

Simplified Employee Pension Plans (SEPs)

What Are Simplified Employee Pension Plans?

Simplified Employee Pension Plans (SEPs) are employer-funded plans under which an employer makes contributions to an employee's SEP-IRA (individual retirement account or individual retirement annuity).

Establishing a SEP

Sole proprietorships, partnerships, corporations, and tax-exempt organizations are all eligible to establish SEPs. The plan must be in writing and deductible contributions made by tax-filing time plus extensions. There are three options for setting up the plan:

- execute the IRS Model Agreement, Form 5305-SEP,
- execute a master or prototype plan which has received a favorable opinion letter from the IRS, or
- execute a custom-designed plan.

Either the IRS model SEP agreement or a prototype plan can be used by businesses that seek a simplified way to establish the SEP.

Ineligible Employers

Some employers are **not** eligible to use the IRS model SEP agreement, but may be eligible to use a prototype. These are employers who:

- maintain another qualified plan;
- have ever maintained a defined benefit plan;
- use the services of leased employees;
- have an eligible employee who has not established an IRA;
- are part of an affiliated service group, controlled group of corporations or are under common control unless **all** eligible employees of all such employers participate in the SEP; or
- wish to integrate SEP contributions with Social Security.

Who Can Participate in a SEP?

Every employee who is age 21 or over during the year for which contributions are made and who has performed services for the employer in three of the five years preceding the year for which contributions are made **must** participate in the SEP. Service is defined as any interval of time in which the employee has performed any work for the employer in a particular year.

Once an employee becomes eligible to participate, he or she will share in contributions only if compensation for the year is more than a specified annual threshold (\$450 for 2003, unchanged from 2002). If an employee meets these requirements, a contribution must be made on the employee's behalf for that year even if the employee is no longer employed at the time the contribution is made. There are no exceptions, even for employees who are older than age 70½.

The Purpose of a SEP

The "simplified" aspect of SEPs is the primary reason for their use. Business owners who want to establish an easy-to-administer retirement plan may be especially interested in these plans.

Some employers are reluctant to establish a retirement plan because they fear the administrative requirements associated with reporting to the IRS and Department of Labor. These employers may instead opt for a SEP because these plans provide valuable retirement benefits with a minimum of paperwork and reporting obligations.

Technically, SEPs are not qualified plans, which helps explain why they have simpler administrative requirements. Nonetheless, a SEP makes it possible for an employer to make tax-deductible contributions to an employee's retirement account. The employee benefits because—

- these contributions are not currently taxable, and
- the contributions grow on a tax-deferred basis, giving the employer a tax-favored method for providing substantial benefits to employees.

Reporting Requirements

The employer must notify employees that they are active participants in a pension plan on their W-2 forms in every year that an

employer or employee SEP contribution is made. The employer has no other reporting requirements. The trustee or issuer of the employee's SEP-IRA must report the following to the IRS on Form 5498:

- the December 31 value of the SEP-IRA;
- SEP contributions received in prior calendar year;
- regular IRA contributions made, if any, for prior tax year; and
- any rollover amounts and recharacterizations.

In addition, the SEP-IRA trustee or issuer must also report any distributions on an IRS Form 1099R.

Contribution Limits

An employer can deduct contributions to an employee's SEP-IRA up to the **lesser** of (1) 25% of compensation up to the maximum compensation that may be taken into account for each employee (\$200,000 for 2002 and 2003), or (2) the Section 415 defined contribution dollar limit (\$40,000 for 2002 and 2003). Thus, the practical limit is \$40,000. A technical correction in the Job Creation and Worker Assistance Act of 2002 increased the SEP percentage limit from 15% to 25%, an oversight in the 2001 tax law.

An employee can contribute to a personal IRA in addition to the SEP, but these contributions may not be deductible since an employee whose employer contributes to a SEP on his or her behalf is considered an active participant in an employer-sponsored qualified retirement plan. The employer is **not** obligated to make a SEP contribution each year. The employer cannot be selective about annual contributions; they must be made for all eligible employees or for none.

Highly Compensated Employees

A SEP may not allow contributions which discriminate on behalf of highly compensated employees. In other words, an employer cannot make a 10%-of-salary contribution for executives versus only 2% for clerical staff. Contributions to a SEP must bear a uniform relationship to the compensation of each employee and must be made according to a documented formula.

[Click here to review the definition of a highly compensated employee.](#)

Integration with Social Security

While contributions must meet the uniform relationship standards, the IRS allows a limited disparity with regard to contributions based on income above and below the Social Security taxable wage base. When certain conditions are met, this provision allows employers to provide a slightly higher contribution percentage on behalf of employees whose earnings exceed the taxable wage base.

Social Security integration is **not** available for employers using the IRS's model SEP document (Form 5305-SEP).

Vesting

All contributions are immediately 100% vested to the employee. The money contributed can be withdrawn at any time by the employee. However, any withdrawal is taxable to the employee when taken out, and the 10% premature distribution penalty may apply.

Funding Options

Employees may establish a personal IRA for SEP contributions, and if any eligible employee does not open an IRA, the employer must establish one for him or her. IRA rules govern SEP investments. That means life insurance and/or collectibles (with the exception of gold and silver coins issued by the U.S.) are not permitted funding vehicles for a SEP. Typical IRA investments include fixed and variable annuities, certificates of deposit, mutual funds, money market funds and securities (through a self-directed IRA).

Taxation of SEP Distributions

When an individual receives a distribution from a SEP-IRA, he or she must pay federal income tax on the proceeds in the year the payment is received. If the proceeds are paid out in a lump sum, the tax must be paid on the entire amount in one year. Averaging is not available for SEP-IRA lump-sum distributions.

If a distribution is taken before the employee reaches age 59½, the amount withdrawn is subject to ordinary income tax **and** a 10% penalty tax unless the amount—

- was paid due to death or disability;
- is part of a series of substantially equal periodic payments which have been calculated based on life expectancy;
- is used to pay unreimbursed medical expenses in excess of 7.5% of adjusted gross income;
- is used to purchase health insurance for an unemployed individual;

- is used for qualified higher education expenses; or
- is used within 120 days to pay the acquisition costs of a first-time home buyer.

An individual must begin receiving payments of a minimum required amount from a SEP-IRA by April 1 of the year following the calendar year in which he or she reaches age 70½ (not the later of 70½ or year of retirement as with qualified retirement plans). If this does not happen, a 50% penalty tax is imposed on the amount that should have been paid out but which was not for the year. If it can be proven that the failure to make the minimum distribution was due to reasonable error, the IRS may waive the excise tax (see IRS Form 5329 for further information). Contributions must continue for those who work past age 70½, even though distribution has begun.

[Click here to jump to a detailed discussion of the required minimum distribution rules.](#)

Review of SEP Advantages

- minimal paperwork and bookkeeping
- flexibility regarding employer's decision to contribute each year
- tax-deductible contributions for the employer
- contributions not currently taxable to the employee
- tax-deferred accumulation of funds.

Review of SEP Disadvantages

- virtually all employees, including part-time employees, must be covered under the plan, which could be quite costly
- employees are fully vested immediately, which means the employer has no protection from high turnover
- protection of SEP assets from creditors is not as great as under a qualified retirement plan subject to ERISA
- employer flexibility with regard to contributions could be detrimental to employees in that a lack of commitment would prevent the plan from providing the retirement security originally intended.

SARSEP: The Salary Reduction SEP

Salary Reduction SEPs (SARSEPs) that were established by smaller businesses before 1997 may continue to be funded, and new employees may elect to participate in such plans, even if they were hired after December 31, 1996. However, new SARSEPs may not be established after 1996, having been replaced by the newly authorized SIMPLE (Savings Incentive Match Plan for Employees) retirement plans. The rules below remain applicable to pre-1997 SARSEPs protected by grandfather rules in the tax law.

Participation and Contributions

Employers with 25 or fewer employees who were eligible to participate at any time during the previous calendar year can maintain Salary Reduction SEPs. Under this plan, each eligible employee may elect either to have contributions made to the plan or have that amount paid to them in cash.

At least half of the eligible employees must elect to defer income to the plan.

SARSEP Deferral Amount

The salary reduction SEP arrangement is very similar to a 401(k) plan. SARSEP elective deferrals are not currently taxed to the employee. The salary reduction amount is limited to an annual maximum in accordance with the following table:

<u>Year</u>	<u>Deferral Limit Under Age 50</u>	<u>Deferral Limit Age 50 and Over</u>
2002	\$11,000	\$12,000
2003	\$12,000	\$14,000
2004	\$13,000	\$16,000
2005	\$14,000	\$18,000
2006	\$15,000	\$20,000

Technically, a plan may not permit additional catch-up contributions (elective deferrals) by persons age 50 and over for a particular year that are greater than the lesser of—

- the maximum incremental dollar amount allowable (i.e., \$2,000 for 2003), or
- the excess of the individual's compensation for the year over other elective deferrals made for the year, ignoring the additional catch-up amount.

After 2006, the basic elective deferral limit (\$15,000) and age-50+ catch-up amount (\$5,000) will be indexed to inflation in \$500 increments, rounded down to the next lowest multiple of \$500.

A plan is not required to allow additional "catch-up" contributions by participants age 50 and over; it is merely permitted to do so. A participant is deemed to be age 50 for a particular year if he or she turns 50 during that year.

Nondiscrimination Test

In a SARSEP the deferral percentage for each of the eligible "highly compensated employees" cannot exceed 125% of the average deferral percentage for all other eligible employees. The deferral percentage with respect to a particular employee is the amount of that employee's elective deferrals for the year, divided by the employee's total compensation for the year. Note that this is NOT the same as the nondiscrimination test for a 401(k) plan.

A highly compensated employee is defined as someone who—

- owns more than 5% of the employer's business, or
- receives compensation of more than \$90,000 (for 2003, unchanged from 2002) and, if the employer so elects, is a member of the top-paid 20% group of employees.

Graphic: How the SEP Works

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