Simplified Employee Pensions

SEPs

What Small Businesses Need To Know

U.S. Department of Labor
Pension and Welfare Benefits Administration

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This booklet constitutes a small entity compliance guide for purposes of the Small Business Regulatory Enforcement Fairness Act of 1996.

SEPs

Simplified Employee Pensions

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Introduction

Simplified Employee Pensions - known as SEPs - represent an easy, low-cost retirement plan option for employers. Instead of establishing a separate retirement plan, in a SEP the employer makes contributions to his or her own traditional Individual Retirement Account (IRA) and the IRAs of his or her employees, subject to certain percentages of pay and dollar limits. Employers who establish SEPs can:

- ❐ Make tax deductible contributions to their own and their employees' IRAs.
- ❐ Omit or reduce contributions in years when contributions are unaffordable.
- ❐ Avoid the administrative costs and the reporting requirements of conventional plans.

Whether a SEP is appropriate for your business will depend on factors such as revenue, firm size and the age, compensation and retirement needs of the business owner and work force. You may want to discuss other retirement plan options with a professional advisor.

WHAT ARE SEP-IRAs

SEPs are retirement programs established by you, as an employer, which allow you to provide retirement benefits for yourself and your employees without paying the start-up and operating costs of conventional plans.

SEPs allow an employer to establish and make contributions to traditional IRAs (Roth IRAs cannot be used with SEPs). The two critical differences between SEP-IRAs and other IRAs are:

- ❒ SEP contributions are generally made by employers, not employees.
- ❒ The amounts contributed to IRAs under SEPs can be much larger than the amounts contributed without a SEP.

As a general rule, up to 15 percent (25 percent after 2001) of each employee's pay - including your own - can be put into a SEP-IRA each year.

WHY SET UP A

Advantages for you as an employer

- A SEP can provide a significant source of income at retirement.
- Contributions to a SEP are tax deductible and your business pays no taxes on the earnings on a SEP's investments.
- You are not locked into making contributions in future years. You can decide each year whether to pay into the SEP and how much to contribute.
- Once you put money into a SEP you have no further responsibility for the amounts contributed. The funds are managed by a financial institution.
- A SEP can be established and operated without the administrative expenses, consulting fees or commissions usually associated with maintaining a conventional retirement plan.
- Beginning in 2002, small employers with no more than 100 employees may be eligible for a tax credit for costs incurred of up to 50 percent of start-up costs.
- You ordinarily do not have to file any documents with the government.
- SEPs can be set up by sole proprietors, partnerships and corporations, including S corporations.
- You can deduct contributions to a SEP for a previous tax year if you make contributions by the due date of the employer's tax return, including any extensions.

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Advantages for your employees

- The money you contribute to your employees' SEP accounts, as well as the investment earnings, belongs to them - even if they stop working for you.
- Employers' contributions to the SEP-IRA are not included in employees' income for income tax purposes.
- Employees pay no taxes on the amounts in their SEP accounts until they start withdrawing the funds.
- Employees can change the financial institution where their SEP is invested.
- In case of an employee's death, the assets in a SEP will go to someone the employee has chosen.
- SEP contributions can continue until employees retire, but they must start withdrawing assets from a SEP when they reach age 70½.
- Some employees may be eligible for a nonrefundable tax credit of up to $1,000 for making elective deferrals to a SEP beginning in 2002.
- Employees age 50 and older can make increased or "catch up" contributions beginning in 2002.

ESTABLISHING A

You can set up a SEP by using the Internal Revenue Service's "model SEP" agreement Form 5305-SEP. All you have to do is:

(1) Decide the percentage of pay you want to contribute to the SEP. The contribution is limited to 15 percent of pay or $25,500 (for 2001), (25 percent of pay or $40,000 for 2002), whichever is smaller. A uniform percentage of pay must be contributed for each employee.

(2) Fill out Internal Revenue Service Form 5305-SEP, a short form with instructions. This form is not filed with the Internal Revenue Service.

(3) Set up an IRA at a financial institution to receive your SEP contributions. An IRA can be set up by or for your employees to receive the contributions you make for them.

(4) Mail the SEP contributions to the financial institutions.

(5) Give employees eligible to be included in the SEP a completed copy of the Form 5305-SEP and the other documents and disclosures listed in the instructions, including an annual statement to each participating employee of the amounts contributed to their account for the year.

No other reporting or disclosure ordinarily is required.

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You cannot use the IRS "model SEP" if you currently maintain any type of qualified retirement plan or use the services of leased employees. You also cannot use the model SEP if you have any eligible employees for whom accounts have not been established. For this purpose, eligible employees include certain individuals who have a specific relationship to the employer. For example, eligible employees for purposes of SEP con-tributions include employees or an "affiliated" or "commonly controlled" group of employers of which you are a member. These are technical terms that are defined in the Internal Revenue Code. If you believe any of these terms apply to you, you should consult a professional advisor.

Although using the IRS Form 5305-SEP is an easy way to set up a SEP, you do not have to use this model agreement. Many financial institutions have their own SEP arrangements that have been approved by the Internal Revenue Service.

If you use a non-model SEP, the law allows you to take into account Social Security contributions you made for your employees. If you want to do this, consult your professional advisor.

WHO MUST BE INCLUDED IN A SEP

Generally, any employee who performs services for certain affiliated or commonly controlled employers (see the discussion on page 5 regarding these terms) must be included in a SEP. However, there are five exceptions to this general rule. Employers may exclude from the SEP:

- ❒ Employees who have not worked for the company during 3 out of the last 5 years.
- ❒ Employees who earn less than $450* (for 2001) a year.
- ❒ Employees who have not reached age 21 during the calendar year for which contributions are made.
- ❒ Employees covered by a collective bargaining agreement, if retirement benefits were the subject of good-faith bargaining.
- ❒ Nonresident aliens who do not earn U.S. source income from you.

* This number is indexed for inflation each year.

SALARY REDUCTION SEPs

Starting January 1, 1997, employers may no longer set up Salary Reduction SEPs. However, the Small Business Job Protection Act of 1996 (Public Law 104-188) permitted employers to establish SIMPLE IRA plans beginning in 1997. A SIMPLE IRA plan allows salary reduction contributions of up to $6,000* annually ($7,000 in 2002).

* This number is indexed for inflation each year.

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INVESTMENTS

Financial institutions authorized to hold and invest SEP contributions include banks, savings and loan associations, insurance companies, certain regulated investment companies, federally insured credit unions and brokerage firms. SEP con-tributions can be put into stocks, mutual funds, money market funds, and other similar types of investments.

You and your employees will receive a statement from the financial institutions investing your SEP contributions both at the time you make the first SEP contributions and at least once a year after that. Each institution must provide a plain-language explanation of any fees and commissions it imposes on SEP assets withdrawn before the expiration of a specified period of time.

COMMONLY ASKED QUESTIONS ABOUT

- ❐ If an employer maintains a SEP for its employees, can the employees also make contributions to Individual Retirement Accounts?

  Yes. If the employees choose to do so, they may combine IRA and SEP contributions in one account. NOTE: Because SEP contributions make an individual an "active participant in a qualified plan" for IRA purposes, IRA contributions of certain employees may not be tax deductible. See IRS Publication 590.

- ❐ Can an employee eligible to participate in a SEP choose not to participate?

  No. All eligible employees must participate. An employer can set up an IRA for the employee at a financial institution and make the appropriate contribution.

- ❐ Does the employer have to pay Social Security or Federal unemployment compensation taxes on SEP contributions for employees?

  No.

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- Do employers in companies with Salary Reduction SEPs have to pay Social Security taxes on their employees' pre-tax contributions?

  Yes. In addition, employees have to pay their portion of Social Security taxes.

- When are income taxes paid on money in a SEP account?

  Income taxes are paid when money is withdrawn from a SEP account.

- When can money be withdrawn from a SEP account?

  SEP money can be withdrawn without penalty at age 59½. Earlier withdrawals are generally subject to a 10 percent additional income tax unless the participant becomes disabled or receives distributions in the form of an annuity that are part of substantially equal payments over life or life expectancy.

FOR MORE INFORMATION ABOUT

SEPs

Call the nearest office of the Internal Revenue Service, go to their Web site at **www.irs.gov** or call 1-800-TAX-FORM for Publication 590 and Form 5305-SEP if you are interested in the IRS model SEP. This form and its instructions will help you understand how SEPs work.

For additional copies of this booklet, call the Pension and Welfare Benefits Administration's toll free publications line at **1-800-998-7542** or go to the Web site at **www.dol.gov/dol/pwba**.