Under a SIMPLE plan, any employee with compensation of at least $5,000 must be permitted to enter a "qualified salary reduction arrangement." Under this arrangement, an employee can elect to have a percentage of compensation not in excess of $10,500 (in 2008) set aside in an IRA, instead of receiving it in cash. The $10,500 maximum will be indexed for inflation after 2008.

Amounts taken out of the employee's salary and contributed to a SIMPLE IRA are not taxed to the employee until withdrawn from the SIMPLE IRA. Early withdrawals may be subject to a 10% penalty (25%, if the withdrawal is made within the first two years).

Under a qualified salary reduction arrangement, the employer must make "matching" contributions to the SIMPLE IRA. That is, the employer must make contributions to an employee's SIMPLE IRA in the same amount as the employer contributed under the employee's salary reduction election, up to 3% of the employee's compensation. For example, if an employee with compensation of $50,000 elects to have 10% of his pay contributed to the plan ($5,000), the employer must contribute an additional $1,500 (3% of $50,000). For these purposes, an employee's compensation is the amount reported on his Form W-2, plus the amount of elective deferrals (e.g., the amount of the salary reduction contributed to the SIMPLE IRA). But the matching contribution for the year cannot exceed $10,500 in 2008 (This amount will be indexed for inflation after 2008).

If an employer wishes to contribute less than 3%, he can give employees proper notice and drop the contribution to as low as 1% of compensation, as long as this isn't done for more than two years out of the five-year period ending with the year of reduced contributions.

Alternatively, instead of making "matching" employee contributions, the employer can simply contribute a flat 2% of "compensation" (limited to $230,000 for 2008, and as adjusted for inflation in following years), for every employee eligible to participate in the plan, whether the employee elects to reduce his salary or not. Special notice must be given to employees if the employer wishes to take this approach.

Instead of adopting a simple retirement plan, an employer can set up a SIMPLE 401(k) plan. By making matching contributions (or 2% nonelective contributions) and satisfying rules similar to those for simple plans, SIMPLE 401(k) plans will be considered to satisfy the otherwise complex nondiscrimination test for 401(k) plans. The contribution rules for SIMPLE plans apply to simple 401(k) plans, except that if an employer adopts the matching contribution approach (instead of the flat 2% option), the maximum contribution percentage cannot be dropped below 3%. Unlike a SIMPLE plan, a SIMPLE 401(k) plan is part of a qualified plan, and is subject to the qualified plan rules. Contributions to SIMPLE 401(k) plans are not subject to the 15 percent limits on contributions to profit-sharing or stock bonus plans.

SIMPLE plans have the advantages of simplified reporting requirements and the absence of the qualification rules prohibiting the plan from discriminating against lower-level employees. Some employers may consider the matching contribution requirements a disadvantage. Additionally, to be eligible to adopt a SIMPLE plan, an employer must not contribute to, or accrue benefits under, any qualified retirement plan for services provided during the year (or in any year after the qualified salary reduction arrangement takes effect). But employers that maintain a plan for collectively bargained employees can maintain a SIMPLE plan for noncollectively bargained employees. A restriction similar to the "exclusive plan requirement" applies to SIMPLE 401(k) plans, but only for services provided by employees eligible to participate in the SIMPLE 401(k) plan.