TriStar Pension Consulting

The Best Plan to Drive Your Retirement Needs

NEWSLETTER

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JUNE TOPICS

- Introduction
- Lease or Purchase:
  - Defined Benefit (DB) Plan
  - Defined Contribution (DC) Plan
- The Car Lot
- Compact for Full Size
- One-Car Garage
- Eligibility
- Employee Deferrals
- Matching Contributions
- Profit Sharing Contributions
- Vesting
- Loans & In-Service Withdrawals
- Plan Documents
- Annual Compliance Testing
- Government Reporting
- Conclusion

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INTRODUCTION

Excuse me, can you tell me what kind of car is best for me? It is impossible to answer that question without getting more information. How will the car be used? What is the budget? For fuel efficiency and driving in a crowded downtown area, maybe a Smart Car is best. Hauling heavy loads of construction materials? Perhaps a truck makes sense. Have kids that need to be shuttled from one activity to another? Maybe the less-stylish but ever-so-practical minivan is the perfect solution.

The same is true when selecting a retirement plan. Although there aren't as many makes and models, there are some significant variables, and the most appropriate option depends on some of the same factors. How will you use the plan and what is your budget?

LEASE OR PURCHASE?

There are two general categories of retirement plans: defined benefit and defined contribution. Unlike "crossover SUV," these names give a pretty good indication of the fundamental characteristics of each. Here is a quick summary.

Defined Benefit (DB) Plan

A DB plan specifies the benefits provided to each participant at retirement via a formula that considers items such as compensation and length of service such as 1% of average pay for each year of service. Each year, an actuary calculates the benefits due to each participant, determines how much money is needed to fund those benefits, and compares that amount to actual asset levels to arrive at how much the company must contribute. A DB plan is kind of like buying a car… you commit to making the payments over a period of years until your obligation is paid.

Defined Contribution (DC) Plan

A DC plan sets parameters for the amount that employees and the company contribute each year. Add investment gains or losses to determine the amount of retirement benefits each employee ultimately receives. Think of a DC plan as a series of one-year leases, in which the participants and the company decide each year (and sometimes more often than that) how much to contribute, and whatever is done in one year can be changed the next year.

DB plans allow for larger benefits ($200,000+ per year), but the fixed nature of the contributions makes them a bigger commitment. DC plans offer greater flexibility and discretion in determining annual contributions, but the maximum annual contribution is capped at the lower of $53,000 or 100% of pay per employee. Although it is not

uncommon for companies to sponsor both DB and DC plans, the remainder of this article will focus on DC plans.

THE CAR LOT

In addition to the well-known 401(k) plan, Congress created several other types of DC plans. The Simplified Employee Pension (SEP) and the Savings Incentive Match Plan for Employees (SIMPLE) are meant to be easy for small businesses to set up and maintain. The SIMPLE comes in two models—the SIMPLE IRA and the SIMPLE 401(k).

As with different types of vehicles, these different plan types are suited to different purposes. SEPs and SIMPLEs require minimal documentation, no annual testing and limited (if any) ongoing government filings; however, they also impose more limitations than other plans.

The 401(k) plan, which is really a profit sharing plan with the employee contribution package added, offers maximum flexibility. There is also the 403(b) plan for not-for-profit organizations, which is similar to a 401(k) plan but has its own nuances not addressed in this article.

Let's take a look at some of the specific differences, keeping in mind that these descriptions are meant to be general. There are exceptions to many of these general rules, but if they were all covered here you'd be reading for quite some time.

COMPACT OR FULL SIZE?

Employers of any size can implement SEPs and 401(k) plans; however, SIMPLE plans are only available for companies with 100 or fewer employees with at least $5,000 in compensation during the immediately preceding calendar year.

ONE-CAR GARAGE

A SIMPLE plan must be the only plan a company maintains in a given calendar year. This most often comes into play when a company decides to transition from a SIMPLE to a regular 401(k) plan. Such a transition can only occur at the beginning of a subsequent year, and employers must generally provide the employees with advance notification of the discontinuance of the SIMPLE. So if you are considering a transition, you generally need to get started no later than October 1st to prepare for the upcoming year.

There is no similar requirement that applies to other plan types, so employers can maintain multiple plans or transition from one type to another without concern for the "exclusive plan" requirement.

ELIGIBILITY

401(k) plans and SIMPLE 401(k) plans are allowed to have eligibility requirements as strict as attainment of age 21 and completion of one year of service (a 12-consecutive-month period in which an employee works at least 1,000 hours).

By contrast, neither SEPs nor SIMPLE IRAs can limit eligibility the same way. In a SIMPLE IRA, the maximum is to limit eligibility to those employees who earned at least $5,000 in compensation in the two prior years and are expected to again in the current year.

SEPs can limit plan coverage to those employees who have earned at least $600 in compensation in at least three of the last five years. There is no ability to exclude short service employees—interns, etc.—if they meet these requirements.

EMPLOYEE DEFERRALS

Salary deferrals are generally not allowed in SEPs. SIMPLEs and 401(k) plans allow deferrals but there are some critical differences. First, a 401(k) plan allows deferrals up to $24,000 per year ($18,000 plus an additional $6,000 for those age 50 or older). A SIMPLE caps deferrals at $15,500 ($12,500 plus $3,000)…a whopping $8,500 less.

For a business owner seeking to maximize his or her deferrals, the tax savings alone can more than offset any additional cost of having a regular 401(k) plan.

Another important difference is that SIMPLE plans do not allow Roth deferrals, which could limit the plan's utility as an estate planning tool.

MATCHING CONTRIBUTIONS

SIMPLE plans require a company contribution, which can be either a match or profit sharing contribution. For the match the required formula is 100% of the first 3% deferred, and no additional matching contributions are permitted.

A 401(k) plan can include a discretionary matching feature, allowing the company to decide each year whether to make a match and, if so, how much. Since SEPs do not allow deferrals, they also do not provide for matching contributions.

PROFIT SHARING CONTRIBUTIONS

The profit sharing version of the SIMPLE must be 2% of compensation for each eligible employee. No additional profit sharing contributions are permitted.

SEPs and 401(k) plans allow discretionary profit sharing contributions of up to 25% of pay in total. That discretion provides business owners with flexibility as to if/how much they wish to contribute.

With a SEP, each employee must receive a uniform contribution (as a percentage of pay). So, if the owner contributes 10% of pay for him or herself, each employee must also receive 10% of pay. In a 401(k) plan, there is much greater flexibility to provide larger contributions to those who earn more than the taxable wage base (referred to as Social Security integration) or target contributions based on job classification, e.g. owners and non-owners.

VESTING

A 401(k) plan can impose a vesting schedule of up to six years on employer contributions; however, both SIMPLEs and SEPs require employees to be immediately vested in all company contributions.

LOANS AND IN-SERVICE WITHDRAWALS

Neither SEPs nor SIMPLEs allow participant loans like 401(k) plans do. If a participant takes an in-service withdrawal from a 401(k) plan prior to age 59½, it is subject to regular income tax as well as a 10% early withdrawal penalty. SEP distributions are taxed similar to distributions from a regular IRA and those rules generally resemble the 401(k) rules. For a SIMPLE, however, if withdrawals are made within the first two years of participation, the 10% penalty is increased to 25%!

PLAN DOCUMENTS

All of these plans require some documentation of the provisions. For SEPs and SIMPLEs that truly keep it simple—little (if any) creativity in plan design, no related companies or complex ownership structures, etc.—the IRS has forms that are allegedly DIY: Form 5305-SEP; Form 5304-SIMPLE (each employee selects his or her own financial institution); and Form 5305-SIMPLE (the employer selects a single financial institution for all accounts).

A 401(k) plan (or a SEP/SIMPLE that cannot use the IRS form) must use a more traditional plan document which can follow an IRS pre-approved format, such as a prototype, or be individually customized. Some organizations offer DIY prototypes which may look straightforward on the surface; however, given the importance of the plan document, it is highly recommended that you work with someone with expertise in that area.

ANNUAL COMPLIANCE TESTING

SEPs and SIMPLE IRAs are not required to go through the battery of annual compliance tests. However, as we have described in this article, there are plenty of rules that must be monitored to ensure ongoing compliance. SIMPLE 401(k) plans are required to satisfy the minimum coverage test but are exempt from most of the other tests normally

associated with retirement plans. A traditional 401(k) plan must comply with a series of tests to ensure enough of the rank-and-file employees are receiving adequate benefits but, given the added flexibility of plan design, the testing can be a trade-off that is well worth it.

GOVERNMENT REPORTING

Similar to annual testing, neither the SEP nor the SIMPLE IRA is required to file a Form 5500 each year, whereas both the SIMPLE 401(k) and the "regular" 401(k) must do so. In addition, they must file Form 8955-SSA to report former employees with remaining balances in the plan.

CONCLUSION

Similar to Smart Cars, SUVs and luxury sedans, each type of plan suits different needs. SEPs and SIMPLEs can be extremely effective tools for meeting the retirement plan needs of small businesses that want to offer a plan but don't have the bandwidth to deal with details; however, those plans also offer less flexibility.

A 401(k) plan offers many more optional add-ons but comes with more involved maintenance. At the end of the day, it is important to first understand the goals for the plan and then select the option that fits best and can adapt with your business over time. Regardless of how simple or complex your needs, working with an experienced professional is invaluable to the decision-making process.

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