What is a SIMPLE Plan and what are its advantages?

A "SIMPLE" plan is a type of simplified retirement plan for small businesses. Because of its streamlined features, it is not subject to the complex qualification requirements associated with tax-qualified retirement plans. Administrative and legal costs therefore are minimized.

Other key advantages of SIMPLE plans from an employer's standpoint are that they are subject to simplified reporting requirements and that the employer will not be subject to fiduciary liability resulting from the employee or the employee's beneficiary exercising control over the assets in his or her SIMPLE account.

Who can adopt a Simple plan?

Your business is eligible to adopt a SIMPLE plan if it employs 100 or fewer employees who earned at least $5,000 in compensation for the preceding year and it does not maintain another employer-sponsored retirement plan. If your business is eligible to establish a SIMPLE plan but later becomes ineligible, your company will have a two-year grace period during which it may continue to maintain the plan.

How do SIMPLE plans work?

A SIMPLE plan allows employees to make elective contributions to an individual retirement account (IRA). Employee contributions must be based on a percentage of their compensation and cannot exceed a certain amount per year ($7,000 for 2002). As an employer, your business would have to satisfy one of two contribution formulas:

(1)Under the matching contribution formula, your company generally would be required to match employee contributions dollar-for-dollar up to 3% of each participating employee's compensation. A special rule allows you to elect a lower percentage matching contribution for all employees (but not less than 1% of each employee's compensation). You cannot, however, elect to use such a lower percentage for more than two out of any five years.

(2)Instead of making matching contributions, your company could elect to make a 2% contribution on behalf of each eligible employee who earns at least $5,000 in compensation for the year.
No more than $200,000 (as indexed for inflation) of an employee's compensation can be taken into account in any year under the plan's contribution formula.

No contributions other than employee elective contributions and required employer matching contributions (or, if option #2, above, is elected, required employer contributions) can be made to a SIMPLE plan.

Who is eligible to participate in a SIMPLE plan?

Generally, each of your employees who received at least $5,000 in compensation from your company during any two prior years and who is reasonably expected to receive at least $5,000 in compensation during the current year is eligible to participate in the SIMPLE plan. Self-employed individuals also can participate. All contributions to an employee's SIMPLE account must be fully vested.

How are contributions to a SIMPLE plan taxed?

As an employer, within limits, your contributions to an employee's SIMPLE account generally are deductible. Matching contributions are deductible in a given year only if they are made by the due date (including extensions) for your company's federal income tax return. Contributions to a SIMPLE account are excludible from employees' income and the assets of a SIMPLE account, like those of a qualified retirement plan, grow tax-free.

How are distributions from a SIMPLE plan taxed?

Distributions from a SIMPLE plan generally are taxed under the rules applicable to IRAs, and tax-free rollovers can be made from one SIMPLE account to another. A SIMPLE account can be rolled over to an IRA on a tax-free basis after a two-year period has expired since the individual first became a participant in the SIMPLE plan. If an employee is no longer participating in a SIMPLE plan (e.g., the employee has terminated employment) and two years have passed since the employee first participated in the SIMPLE plan, the employee's SIMPLE account is treated as an IRA.

Do early withdrawal penalties apply to SIMPLE plans?

Yes. Early withdrawals by an employee from his or her SIMPLE account generally are subject to the 10% early withdrawal penalty tax applicable to IRAs. However, if the withdrawals are made during the two-year period beginning on the date that the employee first became a participant in the SIMPLE plan, the penalty tax increases to 25%.

Are employer contributions to a SIMPLE Plan subject to employment taxes?

No. Neither employer matching nor nonelective contributions to a SIMPLE account are subject to employment taxes when made.

What rules apply to employees' elections to contribute to a SIMPLE plan?

An eligible employee can elect, within the 60-day period before the beginning of any year (or the 60-day period before first becoming eligible to participate), to participate in the employer's SIMPLE plan and to modify any previous elections regarding the amount of contributions. As an employer, you are required to contribute employees' elective deferrals to the employee's SIMPLE account within 30 days after the end of the month to which the contributions relate. Employees must be allowed to terminate participation in the plan at any time during the year. A SIMPLE plan can provide that an employee who terminates participation cannot resume participation until the following year. A SIMPLE

plan also can permit an individual to make other changes to his or her salary reduction contribution election during the year. Your company may designate a SIMPLE account trustee to which contributions on behalf of eligible employees are made.

Can SIMPLE plans operate in 401(k) plan form?

Yes. Generally, a §401(k) plan is considered to satisfy the special nondiscrimination tests applicable to employee deferrals and employer matching contributions if the plan satisfies the contribution requirements applicable to SIMPLE plans, including the safe harbors described above (except that the employer cannot reduce the matching percentage under the matching contribution option below 3%) and the annual contribution limit discussed above. For a §401(k) plan to qualify under the SIMPLE plan rules, the employer cannot maintain another qualified retirement plan for the year.