



***FINANCIAL SERVICES FORUM 2003***

**Small Employer  
Tax Favored Plans**

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**Options Update**

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## FINANCIAL SERVICES FORUM 2003

### Small Employer Tax Favored Plan Options Update (Breakout Session – May 20, 2003)

#### I. Simple IRA – Internal Revenue Code ("Code") § 408(p)

##### A. Eligible Employer

- Private sector, tax-exempt organizations and governmental entities, including self-employed (sole proprietors, partnerships, etc.)
- Employ 100 or fewer employees who earn at least \$5,000 compensation in the prior calendar year – with 2-year grace period if number of employees exceeds 100

##### B. Eligible Employees

- Employee who has received at least \$5,000 of compensation from sponsoring employer in any 2 prior calendar years AND employee is reasonably expected to receive at least \$5,000 of compensation in current calendar year
- Employer may establish less restrictive eligibility requirements
- May exclude union employees if negotiated, nonresident aliens with no U.S. earned income, and certain employees acquired in a merger or spin-off for a "safe harbor" period of at least 2 years

##### C. Contributions and Other Requirements

- Employee Elective Pre-Tax Contributions
  - Allowed up to the lesser of 100% of compensation or the deferral limit in effect for that year – see Attachment A
  - Expressed as a percentage of compensation
  - Employee must have right to stop election at any time during the plan year
  - Age 50 catch-up contributions in addition to regular employee contributions allowed up to limit in effect for the year– employee must be at least age 50 by the end of the plan year – see Attachment A
- Employer Contributions – mandatory

- Nonelective contribution – 2% of compensation

OR

- Matching contribution - 100% on the first 3% of compensation deferred (the 3% match may be reduced to as low as 1% in 2 out of every 5 years if timely notice provided to employers)

- Other Requirements

- All employer and employee contributions 100% vested at all times
- Not subject to Code § 415 contribution limits – see Attachment A
- Not subject to Code § 416 "top heavy" plan rules that otherwise have certain minimum contribution and vesting requirements
- Subject to Code § 401(a)(17) compensation limits – see Attachment A
- No participant loans from the plan allowed
- Subject to Code § 401(a)(9) minimum required distribution rules at age 70½ or death
- 60-Day Election Period – employees must have 60-day period before beginning of next plan year to start, modify or stop deferrals for next year
- Annual Notice – Employer must give employees notice before the 60-day election period, including summary description of plan, employee's right to make, stop or modify deferral election, and whether employer will make 3% matching or 2% nonelective contribution for next plan year
- Once an employee is eligible, contributions cannot be subject to the employee performing a minimum number of hours or working the last day of the year

**D. Establishing the Plan**

- Plan year must be calendar year
- Effective date for new plan must be between January 1 and October 1, but must base employer contribution on entire calendar year compensation
- Must be exclusive plan of employer for the calendar year (employees cannot accrue benefits under another "qualified plan" of same employee within same calendar year)

- Required documents
  - SIMPLE-IRA plan document – establishes program and authorizes employer to contribute to an employee's SIMPLE-IRA (IRS has 2 models – see IRS Forms 5304-SIMPLE and 5305-SIMPLE)
  - SIMPLE-IRA document – IRA vehicle that accepts contributions (IRS has 2 models – see IRS Forms 5305-S and 5305-SA)

**E. Miscellaneous**

- Deemed to pass Code §§ 401(k)/(m) nondiscrimination tests
- No IRS/DOL Form 5500 Annual Report required
- Premature distribution penalty increased to 25% if amounts withdrawn before age 59½ and within first 2 years of when employee participated in any SIMPLE-IRA
- Contributions are fully deductible – employer 2% or matching contribution can be made as late as the employer's tax return due date for the year (including extensions)
- Self-employed eligible for both elective contributions and "employer's" 2% nonelective or 3% matching contribution

**F. Simplified Employee Pension (SEP) – Code § 408(k)**

- A SEP was the only "IRA" plan before the SIMPLE IRA Plan, and was and is typically adopted by sole proprietors and other owner dominated employers - but there is no 100 or less employee limit – see Attachment B
- Employer contributions deductible up to 25% of covered wages (or the equivalent 20% of self-employed earned income) or if less the dollar limit under Code § 415 for defined contribution plans - but same percentage of compensation contribution must be made for all eligible employees
- May exclude employees under age 21, employees who have not worked in at least 3 of prior 5 years, union employees if so bargained, non-resident aliens with no U.S. earned income, and employees who earn less than the minimum established for SEPs for the applicable year – see Attachment A
- SEPs established after 1996 cannot allow employee pre-tax elective contributions – but pre-1997 SEPs are grandfathered
- Once an employee is eligible, contributions cannot be subject to the employee performing a minimum number of hours or working the last day of the year

## II. Simple 401(k) Plan – Code § 401(k)(11)

### A. Eligible Employer

- Private sector, and tax-exempt non-governmental employers, including self-employed (sole proprietors, partnerships, etc.)
- Employ 100 or fewer employees who earn at least \$5,000 compensation in the prior calendar year – with 2-year grace period if number of employees exceeds 100

### B. Eligible Employees

- Plan's eligibility requirements apply – but plan cannot require more than 1 year of service (1,000 hours during applicable 12-month period), and age 21 to participate
- Must pass Code §410(b) coverage test – coverage percentage of non-highly compensated employee group must be at least 70% of coverage percentage for highly compensated employee group – see Attachment A

### C. Contributions and Other Requirements

- Employee Elective Pre-Tax Contributions
    - Allowed up to the lesser of 100% of compensation or the deferral limit in effect for that year – see Attachment A
    - Expressed as a percentage of compensation
    - Age 50 catch-up contributions in addition to regular employee contributions allowed, up to limit in effect for the year – employee must be at least age 50 by the end of the plan year – see Attachment A
  - Employer Contributions – mandatory
    - Nonelective contribution – 2% of compensation
- OR
- Matching contribution – 100% on the first 3% of compensation deferred
- Other Requirements
    - All employer and employee contributions 100% vested at all times
    - Not subject to Code § 415 contribution limits – see Attachment A

- Not subject to Code § 416 "top heavy" plan rules that otherwise have certain minimum contribution and vesting requirements
- Subject to Code § 401(a)(17) compensation limits – see Attachment A
- Subject to Code § 401(a)(9) minimum required distribution rules at age 70½ or death
- 60-Day Election Period – employees must have 60-day period before beginning of next plan year to start, modify or stop deferrals for next year.
- Annual Notice – Employer must give employees notice before the 60-day election period, including summary description of plan, employee's right to make, stop or modify deferral election, and whether employer will make matching or nonelective contribution for next plan year
- Once an employee is eligible, contributions cannot be subject to the employee performing a minimum number of hours or working the last day of the year

**D. Establishing the Plan**

- Plan year must be calendar year
- Effective date for new plan must be between January 1 and October 1, but must base employer contributions on calendar year compensation
- Must be exclusive plan of employer for calendar year (employees cannot accrue benefits under another "qualified plan" of same employer within the same calendar year)
- Required documents
  - Plan document – includes both prototype and individual designed plans – see Model Amendment available in Rev. Proc. 97-9
  - Summary plan description

**E. Miscellaneous**

- Deemed to pass Code §§ 401(k)/(m) nondiscrimination tests
- Annual Report, IRS/DOL Form 5500 required

- Employee and employer contributions fully deductible – employer portion deductible even if made after the end of the year if made by the employer's tax return due date including extensions
- Withdrawal provisions defined in plan document—but subject to Code § 401(k) limitations on employee pre-tax elective deferrals
- Participant loans permitted
- Financial hardship withdrawals allowed

### III. 401(k) Safe Harbor Plan

#### A. Eligible Employer

- Private sector employers, tax-exempt non-governmental employers, including self-employed (sole proprietors, partnerships, etc.)
- No limitation on number of employees

#### B. Eligible Employees – mandatory

- All non-highly compensated employees – but plan can require 1 year of service (1,000 hours during applicable 12-month period) and age 21
- Highly compensated employees also may participate

#### C. Contributions and Other Requirements

- Employee Elective Pre-Tax Contributions
  - Allowed up to the lesser of 100% of compensation or the deferral limit in effect for that year – see Attachment A
  - Age 50 Catch-up contributions in addition to regular employee contributions allowed – employee must be at least age 50 by the end of the plan year – see Attachment A
- Employer Contributions – mandatory
  - Safe Harbor Matching Contribution
    - Basic Match
      - 100% on first 3% of compensation deferred
    - Plus
      - 50% on next 2% of compensation deferred

OR

- Enhanced Match
  - The match at each level of deferral may be no less than under the Basic Match formula, up to 6%.
    - The rate of match cannot increase as the rate of deferral increases
    - The rate of match cannot be higher for highly compensated employees

OR

- Safe Harbor Non-elective contribution of at least 3% of compensation
- No permitted disparity under Code § 401(l) permitted for safe harbor contributions
- Additional non-safe harbor contributions allowed up to applicable Code § 415 limits – see Attachment A
- Other Requirements
  - Subject to Code § 415 contribution limits – see Attachment A
  - Not subject to Code § 416 "top heavy" plan rules that otherwise have certain minimum contribution and vesting requirements
  - Subject to Code § 401(a)(17) plan compensation limit – see Attachment A
  - Subject to Code § 401(a)(9) required minimum distribution rules at age 70½ or death
  - Annual Notice – Must give annual written notice between 30 and 90 days **before** the beginning of the plan year. If establishing new plan, may give notice up to the first day of the first plan year and first plan year must be at least 3 months long. For Safe Harbor Non-elective Contribution only – notice given before beginning of plan year may state that the employer is considering giving a Safe Harbor Non-elective contribution AND must give second notice at least 30 days before end of plan year. If employer decides not to give Non-elective Safe Harbor Contribution for the year, must meet current year Code §§ 401(k)/(m) nondiscrimination tests

- Definition of compensation must be safe harbor definition, but may be limited to period of eligibility
- No minimum hours or days worked for allocation of required Safe Harbor Contribution
- Safe Harbor Contributions must be 100% vested, but non-safe harbor contributions may be subject to vesting

**D. Establishing the Plan**

- Required documents
  - Plan document - Safe harbor contribution must be required by the plan
  - Summary plan description
  - Notice required for new plan as noted above
- Automatic enrollment permitted

**E. Miscellaneous**

- Safe Harbor Contributions subject to Code § 401(k) withdrawal restrictions except that Employer Safe Harbor Contributions may not be withdrawn for hardships
- If use Safe Harbor Non-elective Contribution – deemed to pass Code § 401(k) ADP nondiscrimination test
- If use Safe Harbor Matching Contribution – If reduce or cease making Safe Harbor Matching Contribution during plan year, must give at least 30 day notice; must use current year nondiscrimination testing method
- Code § 401(m) nondiscrimination test must be performed on any after-tax contributions
- Employee and employer contributions fully deductible to applicable limits
- Annual Report, Form 5500, required
- Participant loans permitted
- Hardship withdrawals allowed

**NOTE:** A good resource for small employer plan information is IRS Publication 560 [www.irs.gov]. Another is *Choosing A Retirement Solution for Your Small Business* a pamphlet published as a joint project of the U.S. Department of

Labor's Pension and Welfare Benefits Administration (PWBA), the Internal Revenue Service, the U.S. Small Business Administration, and the U.S. Chamber of Commerce.

#### **IV. Tax Sheltered Annuity Plan Code § 403(b) Plan**

##### **A. Eligible Employer**

- Charitable or tax-exempt organizations under Code § 501(c)(3)
- Public education institutions under Code § 170(b)(1)(A)(ii)
- State or political subdivision (*e.g.* county) or agency of a State
- Ministers or employer of ministers under Code § 414(e)(5)(A)

##### **B. Eligible Employees**

- Common law employees of eligible employers (no independent contractors)
- Salary reduction contributions must be available to any employee eligible to defer \$200 or more under the terms of the plan
- May exclude :
  - Employees who are participating in a Code § 401(k) of the employer, or another Code § 403(b) or Code § 457 arrangement maintained by the same employer
  - Nonresident aliens who receive no U.S. source income
  - Students performing services for and enrolled at the education institution sponsoring the plan
- May impose age and service requirements for employer contributions
  - Must satisfy certain minimum coverage requirements – see IRS Notice 89-23 and Notice 90-73
  - May also exclude employees who normally work less than 20 hours per week

##### **C. Contributions and Other Requirements**

- Contributions
  - Employee Elective Pre-Tax Contributions

- Allowed up to the lesser of 100% of compensation or the deferral limit in effect for that year – see Attachment A
- Age 50 Catch-up contributions in addition to regular employee contributions allowed – employee must be at least age 50 by the end of the plan year – see Attachment A
- Code § 403(b) Catch-up contributions – An employee with at least 15 years of service with the employer may increase the deferral limit for a taxable year by the least of \$3,000; \$15,000 reduced by amounts previously excluded under this special Code § 403(b) catch-up rule; or \$5,000 multiplied by the employee's years of service with the employer, reduced by all prior elective deferrals under all plans of the employer and certain deferrals to Code § 457 plans
  - Employer contributions – permissive
    - Nonelective contributions
    - Matching contributions
- Other Requirements
  - Subject to Code § 415 limitations – see Attachment A
  - Subject to Code § 401(a)(17) compensation limits – see Attachment A
  - Employer contributions may be subject to vesting schedule – but typically not because of contribution limit issues in year of vesting
  - Subject to Code § 401(a)(9) minimum required distribution rules at age 70½ or death

**D. Establishing the Plan**

- Required documents
  - Generally, plan document
  - Generally, summary plan description
- Funding vehicles
  - Annuity contracts
  - Custodial accounts – invested solely in mutual funds

- Retirement income accounts (church organizations only)

**E. Miscellaneous**

- Distributions restricted to age 59½, termination of employment, death, disability, or financial hardship (deferrals only)
- Plan termination is not a distributable event
- No Code § 401(k) nondiscrimination or similar test for salary reduction contributions
- Subject to Code § 401(m) after tax and matching contribution nondiscrimination testing (except for state or local governmental plans and church plans)
- Loans permitted
- Automatic enrollment permitted
- Reporting – generally
  - Annual Report IRS/DOL Form 5500
  - Summary Annual Report

**V. New Developments**

**A. Single Participant 401(k) Plans**

- Typically owner-only business or businesses with employees that can be excluded from participation under a traditional Code § 401(k) plan under federal law (*e.g.*, employees work less than 1,000 hours/year)
- Potential Benefits
  - Owners may defer up to the maximum limit (see Safe Harbor 401(k) Plan above for deferral limits), plus 25% of compensation as an "employer contribution", as long as the Code § 415 limitations are met – see Attachment A
  - Age 50-plus owner also is eligible for the catch-up contribution – see Attachment A
  - Sole proprietors and partners are now eligible to take tax-free participant loans from the plan
  - Funding flexibility – owner may determine the contribution on an annual basis (more in a profitable year, less in off years)

- Flexible distribution options – owner may design plan to allow in-service distributions and hardship withdrawals.
- Key Issue – Administration, investment and other plan related costs

**B. Single Participant Defined Benefit Plans**

- Typically owner-only businesses or businesses with employees that can be excluded from participation in a traditional defined benefit plan under federal law (*e.g.*, all employees who work less than 1,000 hours/year)
- Potential Benefits
  - Can fund projected benefit at age 65 of lesser of \$160,000/year or 100% of average compensation (for 3 consecutive high years) - reduced by 10% for each year less than 10 years of participation
  - Benefits may be based on compensation paid in prior years
  - If an individual's average income is less than \$10,000, the plan can fund a *de minimis* \$10,000 per year benefit as long as benefits are paid using an annuity at retirement age
  - Distribution options flexible from lump sum to life annuities
- Key Issues
  - Administration, investment and other plan related costs
  - Funding flexibility limited once established

**C. Other Owner-Favored Plans**

- Consider Code § 412(i) fully insured defined benefit plans
  - *Potentially* higher deduction limits
  - But watch out – IRS is now focusing on potential abuses!
- *Age Weighted* plans are defined contribution (individual account) plans that allow proportionately greater contributions to older participants
  - Should be considered by owners generally much older than their workforce
  - Contribution limit is Code § 415 limit – See Attachment A

- *New Comparability* plans are defined contribution (individual account) plans that allow proportionately greater contributions to highly compensation participants
  - Should be considered by owners with significantly higher income than their general workforce
  - Contribution limit is Code § 415 limit – see Attachment A

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**ATTACHMENT A**

**INTERNAL REVENUE CODE PLAN LIMITS**

<u>Limitation</u>	<u>2002</u>	<u>2003</u>	<u>2004</u>	<u>2005</u>	<u>2006</u>	<u>2007</u>
Code §§ 401(k) and 403(b) Plans – Employee Pre-Tax Deferrals Limits (not including catch-ups)	\$11,000	\$12,000	\$13,000	\$14,000	\$15,000	+COLA
Code §§ 401(k) and 403(b) Plans – Employee Pre-Tax Age 50 Catch-up Limits	\$1,000	\$2,000	\$3,000	\$4,000	\$5,000	+COLA
Defined Benefit Code § 415 Limits	\$160,000	\$160,000	+COLA	+COLA	+COLA	+COLA
Defined Contribution Code § 415	\$40,000	\$40,000	+COLA	+COLA	+COLA	+COLA
Highly Compensated Employee (5% Owner or Indexed \$75,000 Threshold with COLA)	\$90,000	\$90,000	+COLA	+COLA	+COLA	+COLA
Compensation Limit under Plan	\$200,000	\$200,000	+COLA	+COLA	+COLA	+COLA
SEPs Compensation Minimum (Indexed \$300 with COLA)	\$450	\$450	+COLA	+COLA	+COLA	+COLA
Code § 401(k) SIMPLE Plan and SIMPLE IRA Employee Pre-Tax Deferral Limits	\$7,000	\$8,000	\$9,000	\$10,000	+COLA	+COLA
Employee Pre-Tax Age 50 Catch-up Limits for Code § 401(k) SIMPLE Plan and SIMPLE IRA	\$500	\$1,000	\$1,500	\$2,000	\$2,500	+COLA

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**ATTACHMENT B**

	Code § 408(k) SEP	Code § 408(p) SIMPLE IRA Plan	Code § 401(k)(11) SIMPLE 401(k) Plan	Code § 401(k)(12) Safe Harbor 401(k)	Code § 403(b) Tax Sheltered Annuity
Eligible Employers	All employers (including self-employed), with 100 or fewer employees	All employers (including self-employed), with 100 or fewer employees	All employers (including self-employed), with 100 or fewer employees	All employers (including self-employed), with no limit on number of employees	Certain tax-exempt, and public education institutions, with no limit on number of employees
Maximum Eligibility Requirement	Age 21 <u>and</u> work in at least 3 of 5 prior years and earn more than SEP minimum in prior year – see Attachment A	Earned at least \$5,000 in any 2 prior plan years and expected to earn \$5,000 in current year	1,000 hours in 12-month period <u>and</u> age 21	1,000 hours in 12-month period <u>and</u> age 21	Elective deferrals – immediate Employer contributions – see IRS Notices 89-23 and 90-73
Excludable Employees – See also Maximum Eligibility Requirement above	Union employees (subject to bargaining), nonresident aliens with no U.S. wages, and certain employees acquired in merger or spin-off for a transition period	Union employees (subject to bargaining), nonresident aliens with no U.S. wages, and certain employees acquired in merger or spin-off for a transition period	Union employees (subject to bargaining), nonresident aliens with no U.S. wages, and certain employees acquired in merger or spin-off for a transition period	Union employees (subject to bargaining), nonresident aliens with no U.S. wages, and certain employees acquired in merger or spin-off for a transition period	Nonresident aliens with no U.S. wages, students, normally work less than 20 hours/week, employees participating in 457, 401(k) maintained by employer
Allocation Requirements, such as 1,000 hours and/or work last day of year	Not permitted	Not permitted	Not permitted	Not permitted for safe harbor contributions	Permitted for employer contributions
Employee Pre-Tax Deferral Limit	Not permitted except for pre-1977 grandfathered plans, then lesser of 100% or deferral limit in effect for year – See Attachment A	Lesser of 100% or deferral limit in effect for year – See Attachment A	Lesser of 100% or deferral limit in effect for year – See Attachment A	Lesser of 100% or deferral limit in effect for year – See Attachment A	Lesser of 100% or deferral limit in effect for year – See Attachment A
Age 50 Catch-up Contributions	Yes, if pre-1977 grandfathered plan – See Attachment A	Yes – See Attachment A	Yes – See Attachment A	Yes – See Attachment A	See Attachment A Also special 403(b) catch-up contributions

	Code § 408(k) SEP	Code § 408(p) SIMPLE IRA Plan	Code § 401(k)(11) SIMPLE 401(k) Plan	Code § 401(k)(12) Safe Harbor 401(k)	Code § 403(b) Tax Sheltered Annuity
Required Contributions	None	Match 100% on first 3% of compensation to extent deferred <u>or</u> nonelective 2% of compensation (may be reduced to 1% in 2 out of 5 years)	Match 100% on first 3% of compensation to extent deferred <u>or</u> Nonelective 2% of compensation	Match Basic – 100% on first 3% + 50% of next 2% Enhanced – match at each level of deferral must be no less than Basic, up to 6% <u>or</u> nonelective minimum of 3%	None
Employer Discretionary Contributions	Permitted up to Code Section 415 limit – see Attachment A	Not permitted	Not permitted	Permitted up to Code Section 415 limit – see Attachment A	Permitted up to Code Section 415 limit – see Attachment A
Vesting	All employee and employer contributions – 100%	All employee and employer contributions – 100%	All employee and employer contributions – 100%	All employee and employer contributions – 100% for safe harbor contributions	Employee contributions – 100% Employer-vesting schedule permitted but creates potential problems
Code § 415 Limits Apply? See Attachment A	Yes	No – but cannot contribute more than 100% of compensation	Yes	Yes	Yes
Top Heavy Plan Rules Apply?	Yes	No	No	No	No
Code § 401(k)/(m) Nondiscrimination Testing Required?	No	No	No	No – except employee after-tax contributions	Matching Yes (except for governmental or church plan)
May Employer Maintain Other Plans?	No	No	No	Yes	Yes
IRS/DOL Form 5500 Required?	No	No	Yes	Yes	Yes (generally)
Plan Year	Calendar year	Calendar year	Calendar year	Defined by plan but typically calendar year	Defined by plan but typically calendar year
Participant Loans Allowed?	No	No	Yes (if plan funded with a trust)	Yes	Yes

	Code § 408(k) SEP	Code § 408(p) SIMPLE IRA Plan	Code § 401(k)(11) SIMPLE 401(k) Plan	Code § 401(k)(12) Safe Harbor 401(k)	Code § 403(b) Tax Sheltered Annuity
Withdrawal Restrictions	Permitted at any time	Permitted at any time but 25% penalty if amounts withdrawn within first 2 years	Age 59½; severance from employment; death; disability; hardship	Age 59½; severance from employment; death; disability; hardship (no hardship from safe harbor contributions)	Age 59½; severance from employment; death; disability; hardship (deferrals only)
Age 70½ and Death Minimum Required Distribution Rules Apply?	Yes	Yes	Yes	Yes	Yes
Required Annual Notices	None	Notice at least 60 days before beginning of plan year	Notice at least 60 days before beginning of plan year	30 to 90 days before beginning of plan year	None
Required Documents	Plan document (IRS model plans available); summary description	Plan document (IRS model plans available); summary description	Plan document (IRS model amendment available); summary plan description	Plan document, summary plan description	Generally, plan document and summary plan description

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