

# Qualified Retirement Plans

## Practice Alert

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### What is a (S)implified (E)mployee (P)ension?

As its name implies a SEP is supposed to facilitate the adoption of a retirement plan without all the annoying paper work. No plan document; no annual form 5500; no Summary Plan Description; etc. In practice a SEP is not as simple as its name implies. First let's consider the eligibility rules. To participate in a SEP the employee must have reached age 21, have performed service for at least three of the last five years and have received at least \$550 in compensation for the year. Unlike qualified retirement plans, e.g. a profit sharing plan, a SEP cannot require full time employment, usually defined as a year in which the employee has worked at least 1000 hours. In the absence of this requirement a SEP must provide benefits for all employees whether full time or part time. The only exclusions allowed are union employees and non resident aliens with no U.S. income from the employer.

Similar to qualified plans a SEP may not discriminate in favor of Highly Compensated Employees (HCEs) as defined in IRC §414(q). This means that the employer's contribution must be the same percentage of compensation for the Non Highly Compensated Employees as for the HCEs. The exception to that rule is Social Security integration, currently known as Permitted Disparity. This approach takes into consideration that the employer is already providing a retirement plan for all employees through Social Security. The benefit provided by Social Security can be taken into consideration when the allocation of the employer's SEP contribution is made. The illustration on the left allocates the contribution at a rate of 20% for each employee while the illustration on the right takes Permitted Disparity into consideration.

Salary	Age	Employer Contribution	Percent Of Total Contribution	Salary	Age	Employer Contribution	Percent Of Total Contribution		
HCE 1	\$230,000	60	\$ 46,000	47.33%	HCE 1	\$ 230,000	60	\$ 46,000	51.6%
HCE 2	100,000	55	20,000	20.58%	HCE 2	100,000	55	16,828	18.9%
Sub-Total	<u>\$330,000</u>		<u>\$ 66,000</u>	<u>67.90%</u>		<u>\$ 330,000</u>		<u>\$ 62,828</u>	<u>70.5%</u>
NHCE 1	\$ 25,000	44	\$ 5,000	5.14%	NHCE 1	\$ 25,000	44	\$ 4,207	4.7%
NHCE 2	35,000	38	7,000	7.20%	NHCE 2	35,000	38	5,890	6.6%
NHCE 3	28,000	29	5,600	5.76%	NHCE 3	28,000	29	4,712	5.3%
NHCE 4	18,000	25	3,600	3.70%	NHCE 4	18,000	25	3,029	3.4%
NHCE 5	50,000	45	10,000	10.29%	NHCE 5	50,000	45	8,414	9.4%
Sub-Total	<u>\$156,000</u>		<u>\$ 31,200</u>	<u>32.10%</u>		<u>\$ 156,000</u>		<u>\$ 26,251</u>	<u>29.5%</u>
TOTAL	<u>\$486,000</u>		<u>\$ 97,200</u>	<u>100.00%</u>		<u>\$ 486,000</u>		<u>\$ 89,079</u>	<u>100.0%</u>

Whichever approach is used the allocation formula must be in writing. That brings us to the adoption of a SEP. Although a plan document is not required the employer must complete form 5305-SEP to adopt the plan. The form must be provided to all eligible employees together with a variety of statements including any amendments to the SEP and a notice of contributions made by the employer to the employee's SEP account. The limits on contributions to a SEP are the same as a defined contribution plan, i.e. the lesser of 25% of compensation or \$49,000 (for 2009). Once the employer makes the contribution the employee may withdraw the entire amount since the contribution is 100% vested when made. If a distribution is made the employee may include it in taxable income or roll it over to another IRA. The financial institution that the employer chooses to deposit the contributions must provide full disclosure to the employee in non technical terms including the law that regulates the account, tax consequences of various transactions, eligibility, transactions that would cause penalties, charges that may be deducted from your account, sales commissions as a percentage and an annual statement of your account.

All things considered a SEP may not be as simple as its name implies. In addition considering the limited options available to allocate the contribution compared to a profit sharing plan the benefit of reduced paper work may be more costly than a more efficiently designed profit sharing plan.

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