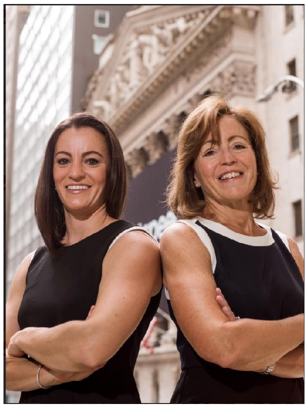

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Simplified Employee Pension Plans (SEPs)

A simplified employee pension (SEP) is a written plan that allows small-business owners to make retirement contributions to traditional IRAs (SEP-IRAs) set up for themselves and for each eligible employee. These contributions may be deducted from your business's income and excluded from your employees' income. A SEP may not only provide you a tax-advantaged way to save for your own retirement, but may also help you attract and retain qualified employees by providing for their retirements. And it may help your business avoid some of the complexities posed by certain other employer-sponsored retirement plans.

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Who can establish a SEP?

You can establish a SEP if you're an employer or you have self-employment income. "Employer" includes a sole proprietor, a partnership, a C corporation, an S corporation, a limited liability company, and a limited liability partnership. You don't need employees to set up a SEP, but if you do have them, all eligible employees must be included as SEP participants.

How do I set up a SEP plan?

Setting up a SEP plan is fairly easy. You may be able to establish a SEP by (1) simply signing IRS Form 5305-SEP, Simplified Employee Pension — Individual Retirement Accounts Contribution Agreement; (2) adopting a prepackaged prototype SEP from a bank, insurance company, financial institution, or other company; or (3) creating a custom-designed SEP. The easiest way is to use Form 5305-SEP. You can use this Form if you don't maintain any other retirement plans, don't use leased employees, and meet certain other IRS requirements.

You have until the due date of your business's federal income tax return (including extensions) to set up a SEP and make contributions. By contrast, an ordinary IRA contribution can't be made later than the due date of your federal income tax return, with no extensions (generally April 15). So if you're self-employed and file for an extension you could have until October 15 to make a SEP contribution to your SEP-IRA.

Which employees must I include in the plan?

In general, you must include all employees who have (1) reached age 21, (2) worked for you at least three of the last five years, and (3) received a minimum amount of pay (at least $650 for 2021) from you for the year the contribution was made. An employee who meets the criteria above in any year must be covered under the SEP for that year even if he or she is not employed by you at the end of the year.

How do I contribute to my plan?

In order to avoid discrimination rules, most employers determine a contribution percentage for a year, and apply that same rate to all employees. However, contribution formulas can be more sophisticated and can even be integrated with Social Security (you'll likely need professional assistance if you adopt a nonstandard contribution formula). Your contributions to the SEP are pre-tax dollars. This means that your employees can exclude your contributions from their gross income. In addition, the funds can grow tax deferred. Employer contributions and earnings are taxed when distributed from the SEP-IRA.

How much can I contribute to a SEP?

You can contribute up to 25% of compensation or $58,000, whichever is less, to an employee's SEP-IRA in 2021 (up from $57,000 in 2020). Generally, when calculating the amount you can contribute in 2021, you can consider only the employee's first $290,000 of compensation (up from $285,000 in 2020).

If you're self-employed, contributions to your own SEP-IRA are calculated differently. While the above limits also apply to you, your compensation is considered to be your net earnings from self-employment. Basically, your net earnings from self-employment represent the net income you earned in the business that established the SEP, less the deduction for contributions to your SEP and the

Prior to 1997, SEPs could include salary reduction arrangements (SARSEPs), under which employees could elect to have you contribute part of their pay to their SEP-IRAs. New SARSEPs, however, can no longer be established (although those established before 1997 can continue to operate provided there are no more than 25 eligible employees at any time during the prior taxable year).

deduction allowed to you for one-half of the self-employment tax. This effectively reduces your maximum contribution rate to 20% of compensation or $58,000 (in 2021), whichever is less.

Can my employees contribute?

SEPs are not like 401(k) plans — your employees cannot elect to contribute pre-tax dollars to a SEP-IRA from their pay.* However, your employees can make normal annual IRA contributions to their SEP-IRAs, just as they can to any other traditional IRA. But SEP-IRAs cannot accept Roth contributions.

What are some advantages of a SEP?

SEPs offer several advantages:

- **You don't have to make contributions to the SEP every year.** You choose whether or not to make a contribution and, if so, how much to contribute. However, if you do make a contribution, it must be allocated among all participating employees according to a written allocation formula and must not discriminate in favor of highly compensated employees.
- **Reporting requirements are minimal.** Reporting requirements are fairly easy to satisfy. In fact, if you use Form 5305-SEP, you don't even file the form with the IRS.
- **Contribution/deduction limits are high.** The contribution limits are much higher than those applicable to traditional IRAs and SIMPLE IRA plans, and are similar to those applicable to qualified retirement plans.
- **A SEP does not preclude you or your employees from establishing or contributing to a separate IRA.** In addition to any contribution made by the sponsoring business to your SEP-IRA, you and your employees can contribute up to the $6,000 annual maximum for 2021 (plus an additional $1,000 catch-up contribution for those age 50 or older — both unchanged from 2020) — or 100% of compensation, whichever is less, to either the SEP-IRA or separate IRA accounts. However, bear in mind that in any year for which SEP contributions are made, you and any of your employees participating in the SEP are considered to be covered by an employer-sponsored retirement plan. That means the deductibility of traditional IRA contributions will be subject to the IRA phase-out rules.
- **Generally, you don't have fiduciary responsibilities for your employees' investment decisions.** After you adopt a SEP plan, your employees typically set up individual SEP-IRAs (traditional IRAs) to accept contributions. Once your employee sets up a SEP-IRA account, he or she makes the investment decisions and bears all the risk of loss.

What are some disadvantages?

- **You must include all eligible employees in the SEP.** The rules for including employees in a SEP plan are generally more inclusive than the corresponding requirements for other employer-sponsored retirement plans. For example, in some cases, more part-time workers must be included in a SEP. As noted earlier, you may even have to include and make contributions for terminated employees. However, you don't have to include an employee in your SEP plan until he or she has worked three years for you.
- **Your employer contributions vest immediately.** Unlike a qualified retirement plan such as a profit sharing plan, which generally allows vesting over time, your employees are immediately vested in SEP plan contributions. Once you make a contribution, it belongs to the employees. Consequently, a SEP might not be the best choice if your goal is to encourage employees to remain with your company long term by having vesting occur more gradually. Immediate vesting can also be costly if you have high employee turnover.
- **All eligible employees must set up a SEP-IRA or modify an existing IRA to accept SEP contributions.** The failure of even one qualifying employee to set up his or her own SEP-IRA or to modify a traditional IRA into a SEP-IRA may defeat the entire SEP. You can set up an IRA for an employee, but doing so may rob a SEP of its fundamental simplicity. It also means that you may incur certain fiduciary obligations.