Simplified Employee Pension (SEP)
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What is it?

A simplified employee pension (SEP) is a written plan that allows employers to make retirement contributions to individual retirement arrangements (called SEP-IRAs) set up for each eligible plan participant. These contributions may be deducted from the business's income and excluded from the employee's income. In addition, eligible employees can make traditional IRA contributions to their existing SEP-IRA accounts. Although SEP-IRAs can accept higher annual contributions than traditional IRAs, SEP-IRAs are subject to most of the procedures and federal income tax rules that apply to traditional IRAs.

A SEP may not only provide you with 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.

Caution: Prior to 1997, SEPs could include salary-reduction arrangements (SAR-SEPs), under which employees could elect to have you contribute part of their pay to their SEP-IRAs. SAR-SEPs, 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). Special rules apply to SAR-SEPs—seek the assistance of a tax professional.

Who can establish a SEP?

You can establish a SEP if you're an employer or if you have self-employment income.

Employers

An employer can set up a SEP. "Employer" includes a sole proprietor, a partnership, a C corporation, an S corporation, a limited liability company, and a limited liability partnership. Although you do not have to have employees to set up a SEP, if you do have them, you must include all eligible employees as participants in the SEP.

Self-employment income can qualify

If you're self-employed, with or without employees, you can set up a SEP plan for yourself and make contributions to the plan. You're considered to be self-employed if you're a sole proprietor or a partner (the partnership establishes the SEP), or are otherwise in business for yourself. Self-employment income can also involve part-time work. If you have self-employment income, a SEP is really an IRA with a higher contribution limit. Think of it as a "super IRA."

What are some advantages of a SEP?

SEPs offer several advantages:

You don't have to make contributions to the SEP every year

A SEP does not require mandatory contributions each 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 not discriminate in favor of highly compensated employees. See Questions & Answers.

You can establish a SEP and contribute to it after year-end

You have until the due date of your business's federal income tax return (including extensions) to set up a SEP and make contributions. In contrast, an ordinary IRA contribution can't be made later than the due date of your federal income tax return, without regard to extensions (generally April 15). So, if you're self-employed, you could potentially have until October 15 for federal income tax purposes to make a SEP contribution to your SEP-IRA.
Tip: Other types of employer-sponsored retirement plans generally must be established by the end of the business's tax year if the business is to take a deduction for contributions made for that year.

SEPs are fairly easy to establish

You may be able to set up a SEP by (1) 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 Form 5305-SEP if you don't maintain any other retirement plans, don't use leased employees, and meet certain other IRS requirements. See Questions & Answers.

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. For more information, see How do you establish a SEP?, below.

Contribution/deduction limits are high

For 2011 (and 2010) you can contribute to an employee's SEP-IRA and deduct up to the lesser of (1) 25 percent of an employee's compensation (20 percent for yourself if you are a self-employed individual contributing to your own SEP-IRA) or (2) $49,000.

Generally, you can consider up to $245,000 in compensation in calculating the contribution that can be made for yourself or an employee to a SEP-IRA (for 2010 and 2011). Excess contributions may be subject to a penalty. See Questions & Answers for a more detailed explanation of the contribution/deduction limits.

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 each contribute up to the annual maximum of $5,000 for 2010 and 2011 (plus an additional $1,000 catch-up contribution for those age 50 or older), or if less, 100 percent of your compensation, 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 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 phaseout rules.

Caution: Your employees can not make Roth contributions to a SEP-IRA.

Employer contributions can be made after age 70½

You can make contributions to the SEP on behalf of your employees after they reach age 70½, and even for yourself after age 70½ as long as you continue to have self-employment income. In contrast, contributions to a traditional IRA can’t be made past age 70½.

Caution: The required minimum distribution rule applies to SEPs. Therefore, although contributions to a SEP-IRA may be made after age 70½, minimum distributions must start by April 1 of the year after you reach age 70½.

Generally, you don't have fiduciary responsibilities for your employees' investment decisions

If you establish a SEP, your employees can set up individual SEP-IRAs. If your employee sets up a SEP-IRA account, he or she makes the investment decisions and bears all of the risk of loss.

Caution: If you have to set up an IRA account for an employee, you may have certain limited fiduciary responsibilities. See How do you establish a SEP?, below.

Pretax dollars are contributed and grow tax deferred

Your contributions to the SEP are pretax dollars--this means that your employees can exclude your employer contributions from their gross income. In addition, the funds can grow income tax deferred. (Employer contributions and earnings will be taxed when distributed from the SEP-IRA.)
SEPs may offer more protection from creditors than non-SEP IRAs in the event of bankruptcy

Funds held in a SEP plan are fully shielded from an employee's creditors under federal law in the event of the employee's bankruptcy. This is in contrast to non-SEP traditional and Roth IRA funds, which are generally protected only up to $1,171,650 (as of April 1, 2010) under federal law, plus any amounts attributable to a rollover from an employer qualified plan or 403(b) plan. (Non-SEP IRAs may also have additional protection under state law.)

What are some disadvantages of a SEP?

You must include all eligible employees in the SEP

All eligible employees must be included in the SEP. The SEP rules for including employees in participation 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. You may even have to include and make contributions for terminated employees. For more information, see Questions & Answers.

**Tip:** However, you don't have to include an employee in your SEP plan until he or she has worked for you for three years.

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 induce 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 defeats the entire SEP. An employer can set up an IRA for an employee, but doing so robs a SEP of its fundamental simplicity. It also means that you incur certain fiduciary obligations.

Employees can't make pre-tax or Roth contributions to a SEP-IRA

An employee can't elect to have pretax dollars contributed to a SEP directly from his or her pay. (However, there's another kind of SEP, a SAR-SEP, that allows employee contributions in some cases--see below.) Employees can also set up their own separate traditional and Roth IRAs. In either case, an employee can make a contribution of up to the annual maximum ($5,000 for 2011; $6,000 if age 50 or older). The deductibility of an employee's IRA contribution is subject to the IRA phaseout rules for persons participating in an employer-sponsored retirement plan.

**Caution:** Prior to 1997, SEPs could include salary-reduction arrangements (SAR-SEPs), under which employees could elect to have you contribute part of their pay to their SEP-IRAs. SAR-SEPs, 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).

SEPs may offer less protection from creditors than non-SEP IRAs outside of bankruptcy

Many states have enacted legislation specifically protecting IRA assets from creditors. These laws clearly apply to IRAs that an employee establishes outside of a SEP plan. However, there is some question whether these laws apply to SEP IRAs. The reason for the ambiguity is that SEP plans are considered "pension plans" for purposes of the Employee Retirement Income Security Act of 1974 (ERISA). While SEP plans are exempt from most of ERISA's provisions, they are covered by ERISA's preemption rules. These rules preempt (that is, render inapplicable) all state laws that "relate to" ERISA plan benefits. It is possible, then, that state laws that provide SEPs with protection from creditors are preempted by ERISA. If this is the case, then SEP IRAs would be fully protected from creditors under federal law in the event of bankruptcy, but would have no protection from creditors under state law outside of

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bankruptcy. If creditor protection is important to you, be sure to consult a qualified professional before establishing a SEP plan. Note: if your SEP plan covers only you (or you and your spouse), then your plan is not subject to ERISA, and your SEP IRA should be entitled to any creditor protection your state's laws provide.

**Tip:** Qualified employer plans subject to ERISA provide virtually total protection from an employee's creditors, regardless of whether the employee has filed for bankruptcy.

### How do you establish a SEP?

**Establish the SEP by the due date (including extensions) of your federal income tax return**

You must set up the plan and make contributions to it by the due date of your business's federal income tax return to take a deduction for that year. With a SEP, an extension of time to file your business's income tax return also extends the period allowable for establishing and making contributions to the business's SEP.

**Each eligible employee must set up an IRA with a qualified sponsor**

All employees who must be covered by a SEP (see Questions & Answers) can establish their own SEP-IRAs with a bank, insurance company, or other qualified financial institution. Alternatively, existing IRAs can be modified to accept SEP contributions. Usually, though, employee IRAs are set up as separate accounts in a group IRA. IRS regulations do allow an employer to set up an IRA for an employee to keep a SEP from being disqualified.

**Determine whether you can use IRS Form 5305-SEP**

You should determine whether you can use Form 5305-SEP. This form satisfies all SEP requirements (if no modifications are made). Form 5305-SEP does not need to be filed with the IRS, but you must keep a permanent copy. For self-employed individuals who do not have employees, this is probably the most efficient route to take. You can use Form 5305-SEP if you don't maintain any other retirement plan, don't use leased employees, and meet certain other IRS requirements.

**If you can't use Form 5305-SEP, consider adopting a master or prototype SEP**

Banks, savings and loan associations, insurance companies, credit unions, and other financial institutions offer prepackaged, preapproved SEP plans. Individually designing a SEP plan is complicated and expensive, requiring the assistance of an attorney and IRS approval.

**Provide a copy of Form 5305-SEP and a statement to your covered employees**

If you're using Form 5305-SEP, you must provide each employee covered by the SEP (and any employee who subsequently becomes eligible to participate) with a copy of the form, the questions and answers that are printed on the form, and a statement each year showing the contribution made for the employee to the SEP. You must also provide each employee with certain information, such as a statement explaining that:

- IRAs other than the IRA into which you are contributing SEP contributions may provide different rates of return and different terms
- In addition to the other information being provided, the administrator of the SEP will provide a copy of any amendment to the plan
- The administrator of the plan will provide written notice of any employer contributions to the SEP

**Tip:** Details regarding this required information can be found in the instructions to Form 5305-SEP.

**If you don't use Form 5305-SEP, you must provide covered employees with specific information**

If you don't set up your SEP with Form 5305-SEP, in order to avoid detailed ERISA reporting requirements you must provide employees covered by the SEP must be provided with certain information, such as:

- Notice that a SEP has been established and the person designated to address questions
The requirements for employee participation in the SEP

The formula to be used in allocating contributions

The general information contained in the Question and Answer section of Form 5305-SEP

You must also give each employee a statement explaining that:

- IRAs other than the IRA into which you are making SEP contributions may provide different rates of return and different terms
- In addition to the other information being provided, the administrator of the SEP will provide a copy of any amendment to the plan
- The administrator of the plan will provide written notice of any employer contributions to the SEP

Tip: Details regarding this required information can be found in Department of Labor regulation section 2520.104-49.

Make annual disclosures

Each year, either you or the institution that administers the SEP must inform employees in writing of all employer contributions to their SEP-IRAs. This must be done by January 31 of the year following the year that the contribution is made or (if later) 30 days after the contribution is made. Fortunately, the financial institution administering the SEP will probably take care of this for you.

What are the tax considerations?

Income Tax

Contributions to a SEP can be deducted from income

Subject to the allowable limits, your business may deduct the contributions it makes to employees' SEP-IRAs. If you're self-employed, you may also deduct the contributions you make to your own SEP-IRA. See Questions & Answers.

For 2011 (and 2010) you can contribute to an employee's SEP-IRA and deduct up to the lesser of (1) 25 percent of an employee's compensation (20 percent for yourself if you are a self-employed individual contributing to your own SEP-IRA) or (2) $49,000. Generally, you can consider up to $245,000 in compensation in calculating the contribution that can be made for yourself or an employee to a SEP-IRA for 2011 (and 2010).

An employee may or may not be able to deduct his or her own contributions to a SEP-IRA (or to a separate traditional IRA). The SEP is considered a qualified plan for purposes of the IRA deduction rules, so the deductibility of an employee's contributions is subject to the traditional IRA phaseout rules.

SEP-IRA accounts accrue tax deferred

Contributions to SEP-IRAs, including earnings, are not subject to income tax until withdrawn.

Income tax is due as distributions are made

Distributions taken from a SEP-IRA are subject to income tax.

A 10 percent premature distribution tax may be assessed on distributions made prior to age 59½

Distributions made prior to reaching age 59½ are subject to the federal 10 percent premature distribution tax (unless an exception applies). Check with your state to see if a state penalty also applies.
Your business may qualify for the small employer pension plan start-up tax credit

If you establish a new SEP, you may be eligible to receive a tax credit of up to $500 (50 percent of the first $1,000 of qualified start-up costs to create or maintain the plan) in three tax years. The credit may be claimed for qualified costs incurred in each of the three years starting with the tax year when the plan became effective.

You or your employees may qualify for the tax saver's credit for IRAs and retirement plans

Some low- and middle-income taxpayers may claim a federal income tax credit ( "Saver's Credit") for contributing to a SEP-IRA (or to certain other employer-sponsored retirement plans).

Gift and Estate Tax

SEP-IRA proceeds are included in determining if estate tax is owed when you die

The full value of your SEP-IRA is added to your other assets when you die to determine if estate tax is due.

Questions & Answers

How do you determine which of your employees must be covered by a SEP?

There are different rules for the different classes of employees, as follows:

- Qualifying employees: All qualifying employees must be covered by a SEP. A qualifying employee is an employee who has: Reached age 21
  - Worked for you in at least three of the last five years, and
  - Received a minimum amount of pay (at least $550 for 2011) from you as the employer for the year the contribution was made

  **Tip:** While you must include qualifying employees in a SEP, you can always establish participation requirements that are less restrictive than those listed above. If, for example, you want to allow employees over the age of 18 to participate, you may.

  **Caution:** 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.

  **Example(s):** Employee Smith is 30 years old and has worked for you for 7 years. In June, you fire Smith. In August, you set up a SEP for your remaining employees. If Smith received more than $550 in compensation for the year, he must be included in the SEP.

- Leased employees: An employee leased from an employment organization generally must be included in the SEP if he or she provided substantially full-time services for you for at least one year and worked under your primary direction or control. (Certain exceptions apply.)

- Excludable employees: You don’t have to include an employee in a SEP if he or she is covered by a union agreement (and his or her retirement benefits were bargained for in good faith by you and the union), or is a nonresident alien employee who has no earned income from U.S. sources.

How much can you contribute to a SEP?

It depends. Contributions that you make to an employee's SEP-IRA cannot exceed the lesser of 25 percent of the employee's compensation or $49,000 (in 2011). (Don't include your contribution to the employee’s SEP when calculating the 25 percent of compensation.) Generally, you can only consider an employee's first $245,000 in compensation in calculating the amount of contribution that you can make to a SEP (in 2011).

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 that you earned in the business that established the SEP, less the deduction for contributions to your SEP and the deduction allowed to you for one-half of the self-employment tax. This effectively reduces your maximum contribution rate to 20 percent of compensation or $49,000 (in 2011), whichever is less.

**Tip:** The calculation of a self-employed individual's deductible contribution can sometimes be complex, especially if you have employees or if your plan is integrated with Social Security. Your tax advisor should be able to assist you in making these difficult calculations. The IRS also provides worksheets in Publication 560.

**What are the definitions of highly compensated employee, key employee, and top-heavy plan, and why are these definitions important?**

There are nondiscrimination rules requiring that plan contributions not discriminate in favor of shareholders, officers, or highly compensated employees. Typically, the nondiscrimination rules are satisfied by providing either an equal percentage of pay or a flat dollar amount for all participating employees. The allocation formula can also take Social Security into account (called “permitted disparity”). In very general terms, this allows you to make larger contributions for employees earning more than the Social Security taxable wage base (or some percentage of the taxable wage base).

Plans that are top-heavy have additional requirements, including a minimum contribution of 3 percent of compensation for each participant who isn't a key employee.

For 2011, a highly compensated employee is an individual who:

- Was a 5 percent owner of the employer during 2010 or 2011, or
- Had compensation in 2010 in excess of $110,000 and, at the election of the employer, was in the top 20 percent of employees in terms of compensation for that year. (This $110,000 limit is subject to cost of living adjustments each year.)

A key employee is an individual who:

- Is a 5 percent owner of the employer
- Is a 1 percent owner of the employer with annual compensation of more than $150,000, or
- Is an officer of the employer with compensation in excess of $160,000 (for 2010 and 2011)

With a top-heavy SEP, for a plan year:

- The sum of the account balances of participants who are key employees for the plan year exceeds 60 percent of the total sum of account balances for all employees under the plan, or
- The plan is part of a top-heavy group

**How does a SEP affect other retirement plans?**

The IRS treats a SEP as a profit-sharing (defined contribution) plan. If you also maintain a qualified profit-sharing plan (other than the SEP), special rules apply. Generally, the 25 percent deduction limit for qualified profit-sharing plans is reduced by any allowable deductions for contributions to the SEP-IRA accounts of individuals who participate in both the SEP and the profit-sharing plan. If you contribute to a defined benefit plan in addition to a SEP-IRA, special deduction limits may apply.

**Tip:** If you're trying to coordinate contributions to multiple retirement plans, seek the assistance of a tax professional.
Can employees also contribute to their SEP-IRAs?

Yes. At its simplest level, a SEP is a collection of IRAs for you and your employees to which you, as employer, can contribute. Your employees can also contribute to these IRAs. As with all IRAs, however, your employees can contribute no more than $5,000 for 2011 ($6,000 if they're age 50 or older), and the deductibility of employee contributions is subject to the IRA phaseout rules.

Caution: The employee contribution limit is an aggregate IRA annual limit—for example, in 2011, an employee cannot contribute $5,000 to a SEP-IRA and another $5,000 to a separate IRA (traditional or Roth).

Caution: SEP-IRAs can not accept Roth contributions.

Caution: Prior to 1997, SEPs could include salary-reduction arrangements (SAR-SEPs), under which employees could elect to have you contribute part of their pay to their SEP-IRAs. SAR-SEPs, however, can no longer be established (although those established before 1997 can continue to operate in some cases).

If you are self-employed and establish a SEP, you can make two types of contributions. First, you can contribute as an employer to the SEP-IRA, based on the rules previously explained. Second, you can contribute up to the annual maximum to your SEP-IRA (or to any other IRA you own) independently of your employer contribution to your SEP-IRA. Whether or not you can deduct the contribution you make to your IRA depends on your specific situation.

How does a SEP allocate contributions among employees?

When you establish a SEP, it must provide in writing the requirements that employees must satisfy to share in the allocation of contributions and must detail the manner in which contributions will be allocated. SEP allocation formulas almost always take the form of a percentage of compensation.

When can employees withdraw funds from their SEP-IRAs?

Once you make a contribution to SEP-IRAs, your employees can withdraw their funds at any time. You cannot prevent an employee from withdrawing funds, nor can you condition your contributions on an employee’s promise not to make a withdrawal. All traditional IRA rules apply, and withdrawals made prior to an employee reaching age 59½ may be subject to a federal 10 percent premature distribution tax, and perhaps a state penalty, too.

When can you set up a SEP and make deductible contributions?

To take a deduction for contributions for a particular year, you must set up the SEP and make the contributions by the due date of your business’s income tax return for that year. In the case of a SEP, an extension of time to file the business’s income tax return also extends the period allowable for making contributions.

Example(s): Joseph, a self-employed carpenter, wants to establish a SEP for year one. Joseph's income tax return for year one is due April 15 of year two. Joseph would ordinarily have until April 15 of year two to set up a SEP and make a contribution for year one. Joseph, however, files for and obtains an extension of time to file his year-one income tax return until October 15 of year two. Joseph has until October 15 of year two to establish a SEP and make contributions to the SEP for year one.

Tip: Consider: What if you have enough money to pay the taxes due on your federal income tax return or to make a contribution to your SEP, but not both? Calculate your tax return as if you made the SEP contribution. File for an extension (paying the tax due). You now have until the extended due date of the tax return to make the SEP contribution. Be careful, though. Failure to make the SEP contribution means additional tax will be due, along with interest. In addition, be sure to file your return by the extended due date.

What are the different ways to establish a SEP?

There are a few ways to establish a SEP. You can use Form 5305-SEP, which satisfies all SEP requirements (if no modifications are made). This form does not need to be filed with the IRS. However, you cannot use Form
5305-SEP if you:

- Currently maintain any other qualified retirement plan
- Previously maintained a defined benefit plan that is now terminated
- Have any eligible employees for whom IRAs have not been established
- Use the services of leased employees
- Are a member of an affiliated service group or a group of commonly controlled businesses, unless all eligible employees are covered by the SEP
- Want to integrate contributions with Social Security

Alternatively, you can use prototype or master SEP plans to establish a SEP. Banks, credit unions, savings and loan associations, insurance companies, and other financial institutions obtain approval from the IRS for their plans and offer them to customers. These prepackaged SEPs may allow for more flexibility than a SEP set up with Form 5305-SEP and can allow for integration with Social Security.

You can also have a custom-designed SEP plan. This requires retaining an attorney to draft the necessary documentation and obtaining a favorable opinion letter from the IRS. Given the cost and complexity involved and the widespread availability of prototype plans, individually designed SEPs are not frequently used.
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