

SIMPLE IRA PLANS for Small Businesses



Simple IRA Plans for Small Businesses is a joint project of the U.S. Department of Labor's Employee Benefits Security Administration (EBSA) and the Internal Revenue Service.

This publication and other EBSA materials are available by calling toll-free:

1-866-444-EBSA (3272)

Or visit the agency's Web site at: **www.dol.gov/ebsa**

Simple IRA Plans for Small Businesses is also available from the Internal Revenue Service at:

1-800-TAX-FORM (1-800-829-3676)

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Thinking about a retirement plan? If it seems like the right thing for your business now, here's a SIMPLE one.

A SIMPLE (Savings Incentive Match Plan for Employees of Small Employers) IRA plan offers great advantages for businesses that meet two basic criteria. First, your business must have 100 or fewer employees (who earned \$5,000 or more during the preceding calendar year). In addition, you cannot currently have another retirement plan. If you are among the thousands of business owners eligible for a SIMPLE IRA plan, read on to learn more.

A SIMPLE IRA provides employers and their employees with a simplified way to contribute toward retirement. It reduces taxes and, at the same time, attracts and retains quality employees. And compared to other types of retirement plans, SIMPLE IRA plans offer lower start-up and annual costs ... they are just *simpler* to operate.

Other Advantages of a SIMPLE IRA Plan:

- SIMPLE IRA plans are easy to set up and run – your financial institution handles most of the details.
- Employees can contribute, on a tax-deferred basis, through convenient payroll deductions.
- You can choose either to match the employee contributions of those who decide to participate or to contribute a fixed percentage of all eligible employees' pay.
- You may be eligible for a tax credit of up to \$500 per year for each of the first 3 years for the cost of starting a SIMPLE IRA plan. (IRS Form 8881, *Credit for Small Employer Pension Plan Startup Costs*).
- Administrative costs are low.
- You are not required to file annual financial reports.

ESTABLISHING THE PLAN

Starting a SIMPLE IRA plan is easy to do!

Step 1: Contact a retirement plan professional or a representative of a financial institution that offers retirement plans. Many financial institutions will probably have a pre-approved SIMPLE IRA plan form that you can review.

Step 2: Choosing a financial institution to maintain employees' SIMPLE IRAs is one of the most important decisions you will make, since that entity becomes a trustee to the plan. (Alternatively, you can decide to let employees choose the financial institution that will receive their contributions.)

Regardless of who makes the choice, only the following institutions can be designated as trustees of SIMPLE IRA plans: banks, mutual funds, insurance companies that issue annuity contracts, and certain other financial institutions that have been approved by the IRS. Trustees agree to:

- Receive and invest contributions, and
- Provide the employer with a summary description of the plan features each year.

Step 3: Choose a model form or other plan document offered by your financial institution. If your financial institution offers a model SIMPLE IRA plan document, you will have a choice of two forms to use:

- IRS Form 5304-SIMPLE, *Savings Incentive Match Plan for Employees of Small Employers (SIMPLE) - Not for Use With a Designated Financial Institution*, or
- IRS Form 5305-SIMPLE, *Savings Incentive Match Plan for Employees of Small Employers (SIMPLE) for Use With a Designated Financial Institution*.

The model form you use will depend on whether you decide to select the financial institution that will receive contributions or to let your employees select financial institutions.

- If employees are allowed to select the financial institutions that will receive their SIMPLE IRA

plan contributions, you will fill out Form 5304-SIMPLE.

- If you require that all contributions under the SIMPLE IRA plan be initially deposited with a designated financial institution, you will fill out Form 5305-SIMPLE.

Your choice of the employees covered will be set out in your selected plan document. You can choose to cover all employees without restriction. Alternatively, you can limit the employees covered to those who received at least \$5,000 in compensation during any 2 years prior to the current calendar year and who are reasonably expected to receive at least \$5,000 during the current calendar year.

Step 4: Complete and sign the selected IRS form (or other plan document, if not using a model form). When it is completed and signed, this document becomes the plan's basic legal document, describing your employees' rights and benefits. Do not send it to the IRS; instead keep it handy.

OPERATING THE PLAN

A SIMPLE IRA plan is true to its name when it comes to plan operation. Contributions under the plan (employees' and yours) are simply deposited into individual retirement accounts or annuities.

Participants in a SIMPLE IRA Plan

Employees who elect to make contributions or to whose accounts you deposit contributions are participants. Your obligation is to provide information to your financial institution on those employees who can participate as described in your plan document. You will want to keep your financial institution aware of any changes in the status of those employees who can participate (for example, new employees).

Enrolling Employees in a SIMPLE IRA Plan

SIMPLE IRA plans operate on a calendar-year basis. An employer may initially set up a SIMPLE IRA plan as late as October 1.

A SIMPLE IRA must be set up for each employee eligible to participate. Employees must receive notice of their right to participate, to make salary reduction contributions, and to receive employer contributions. In addition, employees must receive information about the plan, including a copy of the summary description. The required notice also informs employees of the plan's election periods during which eligible employees can decide to contribute to the plan. For employers that use one of the model forms, page 3 of Form 5304-SIMPLE and page 3 of Form 5305-SIMPLE contain a model notice.

Employee Contributions

Employees can make salary reduction contributions in any amount to a SIMPLE IRA plan up to the legal limits. The maximum amount that an employee can contribute is \$9,000 in 2004, increasing to \$10,000 in 2005. (This amount may be subject to adjustments for years after 2005.) Additional employee contributions (known as catch-up contributions) are allowed for employees age 50 or over. The additional contribution limit is \$1,500 in 2004, \$2,000 in 2005, and \$2,500 in 2006. (This amount may be subject to adjustments for years after 2006.)

Each year employees can change their contribution levels during the plan's election period. This election period must be at least 60 days long, and employees must receive prior notice about an upcoming election opportunity. SIMPLE IRA plans that have already been established must have an annual election period that extends from November 2 to December 31. A plan can have more election periods each year in addition to this 60-day election period.

Employer Contributions

You have two choices in determining your contributions to the SIMPLE IRA plan:

- ❑ A 2 percent nonelective employer contribution, where employees eligible to participate receive an employer contribution equal to 2 percent of their compensation, regardless of whether they make their own contributions.
- ❑ A dollar-for-dollar match up to 3 percent of pay, where only the participating employees who have elected to make contributions will receive an employer contribution, i.e., the matching contribution.

Each year, you can choose which one you will use for the next year's contributions. This choice is part of the information you are required to

communicate to employees before the beginning of the 60-day election period.

Depositing and Investing Plan Contributions

Employee contributions must be deposited in the financial institution serving as trustee for the plan within 30 days after the end of the month in which the amounts would otherwise have been payable to the employee in cash. Your employer contributions must be made by the due date (including extensions) for filing your business's Federal income tax return for the year.

After forwarding the SIMPLE IRA plan contributions to the trustee, the trustee will invest the funds, in many cases at the direction of the

How Does a SIMPLE IRA Plan Work?

Example 1:

Elizabeth works for the Rockland Quarry Company, a small business with 50 employees. Rockland has decided to establish a SIMPLE IRA plan for all its employees and will match its employees' contributions dollar-for-dollar up to 3 percent of each employee's salary. Under this option, if a Rockland employee does not contribute to his or her SIMPLE IRA, then that employee does not receive any matching employer contributions from Rockland.

Elizabeth has a yearly salary of \$50,000 and decides to contribute 5 percent of her salary to her SIMPLE IRA. Elizabeth's yearly contribution is \$2,500 (5 percent of \$50,000). The Rockland matching contribution is \$1,500 (3 percent of \$50,000). Therefore, the total contribution to Elizabeth's SIMPLE IRA that year is \$4,000 (her \$2,500 contribution plus the \$1,500 contribution from Rockland). The financial institution partnering with Rockland on the SIMPLE IRA has several investment choices and Elizabeth is free to pick and choose which ones suit her best.

Example 2:

Austin works for the Skidmore Tire Company, a small business with 75 employees. Skidmore has decided to establish a SIMPLE IRA plan for all its employees and will make a 2 percent nonelective contribution for each of its employees. Under this option, even if an eligible Skidmore employee does not contribute to his or her SIMPLE IRA, that employee would still receive an employer nonelective contribution to his or her SIMPLE IRA equal to 2 percent of salary.

Austin has a yearly salary of \$40,000 and has decided that this year he simply cannot make a contribution to his SIMPLE IRA. Even though Austin does not make a contribution this year, Skidmore must make a nonelective contribution of \$800 (2 percent of \$40,000). The financial institution partnering with Skidmore on the SIMPLE IRA has several investment choices, and Austin has the same investment options as the other plan participants.

participants. SIMPLE IRAs can be invested in stocks, bonds, mutual funds, and similar types of investments. Employee and employer contributions are always 100 percent vested—that is, the money an employee has put aside plus employer contributions and earnings from investments cannot be forfeited. Employees can move their SIMPLE IRA assets from one SIMPLE IRA plan to another in accordance with the procedures of the financial institution.

Communicating With Employees

There are two key disclosure documents that keep participants informed about the basics of how the plan operates, inform them of changes in the plan's structure and operation, and provide them a chance to make decisions and take timely action with respect to their accounts.

The **summary description** is a plain-language explanation of the plan and is comprehensive enough to inform participants of their rights and responsibilities under the plan. It also informs participants about the features of the plan. This document is usually provided by the financial institution and is given to participants at the plan's inception, when employees first join the plan, and annually thereafter.

A summary description must include:

1. The names and addresses of the employer and trustee,
2. A description of the requirements for eligibility to participate,
3. The benefits provided,
4. The time and method of making salary elections, and
5. The procedure for, and effects of, withdrawals and rollovers (including the penalties for early withdrawals).

Employers can satisfy the summary description requirement by providing employees with the most recent copy of IRS Form 5304-SIMPLE or 5305-SIMPLE provided by the Financial Institution (if one of these model forms is used to establish the

SIMPLE IRA plan), along with the financial institution's procedures for withdrawals and transfers.

Each year, in addition to the information above, employees must receive **an annual election notice** describing their right to make salary reduction contributions and the employer's decision to make either matching or nonelective contributions for the following year. For employers that use one of the model forms, page 3 of Form 5304-SIMPLE and page 3 of Form 5305-SIMPLE contain a *Model Notification to Eligible Employees* that can be used to provide this information to employees.

Every year, during the 60-day election period at the end of the year, employees must be given the opportunity to enter into a salary reduction agreement or to modify an existing agreement.

Reporting to the Government

SIMPLE IRA plans are NOT required to file annual financial reports with the government.

Distributions from the plan are reported by the financial institution making the distribution to both the IRS and the recipients of the distributions on Form 1099-R, *Distributions from Pensions, Annuities, Retirement or Profit-Sharing Plans, IRA, Insurance Contracts*.

The financial institution/trustee handling the SIMPLE IRAs provides the IRS and participants with an annual statement containing contribution and fair market value information on Form 5498, *Individual Retirement Arrangement Contribution Information*.

SIMPLE IRA contributions are not included in the "Wages, tips, other compensation" box of Form W-2, *Wage and Tax Statement*. However, salary reduction contributions must be included in the boxes for Social Security and Medicare wages.

When Employees Want to Stop Contributions

Employees may elect to terminate their salary reduction contributions to a SIMPLE IRA plan at any time. If they do so, the SIMPLE IRA plan may preclude them from resuming salary reduction contributions until the beginning of the next calendar year. Employers that are making nonelective employer contributions must continue to make them on behalf of these employees.

Distributions

Participants cannot take loans from their SIMPLE IRAs.

SIMPLE IRA contributions and earnings can be withdrawn at any time. When participants take a distribution, they typically can elect to:

- Take a lump sum distribution of their account, or
- Roll over their account to an IRA or another employer's retirement plan.

Distributions from a SIMPLE IRA are generally subject to income tax for the year in which they are received. If a participant takes a withdrawal from a SIMPLE IRA before age 59 1/2, generally a 10 percent additional tax applies. If such withdrawal occurs within 2 years of beginning participation, the 10 percent tax is increased to 25 percent.

SIMPLE IRA contributions and earnings may be rolled over tax-free from one SIMPLE IRA to another. A tax-free rollover may also be made from a SIMPLE IRA to another type of IRA, or to another employer's qualified plan, after 2 years of beginning participation in the original plan.

A specific minimum amount of SIMPLE IRA contributions and earnings is required to be distributed by April 1 of the year following the year the participant reaches age 70 1/2. After this initial year, the participant must receive a required minimum distribution for each year by December

31 of that year. (For further details regarding the required minimum distribution amount, see IRS Publication 590.)

Monitoring the Trustee

As the plan sponsor, you should monitor the trustee to assure that it is doing everything that it is required to do. You should also ensure that the trustee's fees are no more than reasonable for the services it is providing. If the trustee is not doing its job properly, or if its fees are not reasonable, you should consider replacing the trustee.

TERMINATING THE PLAN

Although SIMPLE IRA plans are established with the intention of being on-going, the time may come when a SIMPLE IRA plan no longer suits the purposes of your business. When that happens, consult with your financial institution to determine if another type of retirement plan might be a better alternative.

To terminate a SIMPLE IRA plan, notify the financial institution that you will not make a contribution for the next calendar year and that you want to terminate the contract or agreement. You must also notify your employees that the SIMPLE IRA plan will be discontinued.

You do not need to give any notice to the IRS that the SIMPLE IRA plan has been terminated.

MISTAKES ... AND HOW TO CORRECT THEM

Even with the best intentions, mistakes in plan operation can still happen. The U.S. Department of Labor and the IRS have correction programs to help SIMPLE IRA plan sponsors correct plan errors, protect participants, and keep the plan's tax benefits. These programs are structured to encourage you to correct the errors early.

Periodically reviewing the plan makes it easier to spot and correct mistakes in plan operation. See the *Resources* section for further information.

YOUR SIMPLE IRA PLAN — A QUICK REVIEW

- Choose a financial institution to set up your SIMPLE IRA plan.
- Enroll your employees and start salary reduction contributions.
- Deposit contributions timely.
- Tell your employees about their rights under the plan.
- Monitor your trustee.

RESOURCES

The U.S. Department of Labor's (DOL's) Employee Benefits Security Administration and the IRS feature this booklet and additional information on retirement plans on their Web sites:

www.dol.gov/ebsa - Click on "Compliance Assistance for Small Employers" and on "Publications/Reports" for information you and your employees can use.

www.irs.gov/ep - Click on "Retirement Source for Plan Sponsors/Employers." All the forms and publications mentioned in this booklet are available on this Web site.

The following jointly developed publications are available on the IRS and DOL Web sites and through the toll-free numbers listed below:

- Choosing a Retirement Solution for Your Small Business*, Publication 3998, provides an overview of retirement plans available to small businesses.
- Retirement Plan Correction Programs*, Publication 4224, provides a brief description of the IRS, DOL, and Pension Benefit Guaranty Corporation (PBGC) correction programs.

- Retirement Plan Correction Programs CD-ROM*, Publication 4050, provides in-depth information on the IRS, DOL, and PBGC correction programs.

Order from:

IRS: 1-800-TAX-FORM (1-800-829-3676)
DOL: 1-866-444-EBSA (3272)

Related materials available from DOL:

DOL sponsors two interactive Web sites - the Small Business Advisor, available on the DOL Web site, and, along with the U.S. Chamber of Commerce and the Small Business Administration, www.selectretirementplan.org.

Related materials available from the IRS:

- Publication 560, *Retirement Plans for Small Business (SEP, SIMPLE, and Qualified Plans)*
- Publication 590, *Individual Retirement Arrangements (IRAs)*

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