The "SIMPLE" Plan: A Retirement Plan for the Really Small Business

Several different types of retirement plan - 401(k), defined benefit, and profit-sharing - can be made to suit a prosperous small business or professional practice. But if yours is a really small business such as a home-based, start-up, or sideline business, maybe you should consider adopting a SIMPLE IRA plan.

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A SIMPLE IRA is a type of retirement plan specifically designed for small business and is an acronym for "Savings Incentive Match Plans for Employees." SIMPLE IRAs are intended to encourage small business employers to offer retirement coverage to their employees, but work just as well for self-employed persons without employees.

SIMPLE IRAs contemplate contributions in two steps: first by the employee out of salary, and then by the employer, as a "matching" contribution (which can be less than the employee contribution). Where SIMPLE Plans are used by self-employed persons without employees - as IRS expressly allows - the self-employed person is contributing both as employee and employer, with both contributions made from self-employment earnings. (One form of SIMPLE allows employer contributions without employee contributions. The ceiling on contributions in this case makes this SIMPLE option unattractive for self-employed individuals without employees.)

Note: If you establish a SIMPLE 401(k) Plan, you:

- Must have 100 or fewer employees.
- Cannot have any other retirement plans.
- Need to annually file a Form 5500.
- Employees must earn $5,000 a year.

A Quick list of pros and cons:

- Plan is not subject to the discrimination rules that everyday 401(k) plans are.
- Employees are fully vested in all contributions.
- Straightforward benefit formula allows for easy administration.
- Optional participant loans and hardship withdrawals add flexibility for employees.
- No other retirement plans can be maintained.
- Withdrawal and loan flexibility adds administrative burden for the employer.

How Much You Can Put in and Deduct

Those with relatively modest earnings will find that a SIMPLE lets them contribute (invest) and deduct more than other plans. With a SIMPLE, you can put in and deduct some or all of your self-employed business earnings. The limit on this "elective deferral" is $11,500 in 2012 (same as 2011). This limit is expected to be adjusted for inflation in future years.

If your earnings exceed that limit, you could make a modest further deductible contribution--specifically, your matching contribution as employer. Your employer contribution would be 3% of your self-employment earnings, up to a maximum of the elective deferral limit for the year. So employee and employer contributions for 2012 can't total more than $23,000 ($11,500 maximum employee elective deferral, plus a maximum $11,500 for the employer contribution.)

Catch up contributions. Owner-employees age 50 or over can make a further deductible "catch up" contribution as employee. This is $2,500 in 2012 (same as 2011).

Example: An owner-employee age 50 or over in 2012 with self-employment earnings of $40,000 could contribute and deduct $11,500 as employee plus a further $2,500 employee catch up contribution, plus $1,200 (3% of $40,000) employer match, or a total of $15,200.

Low-income owner-employees in SIMPLE IRAs may also be allowed a tax credit up to $1,000 in 2012 (same as 2011). Income must not be more than $57,500 for married filing jointly, $28,750 for singles, and $43,125 for heads of household.

SIMPLE IRA plans are an excellent choice for home-based businesses and ideal for full-time employees or homemakers who make a modest income from a sideline business.

If living expenses are covered by your day job (or your spouse's job), you would be free to put all of your sideline earnings, up to the ceiling, into SIMPLE retirement investments.

Keogh plans could allow you to contribute more, often much more, than SIMPLE Plans. For example, if you are under 50 with $50,000 of self-employment earnings in 2012, you could contribute $11,500 as employee to your SIMPLE plus a further 3% of $50,000 as an employer contribution, for a total of $13,000. A Keogh 401(k) plan would allow a $29,500 contribution.

With $100,000 of earnings, it would be a total of $14,500 with a SIMPLE and $42,000 with a 401(k).

Withdrawal: Easy, but Taxable

There's no legal barrier to withdrawing amounts from your SIMPLE, whenever you please. There can be a tax cost, though: Besides regular income tax, the 10% penalty tax on early withdrawal (generally, withdrawal before age 59 1/2) rises to 25% on withdrawals in the first two years the SIMPLE IRA is in existence.

A Simple Plan

A SIMPLE IRA plan really is simpler to set up and operate than most other plans. Contributions go into an IRA you set up. Those familiar with IRA rules investment options, spousal rights, and creditors' rights don't have a lot new to learn.

Requirements for reporting to the IRS and other agencies are negligible, at least for you, the self-employed person. Your SIMPLE plan's trustee or custodian, typically an investment institution, has reporting duties and the process for figuring the deductible contribution is a bit simpler than with other plans.

What's Not So Good about SIMPLE Plans

We've seen that other plans can do better than SIMPLE once self-employment earnings become significant. Other not-so-good features:

Because investments are through an IRA, you're not in direct control. You must work through a financial or other institution acting as trustee or custodian, and will in practice have fewer investment options than if you were your own trustee, as you could be in a Keogh. For many self employed individuals however, this won't be an issue. In this respect, a SIMPLE IRA is like the SEP-IRA.

Other plans for self-employed persons allow a deduction for one year (say 2011) if the contribution is made the following year (2012) before the prior year's (2011) return is due (April 2012 or later extensions). This rule applies with SIMPLE IRAs, for the matching (3% of earnings) contribution you make as employer. But there's no IRS pronouncement on when the employee's portion of the SIMPLE is due where the only employee is the self-employed person. Those who want to delay contribution would argue that they have as long as it takes to compute self-employment earnings for 2011 (though not beyond the 2011 return due date, with extensions).

Tip: The sooner your money goes in the plan, the longer it's working for you tax-free. So delaying your contribution isn't the wisest financial move.

It won't work to set up the SIMPLE plan after a year ends and still get a deduction that year, as is allowed with SEPs. Generally, to make a SIMPLE plan effective for a year it must be set up by October 1 of that year. A later date is allowed where the business is started after October 1; here the SIMPLE must be set up as soon thereafter as administratively feasible.

There's this problem if the SIMPLE is for a sideline business and you're in a 401(k) in another business or as an employee: The total amount you can put into the SIMPLE and the 401(k) combined can't be more than $17,000 in 2012 ($16,500 in 2011)--$22,500 if catch up contributions are made to the 401(k) by one age 50 or over. So someone who is under age 50 who puts $8,000 in her 401(k) can't put more than $9,000 in her SIMPLE IRA in 2012. The same limit applies if you have a SIMPLE IRA while also contributing as an employee to a "403(b) annuity" (typically for government employees and teachers in public and private schools).

How to Get Started in a SIMPLE

You can set up a SIMPLE IRA on your own by using IRS Form 5304-SIMPLE or Form 5305-SIMPLE, but most people turn to financial institutions. SIMPLE IRAs are offered by the same financial institutions that offer IRAs and Keogh plans.

You can expect the institution to give you a plan document (approved by IRS or with approval pending) and an adoption agreement. In the adoption agreement you will choose an "effective date" - the beginning date for payments out of salary or business earnings. That date can't be later than October 1 of the year you adopt the plan, except for a business formed after October 1.

Another key document is the Salary Reduction Agreement, which briefly describes how money goes into your SIMPLE IRA. You need such an agreement even if you pay yourself business profits rather than salary.

Printed guidance on operating the SIMPLE IRA may also be provided. You will also be establishing a SIMPLE IRA account for yourself as participant.

Keoghs, SEPs and SIMPLE Plans Compared For 2012

Keogh	**SEP**	**SIMPLE**
Plan type: Can be defined benefit or defined contribution (profit-sharing or money purchase)	Defined contribution only	Defined contribution only
Owner may have two or more plans of different types, including a SEP, currently or in the past	Owner may have SEP and Keoghs	Generally, SIMPLE is the only current plan

Plan must be in existence by the end of the year for which contributions are made	Plan can be set up later--if by the due date (with extensions) of the return for the year contributions are made	Plan generally must be in existence by October 1st of the year for which contributions are made
Dollar contribution ceiling (for 2012): $50,000 for defined contribution plan; no specific ceiling for defined benefit plan	$50,000	$23,000
Percentage limit on contributions: 50% of earnings, for defined contribution plans(100% of earnings after contribution). Elective deferrals in 401(k) not subject to this limit. No percentage limit for defined benefit plan.	50% of earnings (100% of earnings after contribution). Elective deferrals in SEPs formed before 1997 not subject to this limit.	100% of earnings, up to $11,500 for 2012 for contributions as employee; 3% of earnings, up to $11,500 for contributions as employer
Deduction ceiling: For defined contribution, lesser of $50,000 or 20% of earnings (25% of earnings after contribution). 401(k) elective deferrals not subject to this limit. For defined benefit, net earnings.	Lesser of $50,000 or 20% of earnings (25% of earnings after contribution). Elective deferrals in SEPs formed before 1997 not subject to this limit.	Maximum contribution $11,500 (in 2012)
Catch up contribution 50 or over: Up to $5,500 in 2012 for 401(k)s	Same for SEPs formed before 1997	Half the limit for Keoghs, SEPs (up to $2,750 in 2012)
Prior years' service can count in computing contribution	No	No
Investments: Wide investment opportunities. Owner may directly control investments.	Somewhat narrower range of investments. Less direct control of investments.	Same as SEP
Withdrawals: Some limits on withdrawal before retirement age	No withdrawal limits	No withdrawal limits
Permitted withdrawals before age 59 1/2 may still face 10% penalty	Same as Keogh rule	Same as Keogh rule except penalty is 25% in SIMPLE Plan's first two years

Spouse's rights: Federal law grants spouse certain rights in owner's plan	No federal spousal rights	No federal spousal rights
Rollover allowed to another plan (Keogh or corporate), SEP or IRA, but not a SIMPLE.	Same as Keogh rule	Rollover after 2 years to another SIMPLE and to plans allowed under Keogh rule
Some reporting duties are imposed, depending on plan type and amount of plan assets	Few reporting duties	Negligible reporting duties