What Do We Need to Consider When Switching from a SIMPLE IRA to a 401(k)?

Facts

We've sponsored a SIMPLE IRA for our employees for years and while it's served its purpose, we are beginning to feel the limitations inherent in the plan. As we begin to grow, we'd love to be able to add provisions for eligibility and to be able to reward our key performers. I'm hesitant about making a change from this "known" commodity to a 401(k) plan but feel like we've outgrown our current plan.

Question

What should we consider when looking at a possible switch from a SIMPLE IRA to a 401(k)?

Answer

This is a question we get quite frequently. Good reason to make it a Question of the Week, right?

Plan sponsors who start with a SIMPLE IRA often reach a place where they begin to need or desire the enhancements available with a 401(k) plan. That said, the hesitation of moving forward with something that seems more complex and unfamiliar is also commonplace. Working through a brief comparison and pros/cons list can help you with this important decision.

First, the easy stuff. If your company is experiencing significant growth you may find you've literally outgrown your SIMPLE as these plans are only available to companies with fewer than 100 employees. If you find yourself in this boat, the time to make the change to a 401(k) is upon you. If that's not your situation, let's explore some of the features that may make the 401(k) more enticing anyway.

Things like eligibility, increased contribution limits, and flexible allocations are just some of the reasons sponsors elect to make the move to a 401(k) plan. Let's take these one at a time!

- Eligibility: With the 401(k) plan, sponsors define service and age requirements; this may be up to a year of service and 21 years of age. In addition, they can impose delayed entry into the plan for as long as one year after an employee's date of hire with entry on the first and seventh month of the plan year (think January 1st and July 1st for calendar year plans). Beyond this, it's also possible to restrict eligibility for certain classes of employees or to require different eligibility provisions for employee versus employer contributions. *We know that can be a lot to digest; suffice it to say that there is ample opportunity for customization for your workforce.*

- Increased Contributions: This opportunity is intriguing to many sponsors (and employees) who are looking to save more for retirement. Current limits for a SIMPLE IRA are $13,000 (or $16k for those age 50 or older) compared to $19,000 (or $15,000 for age 50+) for a 401(k) plan. The 401(k) plan also affords the company the ability to contribute up to an additional $37,000 via either a discretionary match or profit sharing contribution. The tax savings on the business owner's increased deferrals alone are often sufficient to cover any additional costs associated with a 401(k) plan. In other words, for a business owner who chooses to maximize his or her deferrals, the switch to a 401(k) plan often pays for itself.

- Flexibility in Allocations: For plan sponsors who want to control who and how much they allocate to various participants each year, the 401(k) plan provides appeal. While 401(k) plans must operate within certain parameters of non-discrimination, the options available for slicing and dicing contribution allocations are broadly available under this plan type.

While the advantages to the change from SIMPLE to 401(k) may be exciting, you may find the potential challenges of this change can cause a bit of hesitation. We get that. Most commonly, the conversations center around concerns of costs and potential administrative burdens.

In terms of cost, it's important to make a thorough review to determine the true net effect of the plan type change. For example, while there are administrative costs associated with compliance testing and Form 5500 preparation, the tax savings and deductions for the 401(k) plan are likely to outweigh these new expenses as noted above. In addition, bringing plan assets under a single record keeper contract will provide for economies of scale and improved investment options and fees, in most cases.

In terms of the potential administrative burdens, we like to think the SIMPLE IRA serves as a sponsors training wheels for a 401(k) plan and that the perceived burdens are mainly just that, perceived. Here's what we mean – like the SIMPLE, the sponsor of a 401(k) plan will need to provide enrollment opportunities, plan-related information, and remit employee contributions as well as employer contributions to the participant accounts. And, by setting up a single contract to maintain all the participant accounts (as is common in the 401(k) world), the process of remitting and reconciling deposits becomes a much more streamlined endeavor. One more thing that helps a 401(k) plan sponsor and eases the burden of a plan? Having a retirement plan consultant as a ready resource to answer questions and provide support!

While offering any type of retirement plan to your employees is a valued benefit, employees tend to be more familiar with the concept of a 401(k) plan, which increases its value to them (compared to a SIMPLE IRA). So, if you're looking to have your retirement plan benefits serve as a recruiting and retention tool, the 401(k) plan is likely to give you more bang for your buck.

When considering this change, there are a few other items to keep in mind. A sponsor cannot have both a SIMPLE IRA and a 401(k) in the same year. Given this restriction, it's best to begin exploring the various designs well before year-end so, if you do elect a change, you can implement it effective for January 1st.

Second, regardless of the reading and research you might do on plan design, it can be hard to compare hypotheticals. In this case, it can be particularly beneficial to request numerical illustrations that show the impact of changes to eligibility, employee contributions, and potential employer contributions to aid in decision-making. Including your retirement plan consultant and CPA in the discussions can ensure you take advantage of all possible tax savings benefits and strategies in your enhanced plan design.

With customization comes complexity, real and implied, and that's where your service provider makes the difference. If you currently sponsor a SIMPLE IRA but are considering a 401(k) for 2020, let DWC help you explore those options.

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