The Problems With Free and Small Retirement Plans

By Ary Rosenbaum, Esq.

There is no such thing as a free lunch. There is no such thing as free advice. The more years I spend in the retirement plan business; I know that there is no such thing as a free retirement plan. When I speak of "free" retirement plans, I'm not talking about those 401(k) plans that large insurance company providers swore was free before fee disclosure regulation made that "free" plan costly. I'm talking about those retirement plans that are geared for small businesses like a SEP-IRA or a SIMPLE-IRA. While these plans are great options for small businesses, there is a cost for them even though they are "free". This article is about the costs and caveats for these small business retirement plans.

There is always a trade-off

Whether a plan sponsor adopts a small business retirement plan or even a qualified plan such as a 401(k), there is always a trade-off. To take advantage of tax-deferred retirement savings for plan participants and tax deductions for businesses for making employer contributions, certain compliance rules plan sponsors must abide by to get that preferred tax treatment. Small business plans offer advantages over qualified plans such as almost no administrative costs, but there is a trade-off that we will certainly explain.

The notion of a "free" plan

Small business plans such as a Simplified Employee Pension Individual Retirement Arrangement (SEP IRA) or Savings Incentive Match Plan for Employees Individual Retirement Account (SIMPLE IRA) are free in the point that there is no administrative expense, almost no compliance, no Form 5500 to file, and the controlling plan document is given away for free by the custodian (usually a mutual fund company or brokerage firm) that offers it. The problem is that there is a cost for this free plan.

SEP-IRA

A SEP IRA is an Individual Retirement Account arrangement adopted by business owners to provide retirement benefits for the business owners and their employees. There are no significant administration costs for a self-employed person with no employees. If the self-employed person does have employees, all employees must receive the same benefits under this plan. Since SEP accounts are treated as IRAs, funds can be invested the same way as any other IRA. The deadline for establishing the plan and making contributions is the filing deadline for the employer's tax return, including extensions. The strictest conditions for an employee to be eligible are as follows. The employee must: be at least 21 years of age; have worked for the employer for at least three of the previous five years, and have received at least $550 in compensation for the tax year

SIMPLE-IRA/SIMPLE 401(k)

A SIMPLE IRA, like a SEP, is a type of IRA that is set up as an employer-provided plan. The plan requires a certain minimum contribution from the employer, but an employee does not have to make his or her contributions. The employer may either match the contributions of employees dollar for dollar up to 3% of the employee's compensation or the employer may contribute a flat 2% of compensation for each employee with at least $5,000 in compensation for the year, regardless of the amount the employee contributes. Unlike a SEP- IRA, a participant under a SIMPLE IRA can defer up to $14,000 for 2022. A catch-up provision is available for participants over the age of 50. The extra catch-up contribution allowed is $3,000 for 2022. The SIMPLE plan can be funded as an IRA or a 401(k). However, it makes no sense to have a SIMPLE 401(k), since the lower contribution and deferral limits of the SIMPLE are required, and there are administrative costs with having a 401(k) plan.

Solo 401(k) Plan

Another free plan is a solo 401(k) plan. While it offers the same features like a

401(k) plan in terms of contributions and salary deferral limits, it's not an option as a. plan if a company has one employee that isn't a spouse as a Solo 401(k) can only cover a business owner and their spouse and that's it. In addition, unlike the SIMPLE and SEP Plans, a 5500 Form must be filed when the plan has more than $250,000 in assets.

Problem #1: No special features

The beauty of qualified retirement plans is the ability to allow features to suit the needs of the plan sponsor. Flexibility is needed because employers have different demographic and financial needs. The problem is that these small plans have no flexibility. If an employer has union employees, SEPs and SIMPLE-IRAs would require these employees to be covered even though any qualified plan would allow the plan sponsor to make them ineligible as plan participants. SEPs and SIMPLE IRAs also don't allow plan loans or hardship distributions that participants may need during times of financial stress.

Problem #2: Uniform and Maybe Required Employer Contributions

There are two problems with employer contributions with these smaller plans: one is uniformity and the other is mandatory. When it comes to retirement plan design, some features allow for a disparity in contributions between highly paid employees and lower-paid employees where highly paid employees can get a higher rate of contribution. This can be through a contribution based on the Social Security Wage Base, age, or a cross-tested allocation where participants are split into groups and each group can get a different allocation. The problem is that SEP-IRAs and SIMPLE-IRAs require that all contributions are uniform across the board, based on the same percentage of compensation. Another problem is that SIMPLE-IRAs have a required contribution, which a plan sponsor may not have to make with a larger, qualified plan.

Problem #3: Zero Help

They say that you get what you pay for and that is often the case when a plan sponsor adopts one of these "free" plans. Since the plans require little or no administration, there is very little administration help that these plan custodians would provide because administration help does cost money. In addition, plan sponsors aren't likely to get any financial guidance since both SEPs and SIMPLEs are IRA products and participants would have to fend for themselves. As a Solo 401(k) plan sponsor, I can assure you that these plans also get zero help, on their own. While the fiduciary liability of setting these plans up is far less than a qualified plan, a lack of financial guidance to plan participants will likely mean fewer retirement savings because participants who get financial guidance have a far higher rate of return than those who don't. Plan sponsors usually have little knowledge on how retirement plans work, so having no help endangers them.

Problem #4: They Still Can Be Compliance Headaches

Why does the IRS have a SEP Fix-it guide? It's not because they aren't going to have any compliance errors. Even though SEP- IRAs, and SIMPLE-IRAs require very little plan administration, they still can have compliance errors, especially because there is no third-party administrator in charge of compliance issues. Failing to include eligible employees and related employers as well as making non-uniform contributions are just some of the errors that can occur because plan sponsors are in control of compliance. Excess contributions and failing to have an updated plan document are other errors that happen because there is no TPA looking things over. I've had major problems with clients' Solo 401(k) Plans. Again, you get what you pay for. Using these free small business plans can end up with costly compliance headaches.

Problem #5: Smaller deferral limit in SIMPLE-IRA

Unlike a SEP-IRA, the Simple plan allows for employee deferrals like a 401(k) does. The problem is that the deferral limits are lower than what a 401(k) can offer. As stated before, the deferral limit for a SIMPLE is $14,000 and $3,000 catch-up. For the 401(k) plan, the deferral limit for 2022 is $20,500 and the catch-up limit is $6,500. That means a participant over 50 can defer $27,000 in a 401(k) plan, but could only defer $17,000 if the employer offered a SIMPLE plan instead. That's a big difference.

Problem #6: The Solo 401(k) plan isn't usually the solution, but a PEP might be

While a Solo 401(k) plan is another free plan with almost zero help from the plan provider, it may not be an option for anyone with employees. However, for employers interested in a savings vehicle that offers some help, there might be an opportunity in adopting a Pooled Employer Plan (PEP), where a pooled plan provider would be the one in charge of the plan.

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