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Provided By:

Horizon Wealth Group LLC
Horizon Wealth Group
2682 Bishop Drive,
San Ramon, CA 94583
www.horizonwealthgroup.com
925-244-6600

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WEALTH GROUP, LLC

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Is Your SIMPLE IRA Holding You Back?

Cyclicality is familiar to nearly every business owner, and the 4th quarter is likely the time of year when you become able to predict this year's results, form expectations about the coming year, and plan accordingly. Naturally, this planning leads to gauging profitability and your resulting tax liabilities.

Looking ahead to 2011, the expiration of the Bush tax cuts means you may find yourself in a higher marginal tax bracket, making tax-deductible retirement plan contributions even more important.

Different retirement plans offer different contribution limits, resulting in different achievable levels of tax savings. Other variables are a plan's effectiveness as an employee retention tool, creditor protection of assets, and flexibility. As a result, your 4th quarter planning provides an ideal opportunity to evaluate whether the retirement plan you have provides the savings opportunity and features you need, and make a switch if warranted.

Many small businesses utilize a SIMPLE IRA to take initial steps into the retirement plan space. A SIMPLE IRA is inexpensive, easy to establish and maintain, and controls the cost of contributions to employees. For these reasons, SIMPLE IRAs are popular choices among small business owners. However, SIMPLE IRAs may fall short of satisfying your requirements for tax savings and features, especially for established businesses.

The first shortcoming of SIMPLE IRAs is their contribution limit. SIMPLEs are funded with two components. The first component is a salary deferral, capped at $11,500 (+ $2,500 catch-up if age 50+). The second component is a contribution from your business, either 2% of compensation for all eligible employees, or a dollar for dollar match up to 3% of pay for employees who choose to defer a portion of salary to the plan. Your company contribution % must be decided before the start of each year, and SIMPLEs do not allow businesses to contribute more than 3% of compensation. Due to these limits, if your deductible contribution goal is beyond $15,000 - $20,000, it may be time to consider a replacement.

The next drawback of a SIMPLE IRA is their "Exclusive Plan Rule". This rule prohibits businesses with SIMPLE IRAs from installing supplemental plans to increase contribution potential. Alternative plans such as a 401(k) allow the use of supplemental plans such as a Profit Sharing Plan or Defined Benefit Plan. These plan combinations lift deductible contribution potential above the limits possible with a stand-alone plan.

For example, an alternative such as a 401(k) / Profit Sharing plan improves on the contribution limits of SIMPLE IRAs in two ways. First, the salary deferral limits are substantially higher, allowing deferrals of $16,500 (+ $5,500 catch-up if age 50+). In other words, a 401(k) offers an instant increase in deduction potential of $5,000 - $8,000. Next, when looking at the contributions coming from your business, the new limit ranges from 0 – 25% of compensation. These employer contribution amounts can usually be decided at your tax filing deadline for the prior year, so not only do you have higher limits, but you also have the flexibility to decide the level of employer contributions at tax time with perfect hindsight. The overall contribution limit per individual is $49,000 or $54,500 depending on age. As a rule of thumb, many business owners see their deductible contribution potential double by replacing their SIMPLE IRAs with a 401(k) / Profit Sharing plan.

In a second example of layering supplemental plans, a business with a 401(k) / Profit Sharing plan can add an additional Defined Benefit plan. Depending on the age and income of the business owner, this three-tiered structure, 401(k) / Profit Sharing / Defined Benefit, can provide business owners with deductible contribution potential in excess of $100,000. These levels of deductible contributions are not achievable in a SIMPLE IRA.

401(k) plans offer additional flexibility concerning the tax treatment of salary deferrals. SIMPLE IRAs offer only one form of tax treatment: deduct salary deferrals, and receive ordinary income tax treatment on withdrawals. On the other hand, 401(k) plans offer tax diversification: a choice between deductible contributions and taxable withdrawals (identical to the SIMPLE) or Roth treatment, which allows you to forego a deduction on salary deferrals in favor of tax-free normal distributions. The availability of Roth treatment is not restricted based on income, unlike the Roth IRA. If you expect your tax bracket during retirement to be higher than your tax bracket today, or if you like the idea of having a portion of your retirement savings available tax-free, then you may find Roth treatment attractive.

Another drawback SIMPLE IRAs is that they are not a particularly effective employee retention tool. SIMPLEs cannot include a "Last Day Rule" or vesting provisions. A last day rule means you may not be required to contribute to the accounts of employees who separated throughout the year, while vesting rules allow you to recapture a portion of the contributions you make to your staff if they separate from service before working a requisite number of years. SIMPLEs also permit employees to take distributions at any time, for any reason, although the taxes and penalties may be severe. Since SIMPLEs have no vesting features and no prerequisites for distributions, SIMPLEs may not be an effective tool to reduce costly employee turnover.

Liquidity, pre-retirement access to retirement savings, is another variable that should be considered. SIMPLE IRAs offer short term access to savings by way of an indirect rollover. Those doing an indirect rollover can receive a distribution from their SIMPLE IRA and have up to 60 calendar days to return the funds to their account. This can be done once per rolling 12 months without taxes or penalties. SIMPLEs also allow distributions at any time, for any reason, with no triggering events are required, although distributions taking place before age 59.5 could be subject to penalties as high as 25%, in addition to ordinary income taxes. Alternative plans such as a 401(k) provide an improvement in liquidity by way of a loan feature. These plans allow you to borrow the lesser of 50% of your vested account balance or $50,000. Loans are not taxable as long as they are repaid within 5 years with interest, and payments occur at least quarterly.

One final consideration is the level of creditor protection available for your qualified plan assets. Any IRA, including a SIMPLE IRA, has limited protection in the event of a bankruptcy under the Bankruptcy Abuse Prevention and Consumer Protection Act. In contrast, 401(k), Profit Sharing, and Defined Benefit plans covering at least one rank and file employee or unrelated shareholder receive a more robust form of creditor protection under Title I of ERISA. ERISA protection applies not only in bankruptcy situations but also protects assets from judgment creditors without a bankruptcy occurring.

Whether it's the contribution limits, lack of tax diversification, ineffectiveness as an employee retention tool, liquidity, or creditor protection, you may feel that your SIMPLE could be holding you back. As a result, you may want to replace your SIMPLE IRA plan with one that aligns more closely with their goals. SIMPLEs operate on the calendar year, which means now is the time to install your new plan to take effect in January. The process to replace your SIMPLE is as follows:

1. Begin by designing your new plan – we can work together to assemble a plan that accommodates your contribution goals and contains the features you need.
2. Notify your employees of the change – employees in your SIMPLE IRA must be notified at least 60 days before the change takes effect. This means November 2, 2010 is the date by which you should notify your employees if you intend to replace your SIMPLE in the New Year.
3. Set up your new plan so you can to begin making contributions in the New Year.

For questions regarding your retirement plan, or to examine the options available to you, please contact me today. The data gathering process usually takes less than an hour, and the results can last a lifetime.