

## SEP Plan Fix-It Guide

-----Trends-----	-----Tips-----			
Potential Mistake	How to Find the Mistake	How to Fix the Mistake		How to Avoid the Mistake
		Corrective Action	Correction Program(s) Available	
1) Has your SEP been amended for current law? <a href="#">(More)</a>	Determine if your Form 5305-SEP is the current revision (December 2004). <a href="#">(More)</a>	EPCRS Adopt revised Form 5305-SEP. <a href="#">(More)</a>	VCP Audit CAP <a href="#">(More)</a>	Maintain regular contact with the company that sold you the plan. <a href="#">(More)</a>
2) Are all eligible employees participating in the SEP? <a href="#">(More)</a>	Review the section of your plan document concerning eligibility and participation. Check when employees are entering the plan. <a href="#">(More)</a>	EPCRS Apply reasonable correction method that would place affected employees in the position they would have been in if there were no operational plan mistakes. <a href="#">(More)</a>	SCP* VCP Audit CAP <a href="#">(More)</a>	You should review the participation status of all employees at least once a year. <a href="#">(More)</a>
3) Is the business that the SEP covers the only business that you own? <a href="#">(More)</a>	You should identify any companies that you own or with which you have a financial relationship. <a href="#">(More)</a>	EPCRS Corrective contribution. <a href="#">(More)</a>	SCP* VCP Audit CAP <a href="#">(More)</a>	Determine if you own any other businesses. <a href="#">(More)</a>
4) Are you determining each eligible employee's compensation using the definition in your SEP document? <a href="#">(More)</a>	To determine if you are using the proper compensation for allocations, you'll need to review the plan document. <a href="#">(More)</a>	EPCRS Correction is based upon the terms of the plan and other applicable information at the time of the mistake. <a href="#">(More)</a>	SCP* VCP Audit CAP <a href="#">(More)</a>	When calculating allocations, it is important for you to carefully review the plan terms to ensure that the correct amount of compensation is being considered. <a href="#">(More)</a>
5) Are SEP contributions to each employee's IRA limited as required by the Internal Revenue Code (Code)? <a href="#">(More)</a>	Calculate 25% of each employee's compensation and compare the total contribution made for the employee to the lesser of that amount or the dollar limitation for that year (\$49,000 in 2009). <a href="#">(More)</a>	EPCRS Correction for a failure to limit contributions allocated to employees is to either distribute or retain the excess amount. <a href="#">(More)</a>	SCP* VCP Audit CAP <a href="#">(More)</a>	After the initial calculation of allocations based on the terms of the plan, you should check to make sure none of the proposed allocations would violate the Code. <a href="#">(More)</a>

**\* In order to utilize SCP, you must have established practices and procedures reasonably designed to promote and facilitate overall compliance with applicable Internal Revenue Code requirements. Also, an analysis of whether mistakes in the aggregate are significant or insignificant needs to be made. If insignificant, correction generally can be made at any time. However, if the mistakes are significant in the aggregate, then you must use VCP to correct the mistake.**

## SEP Plan - Overview

A SEP is a **Simplified Employee Pension** plan. To establish a SEP, the employer:

- Can be a business of any size, even self-employed.
- Must adopt a SEP plan document.

Under a SEP, the employer makes contributions to traditional Individual Retirement Arrangements (IRAs) set up for eligible employees (including self-employed individuals), subject to certain limits. A SEP is funded solely by employer contributions. Each employee is always 100% vested in (or, has ownership of) all money in his or her SEP-IRA.

There are three basic steps in setting up a SEP.

- 1) You must execute a formal written agreement to provide benefits to all eligible employees.
- 2) You must give each eligible employee certain information about the SEP.
- 3) A SEP-IRA must be set up by or for each eligible employee.

**Formal written agreement.** You must execute a formal written agreement to provide benefits to all eligible employees under a SEP. You can satisfy the written agreement requirement by adopting an IRS Model SEP using [Form 5305-SEP](#).

If you adopt an IRS Model SEP using Form 5305-SEP, no prior IRS approval or determination letter is required. Keep the original form. Do not file it with the IRS. Also, using Form 5305-SEP will usually relieve you from filing annual retirement plan information returns with the IRS and Department of Labor. See the Form 5305-SEP instructions for details.

**When not to use Form 5305-SEP.** You cannot use Form 5305-SEP if any of the following apply.

- 1) You currently maintain any other qualified retirement plan.
- 2) You have any eligible employees for whom you have not set up IRAs.
- 3) You use the services of leased employees.
- 4) You are a member of any of the following, unless eligible employees of all the members of these groups, trades, or businesses participate under the SEP.
  - a. An affiliated service group described in §414(m) of the Code.
  - b. A controlled group of corporations described in §414(b) of the Code.
  - c. Trades or businesses under common control described in §414(c) of the Code.

**Use of prototype SEPs.** Financial institutions and other approved sponsoring organizations can sponsor a prototype SEP document. The IRS issues opinion letters approving prototypes. Plan sponsors can use individually designed documents, but the IRS has not established an approval process for these.

**Information you must give to employees.** You must give each eligible employee a copy of Form 5305-SEP, its instructions, and the other information listed in the Form 5305-SEP instructions. An IRS Model SEP is not considered adopted until you give each employee this information. If you adopt a prototype SEP, you must give each eligible employee similar information.

**Setting up the employee's SEP-IRA.** A SEP-IRA must be set up by or for each eligible employee. SEP-IRAs can be set up with banks, insurance companies, or other qualified

financial institutions. You send SEP contributions to the financial institution where the SEP-IRA is maintained.

***Deadline for setting up a SEP.*** A SEP can be set up for a year as late as the due date (including extensions) of the business's income tax return for that year.

### **Who is eligible to participate?**

Generally, any employee who performs services for the business must be included in a SEP. However, there are some exceptions to this general rule. Among the employees that you may exclude from a SEP are those who:

- Have not worked for you during three out of the last five years.
- Have not reached age 21.
- Are employees who are covered by a union agreement and whose retirement benefits were bargained for in good faith by you and the employees' union.
- Are nonresident alien employees who have received no U.S. source wages, salaries, or other personal services compensation from you.
- Received less than \$550 in compensation (subject to [cost-of-living adjustments](#)) during the year. Generally, W-2 compensation will satisfy the definition of "compensation."

### **What are the contribution requirements?**

By establishing a SEP, you have adopted a plan that requires a SEP-IRA to hold the contributions made on behalf of each of the eligible employees. A SEP is funded by employer contributions. The SEP plan document will indicate the amounts the employer has agreed to contribute. This amount can be discretionary, including zero. The SEP document must include a definite written allocation formula for determining how the employer's contribution is allocated to the employees' SEP-IRAs.

SEP contributions must bear a uniform relationship to compensation. Generally, a uniform relationship means that each employee's contribution must represent the same percentage of compensation. Nonuniformity is possible with a permitted disparity formula (see §408(k)(3)(D) of the Code). The amount of compensation taken into account under the plan cannot exceed \$245,000 in 2009, and is subject to [cost-of-living adjustments](#) for later years.

Total contributions to each employee's SEP-IRA cannot exceed the lesser of \$49,000 for 2009, (subject to [cost-of-living adjustments](#) for later years) or 25% of compensation. Each employee is always 100% vested in (or, has ownership of) all contributions to his or her SEP-IRA.

After you send the SEP contributions to the financial institution, it will manage the funds. Depending on the financial institution, SEP contributions can be invested in individual stocks, mutual funds, and other, similar types of investments.

Each participating employee must receive an annual statement stating the amount contributed to the account for the year.

### **What are the basic distribution/withdrawal rules?**

Employees can withdraw SEP contributions and earnings at any time. A withdrawal is taxable in the year received. If an employee makes a withdrawal before he or she is age 59½, generally a 10% additional tax applies. Employees may roll over SEP contributions and earnings tax-free to other IRAs and retirement plans.

SEP contributions and earnings must eventually be distributed. A specific minimum amount is required to be distributed by April 1 of the year following the year the employee reaches age 70½. (For further details regarding the required minimum distribution amount, see [Publication 590, Individual Retirement Arrangements \(IRAs\)](#).)

### **What are the filing requirements?**

An employer generally has no filing requirements. The annual reporting required for qualified plans (Form 5500 series) is normally not required for SEPs. The financial institution that holds the plan's SEP-IRAs handles most of the other paperwork.

## **Employee Plans Compliance Resolution System (EPCRS) – Overview**

If you make mistakes with respect to your SEP plan, you may utilize the IRS's Employee Plans Compliance Resolution System (EPCRS) to remedy your mistakes and avoid the consequences of plan disqualification. A correction for a mistake should be reasonable and appropriate. The correction methodology should resemble one already provided for in the Code and you should consider all applicable facts and circumstances. [Rev. Proc. 2008-50, 2008-35 I.R.B. 464](#) sets forth the EPCRS. There are three components of EPCRS:

- 1) Self-Correction Program (SCP)** - permits a plan sponsor to correct certain plan failures without contacting the IRS.
- 2) Voluntary Correction Program (VCP)** - permits a plan sponsor to, any time before audit, pay a fee, and receive the IRS's approval for correction of plan failures.
- 3) Audit Closing Agreement Program (Audit CAP)** - permits a plan sponsor to pay a sanction and correct a plan failure while the plan is under audit.

A general description of each component of EPCRS is provided below:

### **SCP:**

- In order to be eligible for SCP, the plan sponsor or administrator of a plan must have established practices and procedures (formal or informal) reasonably designed to promote and facilitate overall compliance with applicable Code requirements. A plan document alone does not constitute evidence of established procedures.
- SCP is available for correcting operational problems only – that is, the failure to follow the terms of your plan. SCP is not available for other types of problems, such as the failure to keep your plan document up to date to reflect changes in the law.
- The plan sponsor effects correction using the General Correction Principles set forth in Rev. Proc. 2008-50, section 6.
- A plan sponsor that corrects a mistake listed in, and in accordance with, the correction methods included in Appendix A or Appendix B of Rev. Proc. 2008-50 may be certain that the correction effected is reasonable and appropriate for the failure.
- If needed, the plan sponsor effects changes to its administrative procedures to ensure the mistakes do not recur.
- The SCP may be used if, considering all of the facts and circumstances, the mistakes, in the aggregate, are insignificant operational failures.
- When using SCP, the plan sponsor should maintain adequate records to demonstrate correction in the event of an audit of the plan.
- There is no fee for self-correction.

**VCP:**

- The plan sponsor identifies the mistakes.
- The plan sponsor proposes correction using the General Correction Principles set forth in Rev. Proc. 2008-50, section 6.
- The plan sponsor proposes changes to its administrative procedures to ensure the mistakes do not recur.
- The plan sponsor pays a compliance fee of \$250.
- The IRS issues a Compliance Statement with respect to the plan detailing the qualification mistakes identified by the plan sponsor and the applicable correction methods approved by the IRS.
- The plan sponsor corrects the identified mistakes within 150 days of the issuance of the Compliance Statement.
- While the submission is pending, the plan will not be examined by Employee Plans, except under unusual circumstances.

**Audit CAP:**

- The plan sponsor or plan is under examination.
- The plan sponsor enters into a Closing Agreement with the IRS.
- The plan sponsor effects correction prior to entering into the Closing Agreement.
- The plan sponsor pays a sanction negotiated with the IRS.
- The sanction paid under Audit CAP should be greater than the fee paid under VCP.
- For plans intended to be qualified, the sanction under Audit CAP is a negotiated percentage of the Maximum Payment Amount (MPA) based on the sum for all open taxable years of the:
  - 1) Additional income tax resulting from income inclusion for employees in the plan (Form 1040), including the tax on plan distributions that have been rolled over to other IRAs (and any interest and penalties applicable to the employees' tax return).
  - 2) Additional tax resulting from the 6% tax imposed under §4973 of the Code on excess contributions to IRAs.

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		Corrective Action	Correction Program(s) Available	
1) Has your SEP been amended for current law? <a href="#">(More)</a>	Determine if your Form 5305-SEP is the current revision (December 2004). <a href="#">(More)</a>	EPCRS Adopt revised Form 5305-SEP. <a href="#">(More)</a>	VCP Audit CAP <a href="#">(More)</a>	Maintain regular contact with the company that sold you the plan. <a href="#">(More)</a>

### 1) Has your SEP been amended for current law?

Laws related to retirement plans change quite frequently. There are statutory deadlines for which many provisions must become effective. The IRS generally establishes a firm deadline for adopting these changes. Also, these law changes might mean you can simplify some areas of plan administration or improve benefits. You will need to change plan language and operation to keep the plan within the law and to take advantage of increased benefit limits.

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#### **How to Find the Mistake:**

At some point in the plan's existence, you may be asked to demonstrate your plan has been in compliance with current and prior law. This request may come from a financial institution, third-party administrator (TPA), or other plan service provider, or it may come from the IRS during an audit. You may be asked to demonstrate the plan has been in compliance with all current and prior law, sometimes reaching back several years.

You may have a written plan document that is a Model SEP ([Form 5305-SEP](#), *Simplified Employee Pension - Individual Retirement Accounts Contribution Agreement*) or a [pre-approved plan](#). A Model SEP and a pre-approved plan have already been reviewed favorably by the IRS.

**If your plan is a Model SEP ([Form 5305-SEP](#)) that is the current revision (December 2004), you can be assured that it is in compliance with the law.** If your plan is a pre-approved plan, you have a level of assurance that the plan is written in compliance with the law even if you do not apply for a determination letter. Individually designed SEPs must be updated for law changes. If you have this situation, consult your tax advisor.

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#### **How to Fix the Mistake:**

##### **Corrective Action:**

If you find you have not amended your plan timely for the various law changes, you should adopt amendment(s) for the law changes you have missed. You may be able to utilize model or sample amendments published by the IRS that apply to your SEP plan. You will need to confirm that the operation of the plan is consistent with the terms of the plan.

##### **Example:**

Employer Y established a SEP in 1995 using a prototype plan and never subsequently amended for any law changes. Starting in 2002, the plan began using the increased limits of the Economic Growth and Tax Relief Reconciliation Act of 2001, Pub. L. 107-16 (EGTRRA).

Due to the changes made by EGTRRA (e.g., increased IRA limits) and the revised minimum distribution regulations under §401(a)(9) of the Code, the IRS issued revised Model SEP documents in 2002. The pre-EGTRRA Model SEP documents could not be used to establish a new SEP after October 1, 2002. If an employer is using a pre-EGTRRA Model SEP and wanted to take advantage of the EGTRRA changes in the 2002 plan year, the revised Model document (or an appropriate revised prototype document) had to have been adopted by the end of the 2002 plan year. If an employer is using a prototype SEP and wanted to take advantage of the EGTRRA changes in the 2002 plan year, an EGTRRA-revised prototype document had to have been adopted within 180 days after the favorable EGTRRA opinion letter was issued to the sponsoring organization of the prototype SEP.

The employer in the above example would have to adopt an EGTRRA-revised document within 180 days after the favorable EGTRRA opinion letter was issued to the sponsoring organization of the prototype SEP. If any of these conditions were not satisfied, then EPCRS would have to be used to correct the mistake by adopting the proper document.

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#### **Correction Program(s) Available:**

##### **SCP:**

This type of mistake may not be corrected under SCP. As stated above, SCP is limited to operational problems, and this mistake is the result of the failure to keep the plan language up to date. In order to retain plan qualification, you must correct this mistake under VCP.

##### **VCP:**

The plan sponsor makes a VCP submission to the IRS pursuant to Rev. Proc. 2008-50 identifying the failure. The fee for this mistake would be \$250.

##### **Audit CAP:**

If this mistake is discovered on audit, it may be corrected under Audit CAP. Correction of the mistake under Audit CAP should be very similar to correction under VCP. The sanction under Audit CAP is a percentage of the [Maximum Payment Amount \(MPA\)](#).

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#### **How to Avoid the Mistake:**

There are a number of ways to avoid this mistake:

- Do an annual review of your plan document.
- Make sure your plan document and Summary Plan Description (SPD) match. If your plan document is amended, check the language against the old plan document, noting any differences.
- Knowing your plan has been properly updated may not be a simple process. Certain plans must be individually amended for each change, while others may have a prototype document that is amended. We recommend you maintain contact, on at least a yearly basis, with the company that sold you the plan. If the company sends you a set of amendments to formally adopt, make certain you timely execute the documents per their instructions. Keep signed and dated copies of your plan document and any amendments for your records.

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2) Are all eligible employees participating in the SEP? <a href="#">(More)</a>	Review the section of your plan document concerning eligibility and participation. Check when employees are entering the plan. <a href="#">(More)</a>	EPCRS Apply reasonable correction method that would place affected employees in the position they would have been in if there were no operational plan mistakes. <a href="#">(More)</a>	SCP* VCP Audit CAP <a href="#">(More)</a>	You should review the participation status of all employees at least once a year. <a href="#">(More)</a>

## 2) Are all eligible employees participating in the SEP?

You must allow all eligible employees to participate, including part-time employees, seasonal employees, and employees who die or terminate employment during the year. An eligible employee is an employee who:

- a) Is at least 21 years of age.
- b) Has performed service for you in at least three of the immediately preceding five years.

The term “employee” includes a self-employed individual who has earned income and a working business owner.

You must treat certain leased employees as “employees.”

Your SEP document can provide for less restrictive eligibility requirements (but not more restrictive ones). “Service” means any work performed for you for any period of time, however short. A SEP may not impose an hours-of-service requirement.

**Excludable employees:** The following employees do not need to be covered under a SEP:

- Employees covered by a union agreement whose retirement benefits were bargained for in good faith by you and their union.
- Nonresident alien employees who did not earn U.S. source income from you.
- Employees who received less than \$550 in compensation during the year. This amount is subject to [cost-of-living adjustments](#) after 2009.

“Employees” for purposes of determining who is an eligible employee under a SEP includes all employees of all related employers. Related employers include controlled groups of corporations that include your business, trades or businesses under common control with your business, and affiliated service groups that include your business. This means, for example, that if you and/or your family members own a controlling interest in another business, employees of that other business are “employees” for purposes of determining who is eligible to participate in a SEP.

Example 1: Employer X maintains a calendar year SEP. Under the SEP, an employee must perform service in at least three of the immediately preceding five years, reach age 21, and earn



the minimum amount of compensation during the current year. Employee A worked for Employer X during his summer breaks from school in 2005, 2006, and 2007, but never more than 34 days in any year. In July 2008, Employee A turns 21. In August 2008, Employee A begins working for Employer X on a full-time basis, earning \$12,000 in 2008. Employee A is an eligible employee in 2008 because he has met the minimum age requirement, has worked for Employer X in three of the five preceding years, and has met the minimum compensation requirement for 2008.

Example 2: Employer Y designs its SEP to provide for immediate participation regardless of age, service, or compensation. Employee B is age 18, and begins working part-time for Employer Y in 2008. Employee B is an eligible employee for 2008.

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### **How to Find the Mistake:**

Review the section of your plan document concerning eligibility and participation. Check when employees are entering the plan.

- Make a list of all employees who received a W-2.
- Compare their dates of hire and annual compensation against the eligibility and participation requirements in the plan document.
- Determine the date that each employee is entitled to become a participant in the plan according to the plan document.
- Inspect payroll and plan records to make certain the employees timely entered the plan.

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### **How to Fix the Mistake:**

#### **Corrective Action:**

Generally, if you did not provide an employee the opportunity to participate in your SEP plan, you must make a fully vested contribution to the plan on behalf of the employee that compensates for the missed contribution. The corrective contribution is an employer contribution that is intended to place the employee in the same position had s/he participated in the plan timely.

#### **Example:**

Employer D maintains a SEP plan that provides for discretionary employer contributions. Employer D has 20 employees. The plan provides that the employer's contributions are allocated to account balances in the ratio that each eligible employee's compensation for the year bears to the compensation of all eligible employees for the year. For 2007, Employer D made a contribution to the plan of a fixed dollar amount. However, Employer D inadvertently excluded one employee who met the eligibility requirements from participating in the plan. The employee had terminated during the plan year and did not receive an allocation of the contribution. The contribution resulted in an allocation on behalf of each of the eligible employees, other than the excluded employee, equal to 10% of compensation. Most of the employees who received allocations under the plan for the year of the failure were nonhighly compensated employees. If the one excluded employee had shared in the original allocation, the allocation made on behalf of each employee would have equaled 9% of compensation.

#### **Reasonable Correction:**

Section 2.02(2) of Appendix B to Revenue Procedure 2008-50 provides two different methods for correcting the exclusion of eligible employees. Only the contribution method, and not the reallocation method, is proper for SEPs in most cases since the assets of the plan are held in IRAs. The contribution method requires the employer to make a corrective contribution to the

plan. The corrective contribution is determined taking into account the excluded employees' compensation. This amount is adjusted for earnings. No adjustments are made to the employees who shared in the prior allocation, even though their allocations would have been different had the excluded employee not been excluded. For the above example, the employer would contribute an amount that equals 10% of the excluded employee's compensation for the 2007 year (adjusted for earnings), and does not adjust the 10% allocations that were made to the other employees.

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**Correction Program(s) Available:**

**SCP:**

The example illustrates an insignificant operational problem, in that the employer failed to follow the terms of the plan by failing to give one employee an allocation of the employer contribution to the plan for the 2007 year. Therefore, provided that the other eligibility requirements of SCP are satisfied, Employer D may use SCP to correct the failure.

- No fees for self-correction.
- Practices and procedures must be in place.

**VCP:**

Under VCP, correction is the same as described above under "Reasonable Correction." Employer D makes a VCP submission in accordance with Rev. Proc. 2008-50. The fee for the VCP submission is \$250.

**Audit CAP:**

Under Audit CAP, correction is the same as described above under "Reasonable Correction." Employer D and the IRS enter into a Closing Agreement outlining the corrective action and negotiate a sanction based on the [Maximum Payment Amount \(MPA\)](#).

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**How to Avoid the Mistake:**

You should review the participation status of all employees at least once a year. The person assigned the task should have a good understanding of the eligibility requirements and have access to the employment and payroll records necessary to make eligibility decisions for all employees.

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### 3) Is the business that the SEP covers the only business that you own?

As stated above, “employees” for purposes of determining who is an eligible employee under a SEP includes all employees of all related employers. Related employers include controlled groups of corporations that include your business, trades or businesses under common control with your business, and affiliated service groups that include your business. This means, for example, that if you and/or your family members own a controlling interest in another business, employees of that other business are “employees” for purposes of determining who is eligible to participate in a SEP.

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#### **How to Find the Mistake:**

All owners or partners of your business should identify any companies that they own or with which you have a financial relationship. If any of these companies or relationships exist, the requirements of §§414(b), (c), and (m) of the Code should be scrutinized to ensure that all required employees are included in the plan.

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#### **How to Fix the Mistake:**

##### **Corrective Action:**

Generally, if you did not provide an employee the opportunity to participate in your SEP plan, you must make a fully vested contribution to the plan on behalf of the employee that compensates for the missed contribution. The corrective contribution is an employer contribution that is intended to place the employee in the same position had s/he participated in the plan timely.

##### **Example:**

Employer E owns Business A, a restaurant that has 40 employees. Employer E also owns Business B, a bakery that has 30 employees. Employer E established a SEP plan in 2007 and only the eligible employees in Business A were included in the plan.

##### **Reasonable Correction:**

The 30 employees of Business B are considered eligible employees who were improperly excluded. These employees would have to receive allocations using the method described in

question #2 above or an alternative correction method that satisfies the general correction principles prescribed by the Revenue Procedure 2008-50.

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**Correction Program(s) Available:**

**SCP:**

The example illustrates a significant operational problem, in that the employer failed to follow the terms of the plan by improperly excluding employees from Business B. Because this example is a significant operational failure, SCP is not available for the mistake and must be corrected using VCP.

**VCP:**

Under VCP, correction is the same as described above under “Corrective Action.” Employer E makes a VCP submission in accordance with Rev. Proc. 2008-50. The fee for the VCP submission is \$250.

**Audit CAP:**

Under Audit CAP, correction is the same as described above under “Corrective Action.” Employer E and the IRS enter into a Closing Agreement outlining the corrective action and negotiate a sanction based on the [Maximum Payment Amount \(MPA\)](#).

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**How to Avoid the Mistake:**

The steps listed in question #2 should be followed and should include determining if any other businesses are owned by all owners or partners of your business.

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#### 4) Are you determining each eligible employee's compensation using the definition in your SEP document?

A plan's definition of compensation must satisfy applicable rules for the purpose of determining the amount of contributions. The amount of compensation taken into account under the plan cannot exceed \$245,000 in 2009 and is subject to [cost-of-living adjustments](#) for later years.

You must follow the definition of compensation stated in the plan document in the operation of the plan. Compensation generally includes the pay an employee received from you for personal services for a year including:

- Wages and salaries.
- Fees for professional services.
- Other amounts received (cash or non-cash) for personal services actually rendered by an employee, including, but not limited to, the following items:
  - Commissions and tips.
  - Fringe benefits.
  - Bonuses.

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#### **How to Find the Mistake:**

To determine if you are using the proper compensation for allocations, you'll need to review the plan document.

Spot-check allocations to see if you are using the correct compensation. Some of these definitions can get very complicated with expense reimbursements, car allowances, bonuses, commissions, and overtime pay that is included or not included in the definition of compensation. If you have a plan with a complicated definition of compensation, develop a worksheet to calculate the correct amounts. If you are using the Form 5305-SEP, make sure you are basing allocations on total compensation.

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### **How to Fix the Mistake:**

#### **Corrective Action:**

You would make a corrective contribution, including earnings, on behalf of the affected employees.

#### **Example:**

Employer G operates a restaurant with 15 employees. Under the terms of the SEP document, compensation for determining allocations of the employer contribution is total wages earned including bonuses, tips, and other income reported on the Form W-2. Since the inception of the plan, it was determined that Employer G considered bonuses and other income for the contribution allocation, but tips had not been included.

#### **Reasonable Correction:**

The employer should correct the allocations using the contribution method discussed under question #2 above.

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### **Correction Program(s) Available:**

#### **SCP:**

The example illustrates an operational problem, in that the employer failed to follow the terms of the plan by failing to include tips in compensation used to determine allocations under the plan. Therefore, provided that the other eligibility requirements of SCP are satisfied, Employer G may use SCP to correct the mistake.

- No fees for self-correction.
- Practices and procedures must be in place.

#### **VCP:**

Under VCP, correction is the same as described above under “Corrective Action.” Employer G makes a VCP submission in accordance with Rev. Proc. 2008-50. The fee for the VCP submission is \$250.

#### **Audit CAP:**

Under Audit CAP, correction is the same as described above under “Corrective Action.” Employer G and the IRS enter into a Closing Agreement outlining the corrective action and negotiate a sanction based on the [Maximum Payment Amount \(MPA\)](#).

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### **How to Avoid the Mistake:**

When calculating allocations, it is important for you to carefully review the plan terms to ensure that you are using the correct amounts of compensation. If necessary, you may wish to include in your payroll program an account that accumulates the proper compensation figures for all employees.

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-----Trends-----	-----Tips-----			
Potential Mistake	How to Find the Mistake	How to Fix the Mistake		How to Avoid the Mistake
		Corrective Action	Correction Program(s) Available	
5) Are SEP contributions to each employee's IRA limited as required by the Internal Revenue Code (Code)? <a href="#">(More)</a>	Calculate 25% of each employee's compensation and compare the total contribution made for the employee to the lesser of that amount or the dollar limitation for that year (\$49,000 in 2009). <a href="#">(More)</a>	EPCRS Correction for a failure to limit contributions allocated to employees is to either distribute or retain the excess amount. <a href="#">(More)</a>	SCP* VCP Audit CAP <a href="#">(More)</a>	After the initial calculation of allocations based on the terms of the plan, you should check to make sure none of the proposed allocations would violate the Code. <a href="#">(More)</a>

### 5) Are SEP contributions to each employee's IRA limited as required by the Internal Revenue Code?

All contributions made under a SEP are employer contributions.

Section 415 of the Code limits the amount of contributions made to an employee's SEP-IRA. Contributions made to each employee's SEP-IRA cannot exceed the lesser of \$49,000 in 2009 (subject to [cost-of-living adjustments](#) for later years) or 25% of the eligible employee's compensation. The amount of compensation taken into account is limited to \$245,000 in 2009 (subject to [cost-of-living adjustments](#) for later years). If your SEP plan document specifies lower contribution limits, then the lower limits control.

There are special rules if you are a self-employed individual. When calculating the deduction for contributions made to your own SEP-IRA, compensation is your net earnings from self-employment, which takes into account both the deduction for one-half of your self-employment tax and the deduction for contributions to your own SEP-IRA. For this reason, you determine the deduction for contributions to your own SEP-IRA indirectly by reducing the contribution rate called for in your plan. For more information on the deduction limitations for self-employed individuals, see [Publication 560](#), *Retirement Plans for Small Business (SEP, SIMPLE, and Qualified Plans)*.

Employer contributions to a SEP-IRA will not affect the amount an individual can contribute to a Roth IRA or a traditional IRA. However, it may preclude an individual from receiving a tax deduction for contributions to a traditional IRA. See [Publication 590](#), *Individual Retirement Arrangements (IRAs)*, for details.

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#### **How to Find the Mistake:**

Calculate 25% of each employee's compensation and compare the total contribution made for the employee to the lesser of that amount or the dollar limitation for that year (\$49,000 in 2009). Review the special calculations in Publication 560 for self-employed individuals.

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## **How to Fix the Mistake:**

### **Corrective Action:**

There are two alternative methods to correct a failure to limit employer contributions to employees as required under the Code.

The two methods of correction are:

- 1) You may effect a distribution of the amount in excess of the §415 limit, adjusted for earnings, through the date of correction. Base the earnings adjustment on the actual rate of return of the SEP-IRA from the date you made the excess employer contribution through the date of correction. The amount returned to you is not includible in the gross income of the affected employee. You are not entitled to a deduction for the excess contribution. Report the amount returned on Form 1099-R as a distribution issued to the affected employee, indicating the taxable amount as zero.
- 2) The amount in excess of the §415 limit may be retained in the SEP-IRA. This correction method is available under VCP and requires an additional fee. The fee is equal to at least 10% of the excess amount excluding earnings. The excess amount, adjusted for earnings through the date of correction, must reduce affected employees' §415 limit for the year of correction and subsequent years, until the excess is eliminated.

### **Example:**

Employer I maintains a SEP plan. For the 2007 year, the contributions made on behalf of two employees, T and U, exceeded the limit in §415 of the Code. Employee T had an excess of \$3,000 and U had an excess of \$300. On January 1, 2008, Employee U terminated his employment.

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## **Correction Program(s) Available:**

### **SCP:**

The example illustrates an operational problem, in that the employer failed to follow the terms of the plan by improperly exceeding the 415 limitations provided for in the plan document and the Code. Therefore, provided that the other eligibility requirements of SCP are satisfied, Employer I may use SCP to correct the failure by using the distribution of excess amounts correction method described above.

- No fees for self-correction.
- Practices and procedures must be in place.

### **VCP:**

Under VCP, correction is the same as described above under "Corrective Action." Employer I makes a VCP submission in accordance with Rev. Proc. 2008-50. The fee for the VCP submission is \$250. If you make correction under the retention method described above under "Corrective Action" (#2), the Rev. Proc. imposes an additional fee equal to at least 10% of the excess amount excluding earnings in addition to the \$250 submission fee.

### **Audit CAP:**

Under Audit CAP, correction is the same as described above under "Corrective Action." Employer I and the IRS enter into a Closing Agreement outlining the corrective action and negotiate a sanction based on the [Maximum Payment Amount \(MPA\)](#).

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**How to Avoid the Mistake:**

After the initial calculation of allocations based on the terms of the plan, you should check to make sure none of the proposed allocations would violate §415 of the Code. Make the calculation based on the plan language. Check this against the §415 rules before the actual allocation is made to the SEP. If there is a problem, you can adjust it before you transfer the money into the SEP accounts.

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