Chapter 13

SEP, SARSEP Audit Techniques

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INTERNAL REVENUE SERVICE
TAX EXEMPT AND GOVERNMENT ENTITIES

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Overview of chapter

Introduction

This chapter is intended to serve as a guideline to the examination techniques appropriate for use in SEP/SARSEP examinations. It also includes

- a summary of the issues encountered by agents around the country during the SARSEP project and
- a brief technical overview of the law in respect to these plans, including any changes as a result of the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) and the Job Creation and Worker Assistance Act of 2002 (JCWAA).

The technical aspects of SEP/SARSEPs were covered in detail in Chapter 15 of the CPE 2002 text. Our goal here is to summarize the technical aspects of these plans and concentrate more on the examination techniques and the issues encountered during the recent project.

Internal revenue manual

Internal Revenue Manual ("IRM") 4.72.17, Simplified Employee Pensions (SEPs) and Salary Reduction Simplified Employee Pensions (SARSEPs) is a good source for the technical requirements and will be followed for the law section of this chapter. The various issue reports and SARSEP Q & A reports issued by Voluntary Compliance will be the basis for the examination techniques and issues sections of this chapter.

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Overview of chapter, Continued

Most important issues found in examination cases

EP field offices conducted SEP/SARSEP examinations during fiscal year 2002. The goal of the project was to research, select and study a statistically reliable sample of plans from the SEP plan universe identified for the 2000 year. Code F in box 13 on the W-2 indicates that an employee has made a salary reduction contribution to a SARSEP. The EP personnel encountered various issues in their examination of these project cases.

The most important issues are:

1) top-heavy failure;

2) lack of documentation for the plans due to no filing requirements;

3) in SARSEPs, failure to satisfy the 50% participation rule for eligible employees;

4) in SARSEPs, failure of the deferral percentage test; and

5) in SARSEPs, failure of the 25employee rule.

Goal of chapter

The chapter will provide an overview of the applicable law for SEPs and SARSEPs, a discussion of the various examination techniques and a review of the important issues uncovered during the project examinations.

NOTE: THE PROJECT CODE FOR FY 2003 IS 103.

Technical Overview

Definition of SEP

A SEP is a written arrangement that allows an employer (including a self-employed individual) to make contributions toward employees' retirement without being involved in a more complex plan. A SEP must satisfy the requirements of IRC §408(k) as well as the top-heavy requirements of IRC §416 and the limitations on annual additions under IRC §415. Under a SEP, IRAs (not Roth or SIMPLE-IRAs) are set up for each eligible employee.

SAR-SEP

Simplified employee pensions with a salary reduction feature (SARSEPs) are defined in IRC §408(k)(6). Under this type of arrangement, an employee can elect to contribute part of his or her pay to the SEP. The Small Business Job Protection Act of 1996 (SBJPA) prospectively repealed SARSEPs. No new SARSEP can be established after December 31, 1996.

Any SARSEP already in existence prior to January 1, 1997, was allowed to continue. Also, employees hired after December 31, 1996, by an employer with a SARSEP are allowed to participate in the SARSEP. From W-2 information on the RICS system approximately 99,000 employers had SARSEP plans at the start of the exam program.

Establishing A SEP

Who may establish a SEP

The following entities may establish a SEP:

- Self Employed Individuals can set up a SEP for himself/herself and his/her employees.
- Sole Proprietors (an owner of the entire interest in an unincorporated business) may establish a SEP for himself/herself.
- Partnerships may establish a SEP, because the partnership is treated as the employer of each partner. Compensation would include the earned income of each partner.

When a SEP can be established

A SEP can be established for a particular year after that year has ended. It can be established as late as the latest time to make employer deductible contributions. Therefore, a SEP can be established no later than the due date, including extensions, of the employer's return for the year. This is more generous than for a qualified plan under IRC §401(a). Those plans must be established by the end of the taxable year in which the employer wants to take a deduction.

Objectives

Objectives

At the end of this lesson, you will be able to:

1) Discuss the basic requirements for a SEP.

2) Understand the major SEP law requirements in the areas of contributions, deductions, top-heavy and notice requirements, as amended by EGTRRA and JCWAA.

3) Gain an understanding of the Examination Techniques applicable to SEP and SARSEP examinations.

4) Review and gain an awareness of the unique issues present in SARSEP examinations.

SEP Requirements

Introduction

IRC §408(k)(1) of the Code defines a SEP as an individual retirement account or annuity that meets the requirements of paragraphs (2), (3), (4) and (5) of IRC §408(k). An employer usually will select a financial institution (bank, brokerage house, insurance company, etc.) as the trustee or custodian of the newly established IRAs for the eligible employees. The following sections will summarize the requirements applicable to SEPs.

A more detailed explanation of the SEP requirements can be found in Chapter 15 of the CPE 2002 text. Publication 560 is also a good source of information, and the Form 5305-SEP gives a good review of the various law requirements.

SEP Requirement-Written Arrangement

Introduction

The SEP or SARSEP must be a part of a written arrangement. A written instrument must include:

- ✓ The name of the employer
- ✓ The requirements for employee participation
- ✓ A definite allocation formula
- ✓ The signature of a responsible official

How a SEP or SAR SEP can be established

The SEP or SARSEP can be established using the following methods:

- Model SEP (or SARSEP)-Form 5305-SEP, Simplified Employee Pension-Individual Retirement Accounts Contribution Agreement(included at the end of this Chapter). This form is not filed with the Service. The form cannot be used if the employer maintains another plan other than a SEP or SARSEP. The Form 5305A-SEP is used for SARSEPs.

- Prototype SEP (or SARSEP) –Provided to an employer by a financial institution (sponsor) that has received an opinion letter from the Service on the document.

- Individually Designed SEP-An employer may use an individually designed plan. There is no requirement for approval by the Service to be a qualified plan, but nearly all are Service approved.

SEP Requirement-coverage and participation

Eligible employee defined

All eligible employees must be allowed to participate. An eligible employee is defined as an employee who:

- ✓ Is at least 21 years of age
- ✓ Has performed service for the employer in at least 3 of the immediately preceding 5 years
- ✓ Received at least $450 in compensation from the employer for the current year

Employer can adopt less restrictive eligibility requirements

An employer may establish less restrictive eligibility requirements than those stated above. The main difference between a SEP and a qualified plan is that a qualified plan can exclude whole categories of employees (such as salaried or hourly-paid) that a SEP cannot, provided the qualified plan satisfies the coverage requirements of IRC 410(b).

If employer is a member of a controlled group

If the employer is a member of a CONTROLLED GROUP, all employees of the related employers or affiliated service group must be covered by the SEP. Also, LEASED EMPLOYEES must be included in the SEP (See IRC §414(n)).

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Excludable employees

The following groups of employees are excludible:

- ➢ Employees who do not meet the minimum age, service and compensation requirements
- ➢ Collectively bargained employees
- ➢ Nonresident aliens

SEP Requirement-nondiscrimination

Two requirements

IRC §408(k)(3) imposes two nondiscrimination requirements on employer contributions to SEPs. These are:

- No discrimination in favor of highly compensated employees (HCEs)
- Employer contributions must bear a uniform relationship to employees' compensation up to $170,000 (2000 and 2001).

New Compensation limit for 2002

As amended by EGTRRA, the new compensation limit for 2002 is $200,000 indexed in $5,000 increments per year thereafter. (The limit for 2003 is $200,000.)

SEP Contributions And Deductions

SEP contributions deductible by employer

The amounts contributed under a SEP by an employer on behalf of an eligible employee are not taxable to the employee in the year they are contributed. In 2001, contributions to a SEP are deductible by an employer only up to <u>15% of the total compensation paid to employees participating in the SEP, with no more than $170,000 (for 2000 and 2001, $200,000 for 2002 and 2003) of compensation taken into account for each employee.</u>

<u>If the employer maintains another defined contribution plan, such as a stock bonus or a profit-sharing plan, the 15% limit is an **overall** limit.</u>

Increase in limit

As amended by JCWAA, starting in 2002, the 15% limit described above is increased to 25%.

Contribution Limit

415 limits

A SEP is treated as a defined contribution plan for purposes of the limitations under IRC §415. Therefore, employer contributions to a participating employee's SEP-IRA cannot exceed the lesser of:

- $30,000 (as adjusted under IRC §415(c)-$35,000 for 2001), or
- 25% of a participant's compensation.

EGTRRA amended contribution limit

EGTRRA amended the contribution limit as follows:

Employer contributions to a participating employee's SEP-IRA cannot exceed the lesser of:

- $40,000 (as adjusted – $40,000 for 2003), or
- 100% of a participant's compensation

25% compensation limit--Self employed individuals

In applying the 25% of compensation limit on contributions to self-employed individuals, "compensation" means, "earned income as defined in IRC §401(c)(2). Care has to be taken in this area regarding the self-employment tax effect on the contribution limit. Publication 560, Retirement Plans for Small Business, is a good source for determining the contribution limit for self-employed individuals.

SARSEPs: Special Requirements

Introduction

Salary reduction SEPs (SARSEPs) are similar, in some respects, to IRC §401(k) plans. A SARSEP is a SEP that allows for employee salary deferrals.

The Small Business Job Protection Act of 1996 (SBJPA) prohibited the establishment of any new SARSEPs for years beginning after 1996. Any SARSEP that existed prior to 1997 can continue.

Ineligible employer

A SARSEP cannot be maintained by:

- A tax-exempt organization
- A State or local government
- Any political subdivision, agency or instrumentality of a State or local government
- An employer with more than 25 eligible employees

Condition for making elective deferrals

Elective deferrals cannot be made to a SARSEP for a year unless **at least 50%** of the employer's employees who are eligible to participate make, or have in effect, a salary reduction election under the SARSEP for that year.

Nondiscrimination testing for elective deferrals

The nondiscrimination test of IRC §408(k)(6)(A)(iii) states that the deferral percentage for a year of each highly compensated employee (HCE) eligible to participate must not be more than the average of the deferral percentages for such year of all employees (other than HCEs) eligible to participate, multiplied by 1.25. This is the "Deferral Percentage Test."

Compensation limit

The compensation limit of IRC §401(a)(17) of $170,000 (2000 and 2001) and $200,000 (2002 and 2003) appliese in determining an employee's deferral percentage.

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SARSEPs: Special Requirements, Continued

Limits on deferrals

The deferral limit for 2000 and 2001 was $10,500. This only applies to the amounts deferred from the employee's salary.

EGTRRA amended the deferral limits for years after 2001 as follows:

YEAR	LIMIT
2002	$11,000
2003	$12,000
2004	$13,000
2005	$14,000
2006	$15,000*

*Indexed after 2006

Top heavy Requirements

SEP treated as a DC plan

A SEP is treated as a defined contribution plan for purposes of the minimum contribution top-heavy requirements of IRC §416. Employer contributions are aggregated under the SEP to determine if the 60% threshold under IRC §416(g) has been crossed. Elective deferrals are considered employer contributions for this purpose.

Keep in mind that if an employer who adopts the IRS Model plan (Form 5305A-SEP) in any year has a key employee make an elective deferral, the plan is deemed to be top-heavy regardless of the 60% threshold.

Distributions from a SEP

Employees can withdraw at any time

A SEP-IRA must permit employees to withdraw amounts at any time. Since IRAs are the funding vehicle for SEPs, the rules applicable to IRAs in this area apply to SEP-IRAs. Form 1099-R, Distributions from Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc., is used to report distributions from a SEP-IRA.

SARSEP V. SIMPLE IRA

Introduction

SBJPA introduced the SIMPLE IRA plan as a way for small businesses to have a 401(k)-type plan without the discrimination testing and filing requirements that go with a qualified plan. Since the prohibition on new SARSEPs after 1996, an employer that wants to allow employees to make elective deferrals generally can choose between a **401(k) plan** or a **SIMPLE IRA plan.**

Since a significant number of the field agents in the SARSEP Project encountered SIMPLE IRA plans, may be helpful to briefly identify the major differences between the two plans.

The following is a comparison of the various requirements as of the 2002 year, as amended by EGTRRA:

REQUIREMENT	SARSEP	SIMPLE
Employer contribution	Up to lesser of $40,000 or 25% of compensation	3% matching or 2% non-elective contribution
Elective deferrals	Up to $11,000	Up to $7,000
Employer maintaining another plan	Yes	No, has to be the only plan of employer
Form 5500	No	No
Eligible employee	Age-21, $450 comp. and service for employer in 3 out of last 5 years	Expected to earn at least $5,000 in compensation in current year. No age req.

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SARSEP V. SIMPLE IRA, Continued

REQUIREMENT	SARSEP	SIMPLE
Eligible employer	Employer with less than 25 eligible employees	Employer for prior year had no more than 100 employees who received at least $5,000 in comp.
Establishing	Not allowed since 1996	For a year after 1996, by October 1 of that year
Vesting	Immediate vesting	Immediate vesting

Examination Techniques

Introduction

This section will highlight potential examination techniques that can be incorporated as part of a SEP/SARSEP examination.

Written Arrangement-Exam techniques

Introduction

A plan document must be timely adopted, with all of the required terms, and IRAs should have been established for each eligible employee. If the plan is a SARSEP, see if it was originally established before 1997**.**

Exam techniques

- Model Form-check if all the special requirements and restrictions specified in the form are met.
- Verify the establishment of the SARSEP prior to 1997 through third party documentation (account statements, affidavits, enrollment forms, etc.)
- Secure W-2 forms showing SARSEP deferrals, if available, for years prior to 1997.
- Implement IDRS research if W-2's are not available. IRPTRA report can identify W-2s, 1099-Rs, etc. reported for the taxpayer. A report should be generated for the SSN of each taxpayer listed on the tax return. The IRPTRA summary sheet contains a document code listing which aids in the identification of the particular form.

Coverage & Participation

Introduction

All eligible employees must be allowed to participate in the SEP/SARSEP. Also, if less than 50% of eligible employees are participating in an employer's SARSEP for a year, then NO deferrals can be made by anyone for that year. (This test is applied each year.)

Exam techniques

- Determine the number of employees that may be eligible to participate by examining the payroll records of the employer.
- Check W-2s to determine the number of employees who meet the $450 compensation threshold.
- Check dates of birth, hire, participation and termination. Verify any explanation given why a seemingly eligible employee was not covered. If applicable, verify that all eligible employees who were required to receive contributions did so.
- Check if a controlled group or affiliated service group exists. If so, employees should be included in the plan.

Nondiscrimination

Introduction

Employer contributions to SEPs cannot discriminate in favor of highly compensated employees (HCEs). IRC §414(q) defines a highly compensated employee. Also, the compensation limit of IRC §401(a)(17) must not be exceeded.

Exam techniques

- Identify HCEs based on employer's payroll records.
- Verify that the correct definition of compensation is used and compensation in excess of the limit is disregarded.
- Verify that a uniform rate of contribution is utilized (except in the case of elective deferrals and SEPs utilizing permitted disparity). Varying levels of contributions for various classes of employees is not permitted.
- Identify any family members and/or lineal descendants for purposes of the HCE/key employee identification. Proper classification could alter the deferral percentage test results. Same rules as for a normal 401(k) plan.

Contributions & Deductions

Introduction

The contribution limits cannot be exceeded. Contributions that exceed the deductible limits are subject to the excise tax under IRC §4972.

Exam techniques

- Verify the amount deducted on the employer's income tax returns is accurate. If a corporation, the deduction would be on Form 1120, Line 24 or Form 1120S, Line 17. If a self-employed individual, the deduction would be on the front of Form 1040 in the adjustments to AGI section.
- Review the plan for written allocation formula. If a SARSEP, check the participant enrollment forms to see if the correct amounts were put in the plan.
- Ascertain if the employer maintains any other retirement plan.
- Utilize the W-2 forms to determine whether proper compensation was used and, if a SARSEP, that the amount of the deferrals is correct.
- If a self-employed individual is covered, verify that proper adjustments were made in calculating his or her allocation. Publication 560 is a good source for this purpose.

SARSEP: Ineligible Employer And 50% Rule

Examination techniques

Verify the employer is not a tax exempt organization or a State or local government entity.

Verify that elective deferrals can be made for a year; that the employer had no more than 25 eligible employees during the prior year and that at least 50% of the eligible employees made salary deferrals for the current year.

- Review payroll records to determine if the number of eligible employees exceeds 25 and at least 50% of the eligible employees are participating. W-2s can be used to verify salary deferrals. The law requires the employer to maintain the employment tax records for at least the last 4 years.
- Review of employee personnel records can aid in this determination.

The 25employee rule limitation needs to be reviewed in the preceding plan year for application. So if the employer does not go over 25 employees in the preceding plan year they may make deferrals in the current year. Also, in future years if the employer goes below 25 employees after exceeding the limits, employees may then again make elective deferrals.

SARSEP: Nondiscrimination Test

Exam techniques

The elective deferrals must satisfy the deferral percentage test, described earlier.

- Identify HCEs (IRC §414(q)).
- Calculate the deferral percentage of each eligible non-highly compensated employee (NHCE) and determine the average for all eligible NHCE. No HCE can have a deferral percentage greater than this average multiplied by 1.25.

SARSEP: TOPHEAVY

Examination techniques

The top-heavy requirements of IRC §416 apply to SARSEPs (and regular SEPs).

- Determine, as of the last day of the preceding year, if the aggregate contributions ever made on behalf of key employees under the SARSEP exceed 60% of contributions made for all employees.
- If top-heavy or deemed top-heavy, verify that the top heavy minimum contribution is made to non-key employees. The IRS Form 5305A-SEP model plan and most prototype SARSEPs are deemed top-heavy; thus, a top-heavy minimum contribution must be made for a year that any key employee participates..
- Verify that deferrals of non-key employees are not used to satisfy the top-heavy minimum contribution.
- Verify that deferrals of the key employees were used to determine the minimum that the non-key employees should receive.

SARSEP: DISTRIBUTIONS

Exam Techniques

Generally, the same rules applicable to traditional IRAs apply to IRAs used as the funding vehicle for a SEP or a SARSEP.

- Verify that Form 1099-R is correctly prepared and filed.
- Determine if appropriate distribution information was delivered to the participants.
- Review cancelled checks and/or third party accounts for verification of distribution.

SARSEP EXAMINATION PROJECT ISSUES

Further guidance anticipated

It is anticipated that some further guidance will be forthcoming from Voluntary Compliance regarding the resolution of the various issues encountered in the SARSEP Project. Acceptable resolutions of SEP and SARSEP issues are addressed in Revenue Procedure 2002-47.

Issues uncovered by project cases

The following is a list of the issues uncovered by the revenue agents working the project cases.

- Lack of written documentation regarding timely establishment of a SARSEP.
- Violation of <25 eligible employee rule. 408(k)(6)(B)
- Violation of 50% rule. 408(k)(6)(A)(ii)
- Required top-heavy minimum contributions not made by the employer.
- Employers who adopt the IRS model 5305A-SEP, but then do not follow the deemed top-heavy provisions when a key employee makes elective deferrals.
- Providing top heavy minimum contributions to non-key employees who are making the maximum deferral allowed causing the total contributions to exceed the plan's contribution limits (15% before 2001 and 25% after 2001).
- Failure of the deferral percentage test or not performing the test. 408(k)(6)(A)(iii)
- Allowing deferrals by key employees to exceed the 15% limit.
- Improperly excluding eligible employees from participation. An eligible employee is an individual who meets the following requirements: a) has attained age 21; b) has performed services for the employer (can be 1 hour) in at least 3 of the last 5 years; and c) has received at least $450 in compensation. The plan can have more liberal requirements.

Contact CAP Coordinator for assistance

As you can see, the problems identified above cover a wide area. Until further guidance is issued from VCP, agents should contact their area CAP Coordinator for assistance on the resolution of the problems.

Examination Case Examples:

Example 1-did not follow plan's eligibility requirements in operation

Prior to 1997, an employer adopted the IRS model plan 5305A-SEP, and and completed the form to specify that employees are eligible to participate upon attainment of age 21 and after performing services in any year during the last 5 years. However, in operation, the employer uses the maximum permitted eligibility criteria: that is, the employer kept out employees until they were age 21 and had performed services for the employer in 3 of the last 5 years.

Approach—amend, but only for future eligibility

Employers must follow the terms of their plans, and in this case the employer has not done so. The employer could amend the plan to require 3 years of performed service, but only for future eligibility.

Another issue-key employee participates in the plan

A key employee participates in the plan and makes elective deferrals for the year. Since the employer has adopted the IRS model plan, the employer must make a top-heavy minimum contribution to eligible non-key employees because the plan is deemed top-heavy.

The plan cannot use employee elective deferrals to satisfy the top-heavy minimum contribution. The employer's SARSEP specifies that the top-heavy minimum contribution will be made under the employer's regular (non-elective) SEP. In this case, the agent needs to verify that the employer does, in fact, have a regular SEP and is making the top-heavy minimum contribution to the SARSEP's eligible non-key employees in that SEP.