401(K) PLAN ADMINISTRATION

What's the difference between 401(k) and SIMPLE retirement plans?

NICOLLE WILLSON, J.D., CFP®, C(K)P® • 14.OCT.2019

There's no such thing as a one-size-fits-all approach to retirement. While 401(k) plans that permit both traditional pre-tax and Roth after-tax accounts have caught on as popular options for employers and employees alike, smaller businesses sometimes turn to alternative plans that require less upfront costs or upkeep.

Looking for a quick solution, some small business owners turn to SIMPLE IRA or SIMPLE 401(k) plans. While not as robust as more traditional plans, they come without some of the challenges sometimes associated with establishing and maintaining a regular 401(k) plan. Below, we'll dive into how the different plans compare—and how small businesses should approach choosing the right retirement plan.

Traditional and Roth 401(k) accounts

First, a primer on traditional and Roth offerings. When you think of employer-sponsored retirement benefits, chances are that traditional 401(k) plans come to mind. For 2020, these accounts allow employees to contribute up to $19,500 (or $26,000, if they're at least 50 years old anytime during 2020) on a pre-tax basis. Employees may also make contributions up to the same limit on a post-tax basis (either partly or entirely) if they enroll in a Roth account under the 401(k) plan.

These high contribution limits can be a big win for employees, especially when paired with a generous employer match and/or a profit-sharing contribution. To learn more about the differences between traditional and Roth 401(k) accounts, read our story here.

While offering a 401(k) plan is a great way for businesses to attract and retain talent, such plans require considerable attention in the plan design phase and regular annual upkeep thereafter.

Without a third-party administrator, managing Form 5500 compliance, record-keeping, benefit distribution, and reporting obligations may seem daunting for small businesses. Then, there's the whole matter of potential fiduciary liability. That's why many business owners turn to SIMPLE plans.

Hint: With Guideline as your 401(k) provider, we'll handle the heavy lifting. Our experts advise you on plan set up and take care of plan administration, record-keeping, Form 5500 reporting, and much more.

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SIMPLE IRAs

Simple abbreviation, long name. Savings Incentive Match Plan for Employees Individual Retirement Accounts, or SIMPLE IRAs. As its name suggests, these plans provide eligible employees with separate IRAs established in their names. These IRAs differ from the traditional IRA an individual might establish on his or her own. SIMPLE IRAs were designed exclusively to help small businesses with 100 or fewer employees.

SIMPLE IRAs are generally less expensive to administer than a SIMPLE 401(k) and regular 401(k) plan, making them attractive to companies who want to offer retirement benefits at a low price point. They also don't come with the compliance and reporting requirements associated with regular 401(k) plans. SIMPLE IRAs are not subject to Form 5500 reporting requirements, for example.

As is the case with traditional 401(k) plans, contributions are made on a pre-tax basis. Taxes are only due in the year that the employee receives a distribution from the account. If the employee has not attained age 59½ at the time of distribution, an additional 10 percent penalty is due. Like other retirement plans, employee contributions are capped. For 2020, employees can contribute up to $13,500 to a SIMPLE IRA.

Account holders who are 50 or older at anytime during 2020 may contribute an additional $3,000 "Catch-Up" contribution on top of that. Note that these limits are significantly lower than the regular 401(k) plan contribution limits for 2020 ($19,500 plus "Catch-Up" contribution of $6,500 for employees who are age 50 and over during 2020).

Here's another difference: SIMPLE IRAs *require* employers to contribute to eligible employees' accounts. These contributions can either take the form of a flat 2 percent of employee pay, regardless of whether or not the employee elects to contribute, or a dollar-for-dollar match of the eligible employees' contributions, up to 3 percent of salary. And unlike other matching arrangements, employees are always 100% fully vested in their own contributions and their employer contributions, meaning that they are entitled to keep the full amount contributed, no tenure requirements attached.

In return for this required contribution, the employer's plan does not undergo annual nondiscrimination testing, unlike a regular 401(k) plan.

And which employees are considered eligible for a SIMPLE IRA? All employees who are reasonably expected to receive at least $5,000 in compensation during the year and who received at least $5,000 in compensation from you in any of the 2 preceding years (not necessarily consecutive) must be eligible to participate.

SIMPLE 401(k)s

SIMPLE IRAs and SIMPLE 401(k) plans have a lot in common. Most of the same rules apply: Businesses need to be small to participate, contributions are made on a pre-tax basis, and reporting obligations are limited. Employee contribution limits are also the same.

But there are a few key differences to consider. For both the SIMPLE IRA and the SIMPLE 401(k), eligible employers must have no more than 100 employees who have received at least $5,000 in compensation from the employer for the previous year. However, a SIMPLE 401(k) plan may also make employees wait until they attained age 21 and completed one year of service before they are eligible to participate.

Additionally, while employers are still required to contribute a flat percentage to employee accounts (the same percentages apply), these amounts are capped. For 2020, only the first $285,000 of an employee's earnings can be considered when calculating the match. In other words, a SIMPLE 401(k) plan account holder with compensation in excess of the $285,000 limit couldn't receive a matching contribution of more than $8,550 (3 percent of $285,000) for 2020.

Switching to a regular 401(k) plan

In general, SIMPLE plans are meant for companies with 100 or fewer employees. But as your workforce grows, it becomes increasingly important to reconsider the pros and cons of switching to a regular 401(k) plan. The higher contribution limits and greater potential for employer matching are reasons that your employees will be just as eager to make the change.

First things first: You can't have a SIMPLE IRA and a 401(k) plan within the same year—meaning you can't switch to a new plan before the next January 1. It also means that you need to evaluate your plan design options well in advance of year-end.

Once you've decided to take the leap, you'll need to let employees know by November 2. You should also inform your payroll provider so it can cancel employee contributions to your soon-to-be defunct SIMPLE IRA going into the new year.

That's what you need to consider when switching off of a SIMPLE IRA. Switching from a SIMPLE 401(k) to traditional plan tends to be an easier proposition. Why? Think of your SIMPLE 401(k) as a traditional plan with a special provisions attached.

While you still can't switch until January, changing the plan to a regular 401(k) plan requires adopting an amendment on or before the last day of the current year and providing a restated summary plan description to all employees. Work with your retirement provider or financial advisor to make these adjustments.

While SIMPLE IRAs and SIMPLE 401(k) plans come with fewer compliance requirements than regular 401(k) plans, they are unlikely to meet the needs of a growing business for long. As you grow, it's time to reconsider your options—and offer employees and prospective hires a richer alternative.

Guideline makes it easy to offer great retirement benefits without the heavy lifting. Our experts take care of day-to-day plan administration and compliance testing. What's more, our technology makes completing those daunting Form 5500s a breeze.

Don't just take our word for it. To see how our technology makes administering retirement easy for employers and employees alike, schedule a demo with one of our 401(k) specialists.

The information provided herein is general in nature and is for informational purposes only. It should not be used as a substitute for specific tax advice that considers all relevant facts and circumstances. You are advised to consult a qualified tax professional before relying on the information provided herein.

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