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The SIMPLE IRA

The SIMPLE IRA is a low-cost retirement plan suited for small employers who want to help their employees plan for retirement through shared contributions.

A savings incentive match plan for employees (SIMPLE) IRA is an IRA-based plan that gives small employers an easy way to make contributions toward their employees' retirement by either matching employees' contributions or making non-elective contributions to all employees. The startup and maintenance costs are very low compared to qualified plans. Business entities, including self-employed persons, partnerships and corporations, as well as certain tax-exempt organizations, can establish SIMPLE IRA plans for their employees.

HOW THE SIMPLE IRA WORKS

The SIMPLE IRA allows an employer to help employees to accumulate assets for their retirements. The plan is funded jointly by employees' elective salary deferral contributions and employer contributions. Both employee and employer SIMPLE IRA contributions are tax deductible and, because the contributions are made to an IRA, the earnings inside the account are tax deferred until withdrawal.

Each employee can specify the percentage of pay he or she wants the employer to withhold and contribute to the plan, up to the employer's stated maximum. The maximum amount employees may defer in 2022 is limited to $14,000. Participants who are 50 and older may make additional "catch-up" contributions of up to $3,000.

The employer is required to make a fully vested contribution using one of the following formulas:

- Match elective deferrals dollar for dollar up to 3% of a participant's compensation (compensation includes employee deferrals)
- Make a 2% contribution to all eligible employees, regardless of elective salary deferral, who received $5,000 in compensation from the employer in that year.

SIMPLE IRA INVESTMENT FORMATS

There are two basic investment formats for the SIMPLE IRA – a self-directed IRA and a vendor's product. It is important for employers and employees to understand the advantages and disadvantages of each alternative before implementing or modifying their SIMPLE IRA plans.

Self-directed SIMPLE IRA

A self-directed IRA provides the flexibility to invest in almost the entire spectrum of investment alternatives, including individual stocks, bonds and independent money managers.

Vendor's product

This format provides only the investment options offered by mutual fund and insurance companies, within a SIMPLE IRA "package." While the flexibility may be limited in comparison to the self-directed IRA alternative, the investing process is typically much more streamlined, resulting in lower custodial and service-delivery costs to the participant. For participants investing small amounts on a periodic or payroll-deduction basis, a vendor's product is usually much less expensive and a more efficient way to invest.

ESTABLISHING A SIMPLE IRA

Setup and administration

To establish a SIMPLE IRA, the employer must sign an adoption agreement defining the plan provisions. All eligible participants then must complete and sign elective deferral agreements indicating the percentage of pay they wish to contribute. SIMPLE IRAs are then established to receive the contributions.

Employers should consider the following rules before establishing a SIMPLE IRA plan:

- An employer maintaining a SIMPLE IRA plan may not maintain any other qualified retirement plan from which employees currently receive benefits.
- An employer may not have more than 100 employees who received at least $5,000 in compensation from the employer in the preceding calendar year.
- The employer must allow employees to make deferral elections or modify previous elections within a 60-day period preceding an upcoming plan year. A plan year, for the purposes of a SIMPLE plan, is a calendar year.

Eligibility

Not all employees must be covered under a SIMPLE IRA plan. The employer may exclude any employees who have not earned at least $5,000 during any two preceding years and/or who are not expected to earn at least $5,000 in the current year.

Other considerations

Employees who participate in a SIMPLE plan are considered active participants for the purpose of determining the deductibility of a regular IRA contribution. An employee must elect to defer a specified percentage of compensation as opposed to a dollar amount.

Participants who take withdrawals from a SIMPLE plan prior to age 59 1/2 are generally subject to the same 10% early withdrawal penalty applicable to other IRA account holders. However, participants who withdraw SIMPLE plan contributions during the two-year period beginning on their initial participation date will be assessed a 25% penalty tax instead of the 10% tax.

TAKING THE NEXT STEP

Your advisor can help you determine if a SIMPLE IRA is appropriate for your business.

Investing involves risk and investors may incur a profit or a loss.

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