qualified planand may be withdrawn by the employee at any time. This is certainly not an incentive to retain employees.

**Q. 9.10: What are the advantages and disadvantages of a SEP?**

The advantage of a SEP is simplicity. There is no plan document required—only a one-page IRS form. There are no annual filings required (compared to qualified plans that require an annual Form 5500) and there are no administrative fees because there is no administration.

Another advantage of a SEP is that it may be established as late as the due date for filing the employer’s tax return, including extensions. Other qualified plans must be established by the last day of the employer’s taxable year.

The disadvantage is the liberal eligibility and immediate vesting. If the plan satisfies the needs of the plan sponsor (see Chapter 1), then the advantages outweigh the disadvantages.

**Q. 9.10: What is a SAR-SEP?**

A Salary Reduction SEP (SAR-SEP) is a SEP that is offered on a salary reduction basis.[[35]](#footnote-35) Prior to 401(k)s, these plans were seen as a valuable benefit for employees of small employers. Only employers with 25 or fewer employees could offer a SAR-SEP.[[36]](#footnote-36) SAR-SEPs were replaced by SIMPLE IRAs under the Small Business Job Protection Act of 1996. After 1996, existing SAR-SEPs were allowed to continue, but no new plans could be created.

The amount an employee elects to defer under a SAR-SEP is considered an elective deferral and subject to the $52,000 limit (in 2014). Similarly, a SAR-SEP can provide for catch-up contributions up to $5,500 (in 2014) for employees age fifty or older.[[37]](#footnote-37)

In order to defer salary into a SAR-SEP, at least 50 percent of the employees eligible to participate have to elect to contribute to the SEP and the deferral percentage for highly compensated employees is limited to 125 percent of nonhighly compensated employees.[[38]](#footnote-38)

Employer contributions and employee elective deferrals together cannot exceed the lesser of 25 percent of compensation or $52,000 (in 2014).

1. IRC Sec. 408(p)(2)(C)(i). [↑](#footnote-ref-1)
2. Notice 98-4, 1998-1 C.B. 269. [↑](#footnote-ref-2)
3. See Chapter 2 for a discussion of controlled groups and affiliated service groups. [↑](#footnote-ref-3)
4. IRC Sec. 408(p)(2)(D)(i). [↑](#footnote-ref-4)
5. IRC Sec. 408(p)(2)(D)(ii). [↑](#footnote-ref-5)
6. IRC Sec. 408(p)(4)(A). [↑](#footnote-ref-6)
7. IRC Sec. 408(p)(5)(C), IRC Sec.408(l)(2)(C). [↑](#footnote-ref-7)
8. IRC Sec. 408(p)(4)(B). [↑](#footnote-ref-8)
9. Small Business Job Protection Act (SBJPA), Committee Report; SBJPA Sec. 1421(b)(7). [↑](#footnote-ref-9)
10. IRC Sec. 408(p)(2)(A)(ii). [↑](#footnote-ref-10)
11. IRC Sec. 219(g)(5)(A)(vi). [↑](#footnote-ref-11)
12. IRC Sec. 408(p)(2)(A)(iii), IRC Sec. 408(p)(2)(C)(ii). [↑](#footnote-ref-12)
13. IRC Sec. 408(p)(2)(C)(ii). [↑](#footnote-ref-13)
14. IRC Sec. 408(p)(2)(B)(i). [↑](#footnote-ref-14)
15. Notice 98-4, 1998-1 C.B. 269. [↑](#footnote-ref-15)
16. SBJPA Committee Report. [↑](#footnote-ref-16)
17. IRC Sec. 408(p)(2)(A)(iii); notes in [ ] added. [↑](#footnote-ref-17)
18. IRC Sec. 408(p)(5)(A)(i). [↑](#footnote-ref-18)
19. IRC Sec. 408(p)(5)(A)(ii), IRC Sec. 404(m)(2)(B). [↑](#footnote-ref-19)
20. IRC Sec. 408(p)(5)(B). [↑](#footnote-ref-20)
21. IRC Sec. 408(p)(5)(C). [↑](#footnote-ref-21)
22. SBJPA Committee Report. [↑](#footnote-ref-22)
23. Notice 97-6, Q & A G-1, 1997-2 I.R.B. 26. [↑](#footnote-ref-23)
24. IRC Sec.408(p)(7); Notice 97-6, Q&A J-1 and J-2, 1997-2 I.R.B. 26. [↑](#footnote-ref-24)
25. Notice 97-6, Q&A J-4, 1997-2 I.R.B. 26. [↑](#footnote-ref-25)
26. Notice 97-6, Q&A J-2, 1997-2 I.R.B. 26. [↑](#footnote-ref-26)
27. IRC Sec. 408(l)(2)(B). [↑](#footnote-ref-27)
28. IRC Sec. 408(i). [↑](#footnote-ref-28)
29. IRC Sec. 6693(c)(1), IRC Sec.6693(c)(2)(A), IRC Sec.6693(c)(2)(B), and IRC Sec.6693(c)(3). [↑](#footnote-ref-29)
30. IRC Sec. 408(d)(3)(G)(i). [↑](#footnote-ref-30)
31. IRC Sec. 408(d)(3)(G)(ii). [↑](#footnote-ref-31)
32. IRC Sec. 72(t)(6). [↑](#footnote-ref-32)
33. Treas. Reg. §1.408(A)-4, Q & A 4(b). [↑](#footnote-ref-33)
34. IRC Sec. 408(p). [↑](#footnote-ref-34)
35. IRC Sec. 408(k)(6). [↑](#footnote-ref-35)
36. IRC Sec. 408(k)(6)(B). [↑](#footnote-ref-36)
37. IRC Sec. 402(g)(1). [↑](#footnote-ref-37)
38. IRC Sec. 408(6)(a)(iii). [↑](#footnote-ref-38)