



# **SEP And SEP-IRA**



# **Simplified Employee Pension Plan**

**Questions & Answers**

## **What is a Simplified Employee Pension (SEP) plan?**

A SEP is a retirement plan established by an employer. A one-person business is considered an employer for these purposes and may establish a SEP. An employer can use this SEP plan to make contributions to the IRAs of eligible employees, including himself or herself. A (SEP) is a written arrangement (a plan) that allows an employer to make deductible contributions for the benefit of participating employees. The contributions are made to traditional individual retirement arrangements (IRAs) set up for participants in the plan. Under a SEP, traditional IRAs must be set up for each qualifying employee. IRAs may have to be set up for leased employees, but they do not have to be set up for excludable employees. Traditional IRAs set up under a SEP plan are referred to as SEP-IRAs.

## **Who is eligible to establish a SEP?**

Any employer, including a sole proprietor, partnership, or corporation, can establish a SEP. The corporation may either be a for-profit corporation or a nonprofit corporation. A governmental entity may also establish a SEP. When a self-employed individual sponsors a SEP, he or she is considered to be both the employer and an employee.

## **Why would an employer, including a one-person business, want to have a SEP?**

There are numerous reasons for establishing a SEP:

- ◆ A large deductible contribution may be made by the employer. The employer's contribution must be a percentage (maximum of 25%) of an employee's compensation. The maximum contribution for 2023 for any one employee is \$66,000 and the maximum contribution for 2024 for any one employee is \$68,000.
- ◆ The SEP contribution is deductible by the employer, and it is not included in the employee's income.
- ◆ The SEP contributions are not subject to Federal withholding or Federal payroll taxes unless an individual is self-employed.
- ◆ Interest earned on the SEP deposit is sheltered from federal and most state income taxes until withdrawals are made at retirement.
- ◆ Due to the effects of compounding, the SEP funds can grow into a sizable nest egg for retirement.
- ◆ Administrative and legal costs are generally substantially less than would be incurred under a qualified retirement plan.

## **What employees must an employer cover under the SEP?**

The employer must cover any individual who is a qualifying employee. Such an employee is one who:

- ◆ Has attained the age of 21 years;
- ◆ Has worked for the employer in at least three of the immediately preceding five years, and
- ◆ Received at least \$750 for 2023 or \$750 for 2024.

An employer may establish less strict eligibility requirements.

If an employer fails to cover a person who is eligible, then there is no SEP plan, and the favorable tax benefits will be lost.

The following employees need not be covered by a SEP:

- ◆ Employees covered by a union agreement and whose retirement benefits were bargained for in good faith by their union and the employer, and
- ◆ Nonresident alien employees who have no U.S. source of earned income from the employer.

If an employer “leases” employees, it should consult with its tax advisor, as special rules may apply.

## **Can a person who is age 73 or older establish or contribute to a SEP-IRA after attaining age 73?**

Yes. A self-employed person who is over age 73, but who still has net earnings from his or her business, is eligible to establish a SEP and make a SEP-IRA contribution. A business that sponsors a SEP-IRA plan is required to make a SEP-IRA contribution for each employee who has met the age and service requirement. This includes employees who are age 73 or older. It would be unlawful discrimination for a business to fail to make a SEP-IRA contribution just because an employee had attained age 73 or older.

## **What technical requirements must a plan meet to be a SEP?**

A SEP requires a written plan document that meets the requirements of Internal Revenue Code section 408(k). This plan document requirement is normally met by using IRS Form 5305-SEP or an approved SEP prototype document. A SEP requires each participant to establish an approved IRA. Employer contributions to a SEP must be made under a definite written formula specifying the method for allocating contributions to each participant (a percent of compensation).

## **What is the cost to the employer?**

The cost depends on the degree to which the employer makes contributions. SEPs have relatively few governmental reporting requirements, which makes a SEP less costly to administer.

## **Must the employer make a contribution each year?**

The employer has total discretion whether or not to make a contribution each year under a SEP. The employer need not make any contribution.

## **How much will an employer save on its federal income taxes by making a SEP contribution?**

Savings depends upon the employer's marginal income tax bracket. A corporation would list its deduction for SEP contributions on its corporate tax return. A self-employed person deducts contributions for himself or herself on Form 1040, and for employees on Schedule C or F.

## **May an employer be able to claim a credit for the creation of a SEP?**

Yes. An eligible employer may be able to claim a tax credit of up to \$5,000, for three years for the ordinary and necessary costs incurred when starting a SEP IRA plan. This includes expenses for setting up and administering the plan and the expenses related to educating the employees about the plan. The credit can be claimed for each of the first three years of the plan. It is possible to claim the credit in the tax year before the tax year in which the plan becomes effective.

The credit is 50% of the eligible start-up costs, up to the greater of \$500; or the lesser of \$250 multiplied by the number of NHCEs who are eligible to participate in the plan or \$5,000.

An employer is eligible for this credit if two requirements are met. There is one plan participant who is a non-highly compensated employee (NHCE). In the three tax years before the first year the employer is eligible for the credit the employer did not sponsor another retirement plan which covered essentially the same employees.

Section 102 of the SECURE 2.0 Act enacted in December of 2022 sets forth substantial new tax credits available to certain eligible employers. You will want to discuss these new tax credits with your tax advisor because they are beyond the scope of this brochure. These new credits do not apply to a one-person plan.

## What amount can the employer deduct each year?

The maximum amount is 25% of the eligible employees' compensation paid to them during the year. Compensation for common-law employees is their income as shown on Form W-2. Compensation for a self-employed individual is defined to be his or her net earnings from self-employment as reduced by the deduction one is allowed for one-half of his or her self-employment tax and the deduction of contributions on his or her behalf to the plan. See IRS Publication 560 for a more detailed discussion.

## How much can be contributed and deducted on my behalf for 2023?

For 2023, the SEP rules permit an employer to contribute up to 25% of each participating employee's compensation, or \$66,000, whichever is less, to the employee's SEP-IRA. These contributions are funded by the employer.

## How much can be contributed and deducted on my behalf for 2024?

For 2024, the SEP rules permit an employer to contribute up to 25% of each participating employee's compensation, or

<u>Column A</u> If the Plan Contri- bution Rate is: (shown as a %)	<u>Column B</u> The Self-Employed Person's Rate is: (shown as a decimal)
1 .....	.009901
2 .....	.019606
3 .....	.029126
4 .....	.038482
5 .....	.047619
6 .....	.056604
7 .....	.065421
8 .....	.074074
9 .....	.082569
10 .....	.090909
11 .....	.099099
12 .....	.107143
13 .....	.115044
14 .....	.122807
15 .....	.130435
16 .....	.137931
17 .....	.145299
18 .....	.152542
19 .....	.159664
20 .....	.166667
21 .....	.173554
22 .....	.180328
23 .....	.186992
24 .....	.193548
25 .....	.200000

\$68,000, whichever is less, to the employee's SEP-IRA. These contributions are funded by the employer.

## What is meant by the term "Self-Employed Person's Rate Table"?

Because a self-employed person's deduction amount and his or her compensation are each dependent on the other, the adjustment to net earnings can be made indirectly by using an adjusted contribution rate as determined from the following chart:

Note: The rates in the table apply only if the contribution rate is a whole number, and if the employer only has this one plan.

## What are net earnings from self-employment?

For SEP purposes, your net earnings are your gross income from your business minus allowable deductions for that business. Allowable deductions include contributions to your employees' SEP-IRAs. You also take into account the deduction allowed for one-half of your self-employment tax, and the deduction for contributions to your own SEP-IRA. Include the following items in your net earnings.

1. Foreign earned income and housing cost amounts.
2. If you are a partner, your distributive share of partnership income or loss (other than separately stated items such as capital gains and losses).

If you are a limited partner, guaranteed payments for services to or for the partnership.

4. Elective contributions or deferrals under any of the following plans.
  - a. 401(k) plans.
  - b. 403(b) plans (tax-sheltered annuities).
  - c. SEP plans (salary-reduction arrangements).
  - d. Savings incentive match plans for employees (SIMPLE plans).
  - e. Cafeteria plans.
  - f. 457 plans (plans of state and local governments and certain tax-exempt organizations).

Do not include the following items in your net earnings.

- ◆ Tax-free items (or deductions related to them).
- ◆ If you are a limited partner, distributions of income or loss.
- ◆ Income passed through a S corporation.

## What is the contribution deadline?

The employer's contribution deadline is the due date of that year's tax return, including any extensions. For many corporations, this is March 15. For most individuals, this is April 15. If there is an extension, it is permissible to make the contribu-

tion by September 15 or October 15 of the following year, as applicable.

### **Can an employer prohibit distributions from an employee's SEP-IRA?**

No. Also, an employer cannot condition its SEP-IRA contributions on the keeping of any part of SEP-IRA funds in the IRA.

### **When must a person start to withdraw the money from the SEP-IRA?**

A person must begin distributions by the first day of April following the calendar year in which he or she attains age 73, and December 31 of each year thereafter.

### **May an individual make regular IRA contributions into a SEP-IRA?**

The answer is generally "yes." However, the extent to which a deduction will be allowed for the contribution may be limited by participation in the SEP. The individual should consult with his or her tax advisor to determine the amount of deductible and nondeductible contribution(s) available.

### **How will distributions be taxed?**

Distributions will be taxed as ordinary income. If the participant is under age 59½, penalties may apply.

### **How do my employer's contributions affect my taxes?**

Your employer's contributions to your SEP-IRA are excluded from your income rather than deducted from it.

Unless there are excess contributions, you do not include any contributions in your gross income; nor do you deduct any of them.

### **What are excess contributions?**

If your employer contributes more than is allowed, you must include the excess in your gross income, without any offsetting deduction.

An excess contribution can also arise if you make a regular IRA contribution larger than permitted.

### **How do I correct an excess contribution?**

You should follow the instructions set forth in IRS Publication 590-A. You will normally withdraw the excess contribution plus any related earnings.

## **What happens to a SEP-IRA when the participant dies?**

The funds in a SEP will be paid to a participant's beneficiaries. The standard IRA distribution and RMD rules for beneficiaries will apply.

## **May a SEP be integrated with social security?**

Yes. An integrated SEP will permit a somewhat higher contribution percentage to be given to the more highly compensated employees. Integration is not permissible under the IRS Model Form 5305-SEP. A prototype plan would be needed.

## **Who is responsible to administer the SEP?**

The sponsoring employer is responsible for the SEP's administration. The employer may well need to consult with its tax and legal advisor. A financial institution's general role is to serve as the depository and not as the plan administrator.

## **What is a Salary-Reduction SEP (SAR-SEP), and what advantages does it offer?**

An employer is not permitted to establish a salary-reduction SEP after December 31, 1996. SAR-SEPs established before January 1, 1997, can continue to receive contributions under present rules, and new employees of the employer, hired after December 31, 1996, can participate in the SAR-SEP in accordance with the rules. You should review IRS Publication 560 for additional information.

## **How does an employer establish a SEP?**

The employer will need to adopt or execute a SEP plan agreement (Form 5305-SEP) and furnish the proper notice(s) to the eligible employees. Each eligible employee will need to have a SEP-IRA which is a traditional IRA to which a SEP contribution has been made.

*The information provided in this brochure is not intended to be legal or tax advice. You should consult your attorney or tax advisor for information that relates to your specific circumstances.*