Choosing a Retirement Plan for the Self-employed

601.1 Self-employed individuals can adopt a qualified retirement plan (often referred to as a Keogh plan), a simplified employee pension (SEP) plan, an individual retirement account (IRA), or a savings incentive match plan for employees (SIMPLE IRA plan). These plans offer self-employed individuals the same opportunity to accumulate retirement savings in tax-deferred accounts as individuals covered by corporate retirement plans. Appendix 6B presents a summary of general rules applicable to Keoghs, SEPs, SIMPLE IRA plans, and IRAs for the 2013 tax year.

Keogh Plans for the Self-employed

601.2 Qualified retirement plans (e.g., profit sharing, money purchase, and defined benefit plans) established by sole proprietorships (or partnerships) for the benefit of the sole proprietor (or partners) and their employees are often referred to as Keogh plans.

601.3 Keogh plans are generally subject to the same rules as those covering corporate qualified retirement plans. Like a corporate plan, a Keogh cannot discriminate among employees in determining participation, benefits, or contributions. The deduction limits for contributions on behalf of both employees and self-employed individuals are the same as those for corporate plans. However, the deduction limit for self-employed individuals is based on net self-employment income earned in the trade or business for which the plan is established. See the discussion of deducting Keogh contributions at paragraph 601.6.

601.4 Advantages of a Keogh include:

a. A taxpayer with self-employment income can generally establish a Keogh, even though he is covered, as an employee, by an unrelated employer's retirement plan (Ltr. Rul. 7839059). Examples of common self-employed/employee situations include doctors, lawyers, accountants, and corporate directors.

b. Fees for administering the plan are tax-deductible or may be eligible for a tax credit. See paragraph 601.69.

c. Taxes on earnings in the plan are deferred until withdrawn.

d. The self-employed taxpayer can direct plan investments.
e. The contribution deduction is above-the-line; the taxpayer does not need to itemize deductions to obtain a tax benefit from the contribution, and, because the deduction reduces adjusted gross income (AGI), it can increase the allowable amount of AGI-sensitive deductions and credits.

f. Lump-sum distributions may be eligible for favorable tax treatment (see section 606).

**Example 6-1: Directors fees used to establish a Keogh plan.**

In January 2013, Tim, age 54, was elected to the Board of Directors of the Acme Corp. He receives $40,000 annually for attending quarterly meetings and consulting with the management committee throughout the year. Tim is also an executive of Henderson Hardware Inc., where he participates in the company's retirement plan but owns none of the company's stock.

Tim's director fees are includable in computing net earnings from self-employment and for purposes of making tax-deductible contributions to a Keogh plan established for Tim's business of being a director. Assuming Tim establishes the Keogh plan by year-end (December 31, 2013), he can defer tax on a portion of his directors fees by making a tax-deductible plan contribution, despite his participation in the Henderson Hardware, Inc. retirement plan. Contributions to such a plan could be maximized if the plan includes a 401(k) feature, but only to the extent Tim has not already made elective deferrals to the Henderson Hardware Retirement Plan. (See the discussion later in this section regarding choosing a type of Keogh plan.)

**Variation:** Alternatively, Tim could establish a SEP to shelter a portion of his director fees. A SEP plan would be more flexible in that it does not have to be adopted by year-end; Tim can adopt a SEP plan any time before the deadline for filing his 2013 individual income tax return (including extensions). (See the discussion later in this section regarding SEPs.) A SIMPLE IRA plan is also an option if Tim has not already maximized his allowable elective deferrals to the Henderson plan, but it must be established by October 1, 2013.

601.5 **Caution:** Businesses under common control must be aggregated in applying Section 415
contribution limits. For 2013, the Section 415 contribution limitations are: defined benefit plans-annual benefit that the lesser of (a) $205,000 or (b) 100% of the participant's average compensation for his high three years; defined contribution plans-annual contribution cannot exceed the lesser of (a) $51,000 or (b) 100% of the participant's compensation (limited to $255,000). Common ownership for purposes of IRC Sec. 415 is "more than 50%" business ownership, whether a corporation, partnership, or sole proprietorship [IRC Secs. 414(b) and (c) and 415(h)]. See section 602 of PPC's Guide to Small Employer Retirement Plans for further discussion of these limitations.

601.6 Deducting Keogh Contributions

Like a corporate plan, a Keogh cannot discriminate among employees in determining participation, benefits, or contributions. The deduction limits for contributions on behalf of both employees and self-employed individuals are the same as those for corporate plans. These rules generally allow the following deductions:

a. Money Purchase and Profit-sharing Plans. For 2013, the employer's maximum deduction for contributions to profit-sharing and money purchase plans is limited to 25% of the total compensation of all participants eligible to share in the contribution allocation [IRC Sec. 404(a)(3)]. For this computation, each participant's compensation is limited to $255,000 [IRC Sec. 401(a)(17)]. Elective deferrals to a 401(k) plan are not subject to this limit.

Note: The maximum deductible contribution for a one-participant profit-sharing or money purchase plan for 2013 cannot exceed the participant's Section 415 contribution limit of $51,000 [IRC Sec. 404(j)(1)(B)].

b. Defined Benefit Plans. The employer's deduction limit for contributions to a defined benefit plan is in most cases the minimum funding amount, as discussed in PPC's Guide to Small Employer Retirement Plans. The minimum funding standards generally require the employer's annual contribution to be large enough to cover the annual cost of future benefits and administrative expenses, as well as any past benefits not funded. These deduction limits are actuarially determined. See the discussion of defined benefit plans versus defined contribution plans at paragraph 601.9 to determine when a defined benefit plan is most useful.

601.7 The deduction limit for self-employed individuals is based on net self-employment (SE) income
earned in the trade or business for which the plan is established. Net SE income is calculated after the Keogh contribution deduction and the deduction for half of the self-employment (SE) tax. This first reduction results in a simultaneous equation that effectively reduces the self-employed participant's maximum contribution percentage (based on precontribution earned income). A schedule of the self-employed owner's contribution percentage, based on various levels of employee contribution percentages, is included at Appendix 6C.

Example 6-2: Calculating a self-employed individual's profit-sharing plan contribution.

John, a self-employed architect, generated Schedule C income of $110,000 net of his SE tax deduction but before the plan contribution during 2013. He has a profit-sharing plan with a stated contribution rate of 25%. The plan defines compensation for self-employed individuals as earned income within the meaning of IRC Sec. 401(c)(2).

The maximum John can contribute to the plan is 25% of his Schedule C income less his SE tax deduction and the contributions to the plan. Using the percentage from Appendix 6C, John's maximum contribution is $22,000 ($110,000 × 20%). The proof of the calculation is as follows:

<table>
<thead>
<tr>
<th>Description</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net Schedule C earnings after SE tax deduction</td>
<td>$110,000</td>
</tr>
<tr>
<td>Contributions to the plan</td>
<td>$(22,000)</td>
</tr>
<tr>
<td>Income for calculating pension contribution</td>
<td>$88,000</td>
</tr>
<tr>
<td>Maximum contribution ($88,000 × 25%)</td>
<td>$22,000</td>
</tr>
</tbody>
</table>

601.8 Note: Not only are limits imposed on the amount an employer can deduct, but separate limits apply to the amount of contributions and benefits that can be provided to a participant. These limits, referred to as
Section 415 limits, are discussed in section 602 of PPC's Guide to Small Employer Retirement Plans.

601.9  Defined Benefit versus Defined Contribution Plans

A defined benefit plan for a self-employed individual who is over age 45 (and has significant net business income and the cash necessary to fund required, and possibly large, annual contributions) can be an excellent vehicle for making relatively large tax deductible contributions. This is possible because the benefit the plan participant will receive is established, and the contributions necessary to create a fund that will provide the desired benefit are calculated based on actuarial assumptions such as interest rates, years until retirement, and life expectancy. However, defined benefit plans are most useful when the owner-participant is significantly older (and better paid) than other employees. Otherwise contributions required to be made on behalf of other employees may be prohibitive. Additionally, the costs of implementing (e.g., legal fees) and maintaining (e.g., actuarial fees) a defined benefit plan must be considered.

601.10 Conversely, self-employed individuals under age 45 may be reluctant to establish a defined benefit Keogh plan because of the costs involved in computing the annual contribution, compared to the amount of contribution required for a defined contribution plan (usually not significantly greater compared to other types of self-employed plans since retirement is many years away). Thus, defined contribution (e.g., profit sharing) plans are typically the most popular choice for younger self-employed taxpayers and those without the cash necessary to fund and maintain a defined benefit plan.

601.11 Money purchase plans operate similarly to profit-sharing plans. However, the plan must contain a set formula under which contributions are made instead of allowing discretionary contributions. Once adopted, contributions determined by the formula must be made annually. The contribution deduction limit for money purchase plans is 25% of total compensation for all employees. Since the contribution limit of profit-sharing plans is equal to that of money purchase plans, there is no advantage to establishing a new money purchase plan.

601.12  Plan Loans

Keogh plans can make plan loans to owner-employees under the same rules applicable to other participants. However, the plan document must set out specific loan provisions.

601.13  How to Set Up a Keogh Plan
A Keogh plan must legally exist by the taxpayer's year-end to claim a deduction for the contribution. Thus, calendar-year taxpayers must adopt the plan by December 31. In addition, the trust agreement (if the plan uses a trust) and the plan itself must be in writing and communicated to any employees by that date [Reg. 1.401-1(a)(2)]. Some states require that the trust be funded with at least a nominal amount of money prior to year-end.

601.14 The easiest and quickest way to establish a plan is for the taxpayer to adopt a master or prototype plan (offered by most financial institutions). The sponsoring organization has already applied to the IRS for plan approval of the master or prototype plan document, then provides the taxpayer with a copy of the approved plan and determination letter.

601.15 Note: Taxpayers adopting a custom-designed plan should file Form 5300 to request a determination letter of the plan's qualifications.

601.16 Due Date of Keogh Plan Contributions

Contributions to Keogh plans are generally deductible only in the year paid. However, a special rule permits a deduction for certain contributions made after year-end. Under this rule, a contribution is treated as made on the last day of the tax year if: (a) it is identified as being made for that year, and (b) it is actually made by the due date of the taxpayer's return, including extensions [IRC Sec. 404(a)(6)]. If the contribution is made by mail, the postmark date is the controlling date (see Ltr. Rul. 8551065, which applies to traditional IRA contributions and which, presumably, also applies to contributions to other retirement plans).

Example 6-3: Establishing tax year in which Keogh contribution is deductible.

Fred Ware, a calendar-year taxpayer, is eligible to contribute $15,000 to his Keogh plan. On February 24, 2014, Fred pays $15,000 to the retirement plan trust and identifies the contribution as being for 2013. Since the contribution was made before the due date of Fred's personal tax return and is identified as a 2013 contribution, it is deemed made on the last day of 2013 and thus deductible on Fred's 2013 return (assuming the plan was established on or before December 31, 2013).

601.17 Planning Tip: The extended time limit for making the contribution allows taxpayers who may be
short of cash at year-end the flexibility to avail themselves of retirement plan benefits without having to borrow funds to make the required contribution. However, a Keogh plan must be established before the year-end for a contribution to be allowable for that year. Also note that if the plan is a money purchase or defined benefit plan, the minimum funding rules require contributions to be made no later than 8 1/2 months after the close of the plan year. For such plans, September 15 is the latest possible date for making contributions for purposes of the minimum funding rules, even though October 15 is the latest date contributions can be made for tax deduction purposes.

601.18 **Note:** For an in-depth discussion of Keogh plans and the issues discussed in this section, see section 109 of PPC's *Guide to Small Employer Retirement Plans*.

**One-person 401(k) Plans**

601.19 One-person 401(k) plans are becoming increasingly popular for a business that employs only the owner. Given the right circumstances, these plans can allow a large amount to be contributed on behalf of the owner while maintaining flexibility in making contributions in future years. The cost of preparing the annual return (Form 5500 required after plan assets exceed $250,000) is nominal in comparison to the additional funding a one-person 401(k) plan allows. Also, because the plan has no employees other than the owner, it is not subject to the complicated nondiscrimination tests normally applicable to 401(k) plans.

601.20 For 2013, a business owner can make an elective deferral contribution of up to $17,500 ($23,000 if he is age 50 or older) plus an employer contribution of up to 20% of SE income or 25% of compensation. In calculating the allowable employer contribution, the owner's SE income or compensation is not reduced by the owner's elective deferral contribution [IRC Sec. 404(n)].

601.21 **Note:** Catch-up contributions can be made by individuals age 50 and over if the plan allows. Catch-up contributions are not subject to any other contribution limits. For 2013, the catch-up limit is $5,500 for qualified plans and $2,500 for SIMPLE plans.

601.22 However, the total contributions (elective deferral plus the employer contribution) cannot exceed the lesser of 100% of the participant's compensation or $51,000 ($56,500 if age 50 or older) for 2013.

**Example 6-4:** Maximizing contributions with a one-person 401(k) plan.

Randy, age 50 (by the end of the current year), is the sole owner and employee of
Flight-in-Training, a sole proprietorship. Flight-in-Training is also the sole source of Randy’s earned income. Randy earns $145,000 (net of the SE tax deduction) in the current year and wishes to maximize contributions to a retirement account. Randy believes that the business will probably continue to be profitable, but he would like the flexibility of determining on a year-to-year basis how much to contribute. Randy does not expect to hire employees and will remain a one-person company.

The following table reflects the maximum amount that can be contributed to a profit sharing plan with a 401(k) feature [a one-person 401(k) plan] by Randy in 2013.

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>25% (20% for self-employed individuals)</td>
<td>$29,000</td>
</tr>
<tr>
<td>Profit-sharing contribution ($145,000 × 20%)</td>
<td></td>
</tr>
<tr>
<td>Elective 401(k) deferrals</td>
<td>$17,500</td>
</tr>
<tr>
<td>Contributions subject to annual addition limit</td>
<td>$46,500</td>
</tr>
<tr>
<td>Catch-up contributions</td>
<td>$5,500</td>
</tr>
<tr>
<td><strong>Total contributions</strong></td>
<td><strong>$52,000</strong></td>
</tr>
</tbody>
</table>

In contrast, Randy’s 2013 contribution to a profit sharing plan without a 401(k) feature or a SEP without a salary reduction feature (a regular SEP) would be limited to $29,000 (20% × $145,000).

**Note:** Catch-up contributions for employer retirement plans are available only for plans that allow elective deferrals [401(k) plans, 403(b) plans, SARSEPs, and SIMPLE IRA plans]. If Randy had chosen to use a profit sharing plan without a 401(k) feature or a regular SEP, there would be no additional catch-up contribution available for being age 50.
One-person 401(k) Is Less Advantageous at Higher Income Levels

The higher the business owner's SE income or compensation, the more can be contributed to his one-person 401(k) account—up to the applicable dollar cap (i.e., the annual additions limit). For 2013, the cap on combined elective deferral and employer contributions to a 401(k) plan account is $51,000 if the owner is under age 50 [IRC Sec. 415(c)(1)(A)]. The 2013 cap for a profit-sharing plan without a 401(k) feature or a regular SEP is $51,000, regardless of the owner's age [IRC Sec. 415(c)(1)(A)].

Because of the $51,000 cap (for 2013), the advantage of a one-person 401(k) plan over a SEP is maximized when SE income is $167,500 or less (because the full $17,500 elective deferral is available even with an employer contribution at the maximum 20% rate). On the other hand, when SE income is $255,000 or more, there is no longer an advantage because the full $51,000 limit can be contributed using a SEP ($255,000 × 20% = $51,000).

Similarly, the $51,000 cap impacts the advantage of a corporate one-person 401(k) versus a SEP, except the amounts are different because the corporation can contribute 25% of the individual's compensation (without any reductions). Thus, the maximum advantage of the 401(k) is realized on compensation up to $134,000, and the advantage is lost when compensation is $205,000 or more.

However, when the business owner is age 50 or older, a one-person 401(k) plan will always permit larger annual deductible contributions. This is because the 401(k) cap is increased by the catch-up elective deferral contribution amount. The 401(k) cap for 2013 for a participant who is age 50 or older is $56,500 ("regular" cap of $51,000 plus $5,500 extra due to the catch-up contribution privilege). [See IRC Secs. 402(g)(1), 414(v), and 415(c)(1)(A).]

Other Considerations

The business owner can borrow from his 401(k) account, assuming the plan document so permits. The maximum loan amount is 50% of the account balance or $50,000, whichever is less. In contrast, borrowing from a SEP IRA or SIMPLE IRA is forbidden [IRC Secs. 408(e)(2), 4975(c)(1)(B) and (d)(1), and 4975(f)(6)(B)].

When the business employs someone other than the owner, 401(k) contributions may be required
for the other employees, in which case the plan would become a "standard" 401(k) plan with all the resulting complications. However, the plan can exclude from coverage any employee who is under age 21 and any employee who has not worked for at least 1,000 hours during any 12-month period [IRC Sec. 410(a)(1)(A) and (a)(3)(A)]. Because this exclusion rule allows the business owner to avoid covering young and part-time employees, the plan may still qualify as a simple and easy one-person 401(k) arrangement.

601.29 A one-person 401(k) plan is subject to the same deadlines as Keogh plans. Therefore, the plan must be established before the end of the year for which it is first effective and contributions must be made by the due date of the self-employed person's return, including extensions. See paragraphs 601.13 and 601.16 for more information.

601.30 See section 105 of PPC's Guide to Small Employer Retirement Plans for more on traditional "standard" 401(k) plans. See section 612 of this Guide for a discussion of Roth 401(k) plans.

**SEPs Offer Simplicity but Less Flexibility**

601.31 In a SEP plan, the employer makes annual contributions on the employee's behalf to an IRA established for the employee (referred to as SEP IRAs). A SEP is generally easy to adopt, and the rules governing participation are straightforward. An advantage of establishing a SEP (rather than a Keogh plan) is that reporting, recordkeeping, and funding requirements are minimal. Taxpayers also have the ability to adopt a SEP plan after year-end, and to make contributions up to the due date of their personal tax return.

601.32 An employer is not required to make SEP contributions every year or to maintain a particular contribution level. However, contributions may not discriminate in favor of highly compensated employees. This means contributions for all eligible employees must generally bear a uniform relationship to includable compensation [IRC Secs. 408(k)(3)(C) and (D)]. A contribution rate that decreases as compensation increases is considered uniform [Prop. Reg. 1.408-8(c)(1)].

601.33 Despite a SEP's simplicity and ease of adoption, SEP plans do have disadvantages. For example, all eligible employees must be covered. An eligible employee is one who at a minimum (a) has attained age 21; (b) has performed any services for the employer during at least three of the preceding five years; and (c) has received at least $550 in compensation (for 2013) [IRC Sec. 408(k)(2)]. Additionally, employees have a nonforfeitable right to contributions (i.e., are immediately vested). Thus, there is no partial vesting, and no possibility that contributions will be reallocated back to the employer or key employee. Finally, every eligible employee must set up or modify an IRA to accept a SEP contribution. Failure of even one eligible employee to do so destroys the ability of the employer to use a SEP. However, employers may overcome this problem
by setting up an IRA on the employee's behalf [Prop. Reg. 1.408-7(d)(2)]. Finally, if contributions are made to IRAs of some but not all eligible employees, none of the SEP contributions are deductible (Brown).

601.34 Note: The existence of a SEP and employer contributions to the SEP IRA do not preclude the employee from establishing an additional IRA.

601.35 How to Adopt a SEP Plan

For most self-employed taxpayers, adopting a SEP means completing and signing Form 5305-SEP, "Simplified Employee Pension-Individual Retirement Accounts Contribution Agreement." The form is not filed with the IRS, but should be maintained as part of the employer's permanent records. In addition, a copy of Form 5305-SEP (including the accompanying instructions) must be given to each employee covered by the SEP.

601.36 Post Year-end Tax Planning with a SEP

Unlike Keogh plans, a SEP does not have to be adopted by the taxpayer's year-end; it can be adopted any time before the deadline for filing the taxpayer's return, including extensions [IRC Sec. 404(h)(1)(B); Prop. Reg. 1.408-7(b)].

Example 6-5: Post year-end tax planning with a SEP.


Lisa should consider establishing a SEP, which must be done on or before the due date of her tax return (including extensions). Thus, Lisa has until October 15, 2014, to establish a SEP, make the appropriate contributions, and deduct the amounts on her 2013 tax return if her tax return is extended to that date.
Contribution Limit

For 2013, the contribution limit for a SEP is the lesser of (a) 25% of up to $255,000 of compensation or (b) $51,000. For self-employed individuals, the contribution limit is based on net self-employment (SE) income earned in the business that established the SEP. Net SE income is calculated after the SEP contribution deduction and the SE tax deduction. This first reduction results in a simultaneous equation that effectively reduces the self-employed participant's maximum contribution percentage (based on precontribution earned income). A schedule of the owner’s contribution percentage, based on various levels employee contribution percentages, is included at Appendix 6C. The computation for a self-employed individual is discussed in detail in section 1516 of PPC’s Guide to Small Employer Retirement Plans.

SIMPLE IRA Plans

SIMPLE IRA plans are available to employers with 100 or fewer employees receiving at least $5,000 of compensation in the prior calendar year. Self-employed individuals are also eligible to participate in a SIMPLE IRA plan. An employer may impose less restrictive eligibility requirements by eliminating or reducing the prior year compensation requirements, the current year compensation requirements, or both, under its SIMPLE IRA plan. However, the employer cannot impose any other conditions on participating in a SIMPLE IRA plan (Notice 98-4, Q&A C-2). The employer may not currently maintain any other qualified retirement plans while making contributions to a SIMPLE IRA plan.

SIMPLE IRA plans replace salary reduction simplified employee pensions (SARSEPs). As of January 1, 1997, employers cannot adopt new SARSEPs. However, SARSEPs established before 1997 can continue to receive contributions under present-law rules, and new employees hired after 1996 may participate in the SARSEP under such rules.

Note: A SIMPLE 401(k) plan is also available to the same employers who can establish SIMPLE IRA plans. A SIMPLE 401(k) plan is a qualified plan (profit-sharing plan) and generally is subject to the requirements discussed beginning at paragraph 601.2 for Keogh plans. The main advantage of SIMPLE 401(k) plans over traditional 401(k) plans is that they are subject to simplified nondiscrimination tests and they are not subject to the top-heavy rules. See section 105 of PPC’s Guide to Small Employer Retirement Plans for more on SIMPLE 401(k) plans.

The greatest advantage of SIMPLE IRA plans is that they are easier to operate than Keogh plans. SIMPLE IRA plans do not have to meet the nondiscrimination requirements, minimum participation and
minimum coverage rules, vesting rules, or the top-heavy rules applicable to qualified plans. However, if a plan will cover only the owner-employee, the complicated nondiscrimination rules do not apply. This may make a one-person 401(k) plan worth consideration. Although the fees for setting up and maintaining a one-person 401(k) plan may be higher, the additional allowable contributions may be substantial. See paragraph 601.19.

601.42 Contribution Limits

SIMPLE IRA plans allow employee elective contributions and require employer matching contributions or nonelective contributions. For 2013, employee elective contributions are limited to $12,000.

601.43 SIMPLE IRA plans can also allow catch-up contributions for taxpayers age 50 or older by the end of the applicable year. The catch-up contribution for 2013 is an additional $2,500.

601.44 Employer contributions must be made under one of two formulas [IRC Sec. 408(p)(2)(A), (B), and (C)(ii)]:

a. Matching Contribution Formula. Employers must generally match employee contributions on a dollar-for-dollar basis, up to 3% of the employee's compensation for the calendar year. However, in two out of every five years, the employer has the option of electing a matching percentage as low as 1% of each eligible employee's compensation. For purposes of the matching contribution, compensation is not limited.

b. Nonelective Contribution Formula. In lieu of making matching contributions, the employer may contribute 2% of compensation for each eligible employee having at least $5,000 of compensation during the calendar year. For purposes of this formula, compensation of each eligible participant is limited to the Section 401(a)(17) limit ($255,000 for 2013), thus limiting the contribution to no more than $5,100 (for 2013) per employee.

601.45 There is a limit as to the total amount of compensation an individual can elect to defer each year. This aggregate limit applies to all elective deferrals the individual makes to 401(k) plans, 403(b) plans, SARSEPs, as well as SIMPLE IRA plans for the year regardless of whether the plans are provided by related or unrelated employers [IRC Sec. 402(g)(3)]. For 2013, an employee's aggregate elective deferral
limit is $17,500 ($23,000 if age 50 or older).

**Example 6-6: Computing the elective deferral limit for a SIMPLE IRA.**

Jane, age 40, is a participant in LMN Corp.’s 401(k) plan under which she elected to defer $8,000 during 2013. She has no ownership in LMN Corp. During 2013, Jane earned $20,000 in directors fees from Snakes, Inc., which is not related to LMN Corp. This $20,000 will be reported as SE income (sole proprietorship) on Jane’s 2013 return and she would like to establish a SIMPLE IRA plan on behalf of this business. If she does so, how much can she elect to defer under the plan for 2013?

Jane’s aggregate elective deferral limit for 2013 is $17,500. Therefore, her elective deferral limit for the SIMPLE IRA plan is $9,500 [$17,500 aggregate elective deferral limit − $8,000 elective deferral made to the 401(k) plan].

**Variation 1:** What if Jane had deferred $2,000 (rather than $8,000) to the 401(k) plan? Jane’s remaining aggregate elective deferral limit would be $15,500 [$17,500 aggregate elective deferral limit − $2,000 elective deferral made to the 401(k) plan]. However, the elective deferral to the SIMPLE IRA plan would be limited to $12,000 for 2013.

**Variation 2:** What if LMN Corp. sponsored a SIMPLE IRA plan [rather than a 401(k) plan] and Jane elected to defer $6,000 to that plan? Based on her aggregate elective deferral limit, it appears that Jane can contribute $11,500 ($17,500 − $6,000) to the sole proprietorship SIMPLE IRA plan. Even though making such a contribution will result in a total of $17,500 of elective deferrals being made to the two unrelated SIMPLE IRA plans, the deferrals made to each plan do not exceed the $12,000 annual SIMPLE IRA plan limit.

601.46 Compensation

Under the rules relating to SIMPLE IRA plans, *compensation* equals taxable wages reported on Form W-2,
plus any elective deferrals made by the employee. In the case of a self-employed individual, compensation means net earnings from self-employment, as defined in IRC Sec. 1402(a), without regard to the self-employed person's SIMPLE plan contribution [IRC Sec. 408(p)(6)(A)].

601.47 **Observation:** Under IRC Sec. 1402(a)(12), SE income is reduced by a deduction (equal to 7.65% of SE net income) in lieu of the half of SE tax deduction. Although not entirely clear, a literal reading of the Code requires net SE earnings to be adjusted by this "in lieu of deduction for purposes of the SIMPLE IRA rules." Although not authoritative, IRS Publication 590, "Individual Retirement Arrangements," follows this approach, stating that a self-employed person's earnings are the amount reported on Section A, line 4 of Schedule SE, which is self-employed earnings after taking the "in lieu of deduction."

601.48 **Special Rules for Self-employed Persons**

Self-employed persons must be eligible to participate in the SIMPLE IRA plan the same as any other employee. However, the following special rules apply to such persons:

a. Special rules apply for determining compensation. (See the definition of compensation at paragraph 601.46.)

b. Income is deemed to be earned as of the last day of the year [Reg. 1.401(k)-1(a)(6)(iii)]. This means that elective deferrals on behalf of the self-employed person need not be deposited until after the last day of the year. It also means that a self-employed person's total net earnings for the year are used in determining the maximum contribution allowed, even if the deferral election is made after the first day of the year (but no later than the last day of the year).

c. Matching contributions can be made for self-employed persons in the same manner and under the same rules applicable to any other employee [IRC Sec. 408(p)(9)].

601.49 **When and How Contributions Are Deductible**

Contributions to a SIMPLE IRA plan are deductible in the employer's tax year with or within which the
calendar year for which the contributions were made ends [IRC Sec. 404(m)(2)]. However, for employer matching (or nonelective) contributions, a deduction is allowed for a year only if the contributions are made by the due date (including extensions) for the employer’s tax return.

601.50 SIMPLE IRA contributions made on behalf of employees are deducted on Schedule C (or F). Payments made on behalf of the self-employed business owner are deducted on Form 1040 as an adjustment to gross income.

601.51 Employee elective deferrals (including those attributable to the owner) must be deposited to the employee’s SIMPLE IRA as soon as reasonably possible, but in no case later than 30 days after the end of the month to which the contributions relate [IRC Sec. 408(p)(5); DOL Reg. 2510.3-102(b)(2)].

601.52 **Observation:** Under the timing rules for making contributions, it appears the self-employed owner's elective deferral must be deposited no later than 30 days after the end of the tax year, since the self-employed owner's income is deemed earned as of the last day of the year. The company match, however, need not be made until the due date, including extensions, of the return for the year to which they relate.

601.53 **Distributions from a SIMPLE IRA Plan**

A SIMPLE IRA plan, like a Keogh plan, is attractive to employees because they are not taxed currently on any contributions made to the plan or on any earnings in their accounts until they receive a distribution from the plan. Distributions from a SIMPLE IRA plan generally are subject to IRA distribution rules, not qualified plan distribution rules. However, special rules apply to SIMPLE IRAs that do not apply to other IRAs.

601.54 **Note:** A SIMPLE IRA is one that only accepts contributions from SIMPLE IRA plans (or rollovers from other SIMPLE IRAs). A traditional IRA or a Roth IRA (see section 610) is not subject to the rules discussed in this section. (See section 607 for a discussion of the general distribution rules for IRAs and IRA rollovers, and section 610 for an explanation of the distribution and rollover rules applicable to Roth IRAs.)

601.55 Special rollover and early distribution tax (discussed at paragraph 601.62) rules apply for distributions from SIMPLE IRAs made during the two-year period beginning on the day the employee first
participates in any SIMPLE IRA plan maintained by the employer. An employee begins participating in a SIMPLE IRA plan on the day the employer first deposits contributions to the employee’s SIMPLE IRA (IRS Notice 98-4).

601.56 If an employee terminates employment, and two years have expired since the employee first participated in the SIMPLE plan, the employee's SIMPLE IRA is treated as a traditional IRA.

601.57 During this two-year period, distributions from the SIMPLE IRA can be rolled over tax-free to another SIMPLE IRA, but not a traditional IRA [IRC Sec. 408(d)(3)(G)].

601.58 After the two-year period, a SIMPLE IRA is treated as a traditional IRA for rollover purposes. Based on this classification, a SIMPLE IRA can be rolled over to an eligible retirement plan. An eligible retirement plan includes a traditional IRA, an individual retirement annuity, a qualified pension, profit-sharing, or stock bonus plan, a governmental Section 457 plan, or a Section 403(b) annuity [IRC Secs. 402(c)(2) and (c)(8)(B)]. Rollovers to eligible retirement plans will generally be tax-free. Rollovers from a SIMPLE IRA to a Roth IRA are also permitted, but will be treated as taxable conversions. See section 607 for an expanded discussion of the rollover rules.

601.59 Caution: A transfer from a SIMPLE IRA to any other type of IRA during the two-year period is not a tax-free rollover. This means the transfer is not only taxable (and possibly subject to the 25% early withdrawal tax discussed at paragraph 601.62), but also is an excess IRA contribution to the extent it, plus other contributions made to the individual's traditional IRAs, exceeds the individual's allowable contribution limit (IRS Notice 98-4).

601.60 A rollover must take place within 60 days after the participant receives the distribution. (See section 607.)

601.61 Client Advice: The practitioner should advise taxpayers who terminate employment prior to the two-year period that before any rollover to a traditional IRA or other retirement plan, the funds must remain in the SIMPLE IRA until the two-year period is met.

601.62 Early Distribution Penalty Tax
As with any IRA, early withdrawals (i.e., distributions before age 59\(\frac{1}{2}\)) from a SIMPLE IRA generally are subject to the 10% early distributions tax unless a specific exception applies. (See section 605 for a list of the exceptions.) However, if during the initial two-year period (discussed at paragraph 601.55), a participant who is not yet age 59\(\frac{1}{2}\) receives a distribution (to which an exception does not apply), the early distribution tax is 25% (rather than 10%) [IRC Sec. 72(t)(6)].

**Example 6-7: Tax treatment of SIMPLE IRA plan distributions.**

Jane, age 28, enters her employer's SIMPLE IRA plan on January 1, 2013. Her employer makes the first deposit into her SIMPLE IRA on January 15, 2013. Jane quits on March 13, 2014, when she has $8,000 in her SIMPLE IRA. If she withdraws the $8,000, how can she avoid income tax and the penalty for early withdrawal?

Jane must roll it over into another SIMPLE IRA within 60 days. Since she has not participated in the SIMPLE IRA plan for two years, she cannot roll the proceeds over tax-free to a traditional IRA (and cannot roll it into a qualified plan). If she takes the distribution and does not roll it over to another SIMPLE IRA, the $8,000 will be subject to the 25% early distribution tax as well as income tax.

**Note:** Jane can make tax-free rollovers from the SIMPLE IRA to a traditional IRA or eligible retirement plan (see paragraph 601.58) beginning on January 15, 2015, two years after she first participated in the plan. Also, if Jane was 60 years old, instead of 28, the 25% penalty would not apply because she is over age 59\(\frac{1}{2}\). The distribution would be fully taxable, however.

601.63 **When SIMPLE IRA Plans Can Be Established**

An employer can generally establish a SIMPLE IRA plan effective on any date between January 1 and October 1 of the year. However, if an employer (or predecessor employer) previously maintained a SIMPLE IRA plan, a new SIMPLE IRA plan can be established effective only on January 1. Also, a new employer that comes into existence after October 1 can establish a SIMPLE IRA plan effective between October 1 and December 31 if the plan is established as soon as administratively feasible after the employer comes into existence.
601.64 SIMPLE IRA plans must be maintained on a calendar year basis [IRC Sec. 408(p)(6)(C)]. Accordingly, the contribution amount is determined on a calendar year basis.

601.65 **Adopting a SIMPLE IRA Plan**

An employer can establish a SIMPLE IRA plan by adopting any of the following:

a. An IRS model agreement (i.e., Form 5304-SIMPLE or 5305-SIMPLE). Such plans are referred to as model plans.

b. A prototype SIMPLE IRA plan sponsored by a qualified financial institution (e.g., a bank or mutual fund company) or an individually designed plan. Such plans are referred to as nonmodel plans.

**Choosing between a SIMPLE IRA, SEP, and One-person 401(k)**

601.66 Deciding whether to recommend a SEP, SIMPLE IRA, or one-person 401(k) is often a difficult decision, influenced by subjective assumptions about future profitability, compensation levels, and similar unknowns. However, it is possible to make some generalizations. For example, a SIMPLE IRA plan can be an excellent choice for business owners who have few or no employees and relatively low net income or compensation. But, since employer contributions are required each year under a SIMPLE IRA plan (assuming employees elect to make deferrals), problems can arise if the business has no profits. For employers that are not consistently profitable, this is a major disadvantage over a SEP where employer contributions are discretionary and need not be determined until the extended due date of the employer's return for the year to which the contribution relates. One-person 401(k) plans, on the other hand, may be advantageous when the business owner is age 50 or older, the sole proprietorship's income is high (or his compensation is high, if the business is incorporated), and the only employee is the business owner (or if there are other employees, they are family members).

601.67 Appendix 6D is a chart comparing the key characteristics of SEPs and SIMPLE IRA plans. For a comparison of maximum allowable contributions at various self-employment income levels that also includes one-person 401(k) plans, see Exhibit 6-2. The following examples illustrate some of the key distinctions between SEPs and SIMPLE IRA plans. Ultimately, the practitioner will have to rely on his or her knowledge of the client's unique circumstances to identify the best plan for each client.

**Exhibit 6-2**

*Self-employed Individuals-Maximum Plan Contributions at Various Levels of Earnings (2013)*
<table>
<thead>
<tr>
<th>Scenario</th>
<th>SE Income</th>
<th>Age</th>
<th>Type of Plan</th>
<th>Contributions</th>
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<tr>
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<tr>
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<td>Age</td>
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<td>One-person 401(k)</td>
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<tr>
<td>SIMPLE IRA</td>
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</table>

1. Assumes the individual does not make elective deferrals to any other plan. See Caution at paragraph 601.68.

2. Maximum SEP and 401(k) employer contribution rate is 25% but rate for self-employed person when applied to SE income is 20%.

3. SEP and 401(k) employer contributions = (SE income − deduction for SE tax) × 20%.

4. SIMPLE IRA employer matching contribution up to 3% of compensation = (SE income × .9235) × .03, but cannot exceed employee’s total elective deferral. Compensation limit of $255,000 does not apply.
5. Catch-up contributions not subject to $51,000 overall contribution limit; however, catch-up contribution when combined with other contributions cannot exceed 100% of individual's compensation (earned income).

601.68 Caution: When choosing a plan for a self-employed person, pay special attention to the individual's participation in other employer plans, especially those allowing elective deferrals. As discussed at paragraph 601.45, there is an overall limit on the amount of compensation an individual can elect to defer for all plans in which he or she participates. This can impact the amount of contributions allowed to the plans being considered and is likely to be more of an issue for a full-time employee with a sideline proprietorship, and who wants to establish a retirement plan with regard to the proprietorship income.

Example 6-8: Sole proprietorship with no employees and relatively low income.

Sheila, age 40, operates Newsletters Plus, a sole proprietorship that has no employees. For 2013, she expects to net approximately $20,000 (after reduction for half the self-employment tax liability). If, by October 1, she establishes a SIMPLE IRA plan for the business, she can defer up to $12,000 of her net earnings into a SIMPLE IRA. In addition, Newsletters Plus can make a 3% matching contribution to the IRA on her behalf, for a total contribution of $12,600. If Sheila instead sets up a SEP, the most she can contribute (and deduct) for 2013 is $4,000 (20% of $20,000).

Sheila could increase her allowable contribution to $20,000 [($20,000 × 20%) + 17,500, but limited to 100% of compensation ($20,000)] by establishing a one-person 401(k) plan.

Variation: If Sheila's net income (after reduction for half the self-employment tax liability) is $100,000, a SEP provides much better results than a SIMPLE IRA plan. Under a SIMPLE IRA plan, her maximum contribution would be $12,000 plus a 3% match ($3,000) for a maximum of $15,000. Under a SEP, her maximum contribution would be $20,000 (20% of $100,000).

Sheila could increase her allowable contribution to $37,500 [($100,000 × 20%) + $17,500] by establishing a one-person 401(k) plan.
Example 6-9: Partnership in which only one partner wants a plan.

Assume the same facts as in Example 6-8 except that Newsletters Plus is a partnership with Sharon as Sheila's equal partner. Sheila still wants to save for retirement, but Sharon is only interested in maximizing her cash flow. The partnership could adopt a SIMPLE IRA plan with a 2% nonelective contribution that would allow Sheila to defer up to $12,000 of her net earnings even though Sharon chose to defer nothing. (Sharon's SIMPLE IRA, however, would receive her share of the 2% partnership contribution.)

Example 6-10: Small business owner with employees not interested in saving for retirement.

Lentron, Inc. is 100% owned by Larry, age 40. In addition to Larry, the corporation has three other full-time employees who are in their late 20s and have been with the company for several years, but are more interested in current compensation than in saving for retirement. Larry, however, would like to put away as much as possible for retirement (at the lowest cost possible to the company and preferably on a tax-favored basis). With a traditional retirement plan, Lentron would have to make contributions for all of the employees even though the three nonowners presumably would not appreciate them. The same is true for a SEP, although by integrating the plan with social security, the plan could limit the contributions for the nonowners to 3% of their compensation. However, with a SIMPLE IRA, Larry could defer the lesser of $12,000 or 100% of his salary. In addition, if Lentron selected the 3% matching option, the company will match Larry's contribution dollar-for-dollar, up to 3% of his compensation. Assuming none of the nonowners elected to defer any of their compensation, Lentron would not need to make a contribution for them.

Example 6-11: Desire to establish a plan retroactively.

Bob Boomer operates Boom.com, a sole proprietorship. Bob has only short-term employees who work no more than one year for him. He had fully intended to set up a SIMPLE IRA plan at the first of the year so he could defer $12,000 and match his deferrals up to 3% of his self-employment income for the year. However, he failed to
make the decision and complete the process on a timely basis. This year his
self-employment income net of his SE tax deduction will be at least $70,000, and he
wishes he had done something prior to year end. His CPA suggests that he adopt a SEP.
He can make the decision, adopt, and fund the plan up to the extended due date of his
individual tax return. With self-employment income of $70,000 (net of the SE tax
deduction), he can contribute $14,000 (20% × $70,000) to the SEP, which is more than
he could have contributed to a SIMPLE IRA.

Other Considerations

601.69 Tax Credit for Retirement Plan Start-up Costs

A small employer who starts a new retirement plan is eligible for a nonrefundable income tax credit of up to
$500 per year for the administrative and retirement-education expenses of adopting a new qualified defined
benefit or defined contribution plan, a SIMPLE IRA plan, an annuity plan under 403(a), or a SEP.

601.70 The credit applies to 50% of the first $1,000 of qualified expenses for each of the first three years of
the plan (IRC Sec. 45E). While the credit will offset regular tax, it will not offset the AMT.

601.71 A small employer is defined as an employer that did not employ, in the preceding year, more than
100 employees with compensation of at least $5,000 [IRC Secs. 45E(c)(1) and 408(p)(2)(C)(i)].
Additionally, the plan must cover at least one nonhighly compensated employee [IRC Sec. 45E(d)(1)(B)].

601.72 Observation: Presumably, eligible expenses incurred by a plan that only covers the owner (e.g., a
plan established by a sole proprietor with no employees) do not qualify for the credit since the plan would
not cover any nonhighly compensated employees.

601.73 Qualified expenses are defined as ordinary and necessary expenses of an eligible employer, which
are paid or incurred in connection with the establishment or administration of an eligible employer plan, or
the retirement-related education of employees with respect to the eligible employer plan [IRC
Sec. 45E(d)(1)(A)]. The 50% of qualifying expenses eligible for the credit are not deductible; however, the
other 50% of such expenses (along with other expenses above the $1,000 limit) are deductible to the extent
permitted under present law [IRC Sec. 45E(e)(2)].

601.74 Note: The business does not have to be incorporated to be entitled to the credit. Thus, the credit
and deductible amounts can be claimed by a sole proprietor.

601.75 **Reporting and Disclosure Requirements**

Keogh plans (other than one-participant plans) are required to meet several reporting and disclosure requirements. Form 5500 must be filed annually (by the last day of the seventh month following the plan year-end, unless it is extended). Also, participants must be furnished (a) a summary plan description (SPD) after the plan is adopted (and at 10-year intervals thereafter, or within five years of an amendment to the plan), (b) a summary of material modifications (SMM) after the adoption of any material modification, and (c) a summary annual report (SAR) annually within nine months after the close of the plan year or within two months after the close of extension period for filing the Form 5500, if applicable.

601.76 Simplified reporting and disclosure rules apply to one-participant Keogh plans [such as a one-person 401(k) plan]. These plans cover only the sole owner of a business (whether or not incorporated) and spouse, or partners of a partnership and their spouses. One-participant plans generally must file Form 5500-EZ annually with the IRS. However, Form 5500-EZ need not be filed if the assets of the plan do not exceed $250,000 at the end of the plan year. Also, one-participant plans are not required to furnish participants with SPDs, SMMs, or SARs.

601.77 Prototype SEPs and SEPs established by completing Form 5305-SEP follow simplified reporting and disclosure requirements [IRC Sec. 408(l); Prop. Reg. 1.408-9]. Under these requirements, employers sponsoring SEPs (unlike Keoghs) are not required to file any Form 5500, nor are they required to file SPDs, SMMs, or SARs. However, certain disclosures must be made to employees. (Special reporting requirements apply to individually designed SEPs. See section 1507 of PPC’s *Guide to Small Employer Retirement Plans* for further discussion.)

601.78 If the SEP was established by completing Form 5305-SEP, the disclosure requirement upon its adoption is met by furnishing employees a copy of the executed Form 5305-SEP (including the accompanying instructions). A disclosure statement describing certain additional information the employer will provide to the employee and discussing the terms of the SEP-IRA must also be given to eligible employees.

601.79 Each calendar year, sponsoring employers of an SEP must give each participating employee a statement showing any contribution made to the employee's IRA. If the contribution is made before year-end, this requirement is satisfied by including the information on the employee's Form W-2. If the contribution is made after year-end (but before the employer's income tax return for the year is filed), the
notification should be within 30 days of the contribution and should be made on a separate statement given to each participating employee [Prop. Reg. 1.408-9(b)].

601.80 Simplified reporting and disclosure requirements also apply to SIMPLE plans. The employer maintaining the plan is not required to file any annual reports, such as Form 5500. However, the employer is required to notify employees immediately before the 60-day election period of their right to make contributions under the plan [IRC Sec. 408(l)(2)(C)]. The notice must include a copy of the summary description received from the SIMPLE trustee. See IRS Notice 98-4 for guidance on reporting and disclosure requirements for SIMPLE IRA plans.

601.81 **Fiduciary Requirements**

Fiduciaries are subject to stringent standards and duties and may be personally liable for losses to the plan resulting from breaching any of those duties. A taxpayer who sponsors a Keogh plan (other than a one-participant plan) and, in any way manages (or makes decisions as to the management of) the plan or its assets is a fiduciary.

601.82 The fiduciary rules applicable to Keogh plans generally do not apply to SEPs. However, if an employer sets up a SEP-IRA for an employee who is unable or unwilling to set up his own SEP-IRA, the fiduciary rules apply.

601.83 The employer (and any other plan fiduciary) is not subject to fiduciary liability resulting from the employees exercising control over the assets in their SIMPLE IRAs. Employees are treated as exercising control over the assets in their SIMPLE IRAs one year after the account is established or, if earlier, on the date they make an affirmative election on how to invest the contributions or elect to roll over a contribution (including a trustee-to-trustee transfer) to another SIMPLE IRA or regular IRA [ERISA Sec. 404(c)(2)].

601.84 **Note:** See sections 109, 1501, and 1510 of PPC’s Guide to Small Employer Retirement Plans for in-depth coverage of Keogh plans, SEPs, and SIMPLE IRA plans, respectively.

**Using a Charitable Remainder Trust in Lieu of a Qualified Plan**

601.85 A charitable remainder trust (CRT) can be used to meet a grantor's need for retirement income, and thus can be a useful tax planning tool for a charitable-minded business owner who wants to avoid a qualified retirement plan due to the costs of covering rank-and-file employees. (The coverage and
contribution requirements imposed by the Internal Revenue Code and ERISA on qualified retirement plans do not apply to a CRT.)

601.86 Like a qualified retirement plan, a CRT is a trust that normally is not subject to tax [IRC Sec. 664(c)]. See sections 1405 and 1406 for in-depth discussions of CRTs.