PURPOSE

(1) This transmits new text and Table of Contents for IRM 4.72.17, Employee Plans Technical Guidelines, Simplified Employee Pensions (SEPs) and Salary Reduction Simplified Employee Pensions (SARSEPs).

BACKGROUND

(1) This IRM provides guidelines for examining SEPs and SARSEPs.

NATURE OF MATERIAL

(1) Chapter 17 of IRM 4.72 provides guidance to EP examiners in identifying relevant issues relating to SEPs and SARSEPs. This section reflects statutory changes through the Job Creation and Worker Assistance Act of 2002, P.L. 107-147.

AUDIENCE

TE/GE (Employee Plans)

Carol Gold
Director, Employee Plans
Tax Exempt and Governent Entities Division

4.72.17
Simplified Employee Pensions (SEPs) and Salary Reduction Simplied Employee Pensions (SARSEPs)

Table of Contents

4.72.17.1
(09-12-2006)
Overview of Section 17

(1) The information contained in this section 17 is designed primarily to assist EP examiners in identifying relevant issues relating to SEPs and SARSEPs.

(2) This section 17 reflects statutory changes through the Job Creation and Worker Assistance Act of 2002, P.L. 107-147 (JCWAA).

4.72.17.2
(09-12-2006)
Technical Overview

(1) The requirements for SEPs are set forth in IRC section 408(k). A SEP is a written arrangement (a plan) that allows an employer to make contributions towards its employees' retirement without becoming involved in more complex retirement plans. A self-employed individual may also establish a SEP. The contributions are made to traditional Individual Retirement Arrangements (IRAs) (not Roth or SIMPLE IRAs) of the plan participants. Traditional IRAs used to receive contributions under a SEP are often referred to as "SEP-IRAs", and the SEP participant (IRA owner) can make his or her own regular IRA contributions ($4,000 for 2005, $4,500 if 50 or over) to these IRAs. Under a SEP, IRAs are set up for each eligible employee. They do not have to be set up for excludable employees. These terms are described further below in this section 17.

(2) SARSEPs are defined at IRC section 408(k)(6). A SARSEP is a SEP that includes a salary reduction arrangement. Under this type of arrangement, the employee can elect to contribute part of his or her pay to the SEP. The Small Business Job Protection Act of 1996, P.L. 104-188, (SBJPA) prospectively repealed SARSEPs. No new SARSEPs can be established after December 31, 1996. However, employers that established SARSEPs prior to January 1, 1997, can continue to maintain them, and new employees of the employer hired after December 31, 1996 can participate in the existing SARSEP.

(3) The Economic Growth and Tax Relief Reconciliation Act of 2001, P.L. 107-16, (EGTRRA), as amended by JCWAA, made several changes to the Internal Revenue Code affecting SEPs, that are effective beginning in 2002. Rev. Proc. 2002-10, 2002-4 I.R.B. 401, provides procedures and deadlines for amending SEPs for the new law.

4.72.17.3
(09-12-2006)
Written Arrangement Requirement

(1) The SEP or SARSEP must be part of a written arrangement. Section 1.408-7(b) of the Proposed Income Tax Regulations provides that the employer must execute a written instrument within the time prescribed for making deductible contributions (that is, no later than the due date including extensions of the employer's return for the year). This writing must include: the name of the employer, the requirements for employee participation, the signature of a responsible official, and a definite allocation formula.

(2) This means that a SEP may be set up after the end of the year for which contributions are made, which is more generous than the rule for qualified plans under IRC section 401(a). A qualified plan must be executed by the end of the taxable year for which the employer wants to take a deduction.

(3) A SEP or SARSEP can be established using a model, a prototype document or an individually designed document.

4.72.17.3.1
(09-12-2006)
Model SEP or SARSEP

(1) An employer may use Form 5305-SEP, Simplified Employee Pension-Individual Retirement Accounts Contribution Agreement, or Form 5305A-SEP, Salary Reduction Simplified Employee Pension-Individual Retirement Accounts Contribution Agreement, whichever is applicable, to satisfy the written arrangement requirement.

(2) The form is not filed with the Service but is retained in the employer's records.

(3) A model SEP or SARSEP is considered to be adopted when IRAs have been established for all eligible employees, all blanks on the form (without modification) have been completed, and specified information has been given to all eligible employees as stated in the instructions to the model.

(4) The model forms may not be used by an employer who:

a. Maintains any other qualified retirement plan (except for another SEP or SARSEP),
b. Uses the services of leased employees,
c. Wants a plan other than a calendar-year plan, or
d. Wants an integrated SEP

(5) In addition, each employee's IRA set up to receive contributions made under the SEP must be a pre-approved traditional IRA; i.e., either a Model traditional IRA or a prototype traditional IRA. The IRAs may not be Roth IRAs or SIMPLE IRAs.

4.72.17.3.2
(09-12-2006)
Prototype SEP

(1) A sponsor (usually a mutual fund or a bank) can request from the Service an opinion letter for a prototype SEP. An opinion letter states that a SEP agreement is acceptable in form. The sponsor must accompany any request for an opinion letter with the proper user fee and Form 5306-A. The Service has prepared a Listing of Required Modifications (LRMs), or sample language, to assist sponsors in drafting an acceptable prototype SEP. The LRMs are available on the Service's Web Site, www.irs.gov.

(2) An employer using a prototype document, rather than a model, to establish a SEP can:

a. Use a plan year, other than the calendar year, that is the same as the employer's taxable year,
b. Use an integrated allocation formula, and
c. Contribute a top-heavy minimum only when the plan is actually top-heavy.

4.72.17.3.3
(09-12-2006)
Individually Designed SEP

(1) An employer may use an individually designed plan. Pre-approval by the Service of a SEP is not required for an employer's SEP to be qualified, although nearly all SEPs are Service pre-approved.

4.72.17.4
(09-12-2006)
Coverage and Participation Requirements

(1) All eligible employees must be allowed to participate. An eligible employee is an employee who:

a. Is at least 21 years old (IRC section 408(k)(2)(A)),
b. Has performed service for the employer in at least 3 of the immediately preceding 5 years (IRC section 408(k)(2)(B)), and
c. Has received at least $450 in compensation (as adjusted under IRC

section 408(k)(8)) from the employer for the current year (IRC section 408(k)(2)(C)). See the table at the end of this section 17 for annual dollar limits applicable to SEPs.

(2) An employer may establish less restrictive eligibility requirements than these. Also note that "service," as referenced in b. above, means any work performed for the employer for any period of time, however short. A SEP may not impose a length of service requirement. For example, if a plan requires an employee to work during at least 1 of the 5 years immediately preceding the current year, and the employee is otherwise eligible, the length of time he or she worked for the employer in that period is irrelevant. Even if the employee worked for one day he or she is eligible, assuming the employee otherwise meets the requirements for SEP participation.

Example 1: Employer X maintains a calendar year SEP. Under the SEP, an employee must perform services in at least 3 of the immediately preceding 5 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 2001, 2002, and 2003 but never more than 34 days in any year. In July 2004, Employee A turns 21. In August 2004, Employee A begins working for Employer X on a full-time basis, earning $8,000 a year. Employer X makes a contribution to the SEP for eligible employees for 2004. Employee A is an eligible employee in 2004 and Employer X must make a contribution for Employee A because he has met the minimum age requirement, has worked for Employer X in 3 of the 5 preceding years, and has met the minimum compensation requirement for 2004.

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 2004. Employer Y must make a contribution for Employee B for 2004.

4.72.17.4.1
(09-12-2006)
Member of Controlled Group, etc.

(1) IRC section 414(b), (c) and (m) provide, in relevant part, that for purposes of section 408(k) all employees of all corporations that are members of a controlled group of corporations, trades or businesses under common control, or members of an affiliated service group are treated as employed by a single employer. Since SEPs must cover all employees, the employer sponsoring the SEP must cover employees of such related employers.

4.72.17.4.2
(09-12-2006)
Leased Employees

(1) The person or firm for whom services are performed may have to include in a SEP any leased employee who is treated as an employee of the recipient. Generally speaking, a leased employee is any person who is not an employee of the recipient but who is hired by a leasing organization and performs services for the recipient. See IRC section 414(n).

4.72.17.4.3
(09-12-2006)
Excludible Employees

(1) In addition to employees who do not meet the minimum age, service and compensation requirements, the following employees do not have to be covered:

a. Employees covered by a collective bargaining agreement whose retirement benefits were bargained for in good faith by the employer and the union, and

b. Employees who are nonresident aliens who did not earn U.S. source income from the employer.

(2) Unlike the participation requirements for qualified plans, there are no rules for SEPs that would allow the exclusion of certain percentages of employees. Thus, when the employer is part of a controlled group or uses leased employees, all such eligible employees must be covered under the SEP.

4.72.17.5
(09-12-2006)
Nondiscrimination Requirements

(1) (1) IRC section 408(k)(3) imposes nondiscrimination requirements on employer contributions to SEPs. Under IRC section 408(k)(3)(A), contributions may not discriminate in favor of highly compensated employees (HCEs), and IRC section 408(k)(3)(C) states that contributions shall be considered discriminatory unless they bear a uniform relationship to participants' compensation that does not exceed $200,000 (as adjusted under IRC section 408(k)(8)). See the table at the end of this section 17 for annual dollar limits applicable to SEPs.

(2) Highly compensated employees (HCEs) are defined at IRC section 414(q). The SBJPA made significant changes to the definition of HCE, effective for years after 1996. An HCE is any employee who (i) was a 5-percent owner at any time during the year or the preceding year or (ii) for the preceding year, had compensation from the employer in excess of $80,000 and, if the employer so elects, was in the top-paid group for the preceding year. The $80,000 amount is adjusted at the same time and in the same manner as under IRC section 415(d) except that the base period is the calendar quarter ending September 30, 1996. See Notice 97-45, 1997-2 C.B. 296, for guidance on the definition of HCE. See the table at the end of this section 17 for annual dollar limits applicable to SEPs.

(3) A rate of contribution that actually decreases as compensation increases (for example, the same dollar amount to all participants) is considered uniform. The requirement that contributions bear a uniform relationship to compensation generally means that the SEP may not provide for varying levels of contributions for various classes of employees, such as a higher percentage for senior employees. However, the uniformity requirement is not considered violated in the case of:

a. Salary reduction contributions made under a SARSEP and
b. Contributions made under an integrated allocation formula. See IRC sections 408(k)(3)(D) and 401(l).

(4) Under an integrated allocation formula, a SEP is permitted to provide limited disparity in contributions, under the same rules that apply to defined contribution plans under IRC section 401(a). Therefore, a SEP may provide employees whose compensation is above the Social Security taxable wage base a contribution that is a higher percentage of their compensation than the percentage provided for employees earning less than the taxable wage base (TWB). IRC section 402(h)(2)(B) effectively reduces the $40,000 contribution limit (see below) for HCEs in an integrated SEP by the product of the excess contribution percentage and the integration level. For example, if a SEP had an allocation formula of 10% of compensation up to the TWB ($90,000 in 2005) plus 15.7% of compensation in excess of the TWB, the 415 dollar limit is reduced by $5,130 ($90,000 x 5.7%) for 2005. Note that salary reduction contributions may not be integrated with Social Security.

Example 3: Employer X adopts a SEP with a contribution formula providing for an allocation of 10% of compensation to each employee who worked for 5 or less years for the employer and 12% of compensation to each employee who has worked for more than 5 years. This is discriminatory because the rate of contributions does not bear a uniform relationship to each employee's compensation.

4.72.17.6
(09-12-2006)
Contributions

(1) Under IRC 408(k)(5), SEP contributions must be made under a written allocation formula. A SEP may provide that contributions are a fixed percentage of employees' compensation, a fixed dollar amount for each participant, or that contributions are to be determined each year by the employer (a discretionary contribution). Discretionary contribution formulas are the most common. The employer may uniformly vary the percentage of compensation contributed year by year or contribute nothing for a particular year, but the SEP document must state how the employer contribution will be allocated. An employer may vary the formula or percentage from year to year (for example, to change from a fixed contribution to a discretionary contribution), provided the SEP is timely amended.

4.72.17.6.1
(09-12-2006)
Contribution Limit

(1) A SEP is treated as a defined contribution plan for purposes of the limitations under IRC section 415. Thus, contributions made under an employer's SEP to a participant's IRA cannot exceed the lesser of $40,000 (as adjusted) or 100% of a participant's compensation. All an employer's defined contribution plans must be aggregated for purposes of these limits.

(2) Under IRC section 404(h)(1)(C), an employer cannot deduct contributions that exceed 25% (15% for years beginning before 2002) of employees' compensation for the year, and under IRC section 4972, nondeductible contributions are subject to a 10% tax. Also, under IRC section 402(h), a SEP participant cannot exclude from gross income SEP contributions that exceed 25% (15% for years beginning before 2002) of compensation. For these reasons, SEP documents limit contributions to 25% (15% for years beginning before 2002) — the deduction/exclusion limit, rather than the qualification limit. Therefore, since a SEP is statutorily required to have a written allocation formula, a plan limit of 25% becomes a qualification limit.

(3) The compensation upon which the 25% is based cannot exceed $200,000 (as adjusted under IRC section 408(k)(8)) and it does not include any elective deferrals or other amounts not includible in gross income (see IRC section 402(h)(2)).

Example 4: Employee A earns $200,000 in compensation from Employer X during 2005. For 2005, Employer X could contribute up to $42,000 to the SEP on behalf of Employee A. Of course this assumes all the other requirements for SEPs are satisfied. (For 2005, the maximum contribution on behalf of any participant is the lesser of $42,000 and 25% of the participant's compensation that does not exceed $210,000.)

4.72.17.6.2
(09-12-2006)
Special Rules for Self-employed Individuals

(1) In the case of self-employed individuals, in determining the 25%-of-compensation limit on contributions, compensation means “net earnings from self-employment”.

(2) Net earnings from self-employment for SEP purposes means gross income (net earnings) from the business minus allowable deductions for that business. For SEP purposes, net earnings must take into account the deductions for contributions to the self-employed individual’s own SEP. Because the deduction amount and the net earnings amount are each dependent on the other, this adjustment presents a problem. To solve this problem, adjustments are made indirectly by reducing the contribution rate called for in the plan, in figuring the maximum deduction.

(3) Allowable deductions include contributions to common-law employees’ SEPs. It also takes into account the deduction allowed for half of the self-employment tax.

(4) For more information on the deduction limitations for self-employed individuals, see Publication 560, Retirement Plans for Small Business.

4.72.17.6.3
(09-12-2006)
Employer Deduction

(1) An employer cannot deduct contributions to a SEP that exceed 25% (15% for years beginning before 2002) of employees’ compensation for the year, and if the employer also maintains a stock bonus, a profit-sharing or a money purchase pension plan, the limits on contributions to those plans are reduced by the contributions to the SEP. If more than 25% is contributed for a year, the excess can be deducted in subsequent years to the extent less than 25% is contributed in such subsequent years.

(2) To deduct contributions for a year, the employer must make the contributions not later than the due date (including extensions) of the employer’s return for the year. See IRC section 404(h)(1).

4.72.17.7
(09-12-2006)
Special Requirements for SARSEPs

(1) A SARSEP is a SEP that accepts contributions made pursuant to a salary reduction arrangement. In other words, it is the employee that decides whether and to what extent money will be made to SEP-IRAs established for the employee under the SARSEP, rather than being paid to the employee as compensation. See IRC section 408(k)(6). They are similar in some respects to cash or deferred arrangements under IRC section 401(k). As in section 401(k) plans, contributions funded through salary reduction elections are called “elective deferrals” because the contributions are made at the elections of the employees and because the principal tax effect is to defer payment of income taxes until actually distributed to the employee from the IRA.

(2) Section 1421(c) of SBJPA added IRC section 408(k)(6)(H), effective for years beginning after 1996, that prohibited the establishment of any new SARSEPs. The introduction of SIMPLE IRA plans under IRC section 408(p) by the same act is intended to fill the need for retirement plans like SARSEPs. SARSEPs existing prior to 1997 can continue.

(3) As with regular SEPs, SARSEPs can be adopted using a model form, a prototype document or an individually designed document. Form 5305A-SEP is the model SARSEP issued by the Service. If a SARSEP is individually designed it must have language that satisfies IRC section 408(k)(6). In Rev. Proc. 91-44, 1991-2 C.B. 733, the Service provided a model amendment for SEP prototype plans such that adoption of the amendment would turn the SEP

into a SARSEP. This same revenue procedure sets forth the requirements for obtaining opinion letters on prototype SARSEPs. Rev. Proc. 2002-10 sets forth procedures and deadlines for amending SARSEPs to reflect the law as amended by EGTRRA.

4.72.17.7.1
(09-12-2006)
Ineligible Employer

(1) A SARSEP may not be maintained by a tax-exempt organization or by a state or local government, or any political subdivision, agency or instrumentality of a state or local government.

(2) Elective deferrals cannot be made to a SARSEP for a year if the employer had more than 25 employees who were eligible to participate at any time during the preceding year. This is a year-by-year determination.

(3) 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. This is a year-by-year determination.

Example 5: Employer X established a SARSEP in 1995. In 2001, the employer expanded its business and hired new employees. In 2004, under the terms of the SARSEP more than 25 employees were eligible to participate. Thus, in 2005, Employer X's employees cannot make elective deferrals under the SARSEP since there were more than 25 employees eligible to participate in the preceding year. However, if Employer X had 25 or fewer employees during all of 2005, then elective deferrals under the SEP could be made in 2006.

4.72.17.7.2
(09-12-2006)
Nondiscrimination Test for Elective Deferrals

(1) SARSEPs are subject to a nondiscrimination test similar to the test imposed on section 401(k) plans, but more restrictive. Under IRC section 408(k)(6)(A)(iii), the deferral percentage for a year of each 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 (the "deferral percentage test"). Elective deferrals of an HCE in excess of this limit are called "excess SEP contributions".

(2) The deferral percentage for a participant for a year is the ratio, expressed as a percentage, of elective deferrals made for the year (other than catch-up contributions, discussed later) to the participant's compensation. Compensation in excess of $200,000 (as adjusted under IRC section 408(k)(8)) cannot be considered in determining an employee's deferral percentage. See IRC section 408(k)(6)(D).

(3) This test is different than the actual deferral percentage (ADP) test described in IRC section 401(k)(3) applicable to section 401(k) plans. The deferral percentage test for SARSEPs compares the deferral percentage of **each** HCE with the average of the deferral percentages of all nonhighly compensated employees (NHCEs), whereas the ADP test compares the average of the deferral percentages of all HCEs with the average of all NHCEs. Further, unlike section 401(k) cash or deferred arrangements, nonelective contributions from the employer cannot be used to help the SARSEP satisfy the test and SARSEP HCE and NHCE deferral percentages are compared for the same (testing) year, whereas section 401(k) plans may compare the HCE deferrals for the testing year with the NHCE deferrals for the year before.

(4) The employer must notify each affected HCE within 2½ months following the end of the plan year to which the excess SEP contributions relate, of any excess SEP contributions to the HCE's SEP-IRA for the applicable year. The notice must specify the amount of the excess SEP contribution, and the calendar year in which the contributions are includible in income and provide an explanation of applicable penalties if the excess contributions are not withdrawn in a timely manner. See Regulations section 54.4979-1(a)(4)

(5) Excess SEP contributions of an employee who is age 50 or older by the end of the year do not have to be removed from the employee's SEP-IRA to the extent the employee has not reached his or her catch-up contribution limit (see below).

4.72.17.7.3
(09-12-2006)
Limits on Deferrals

(1) In general, the total income that can be deferred for a participant who is less than 50 years old under a salary reduction arrangement included in a SEP and certain other elective deferral arrangements is limited to $11,000 for 2002, $12,000 for 2003, $13,000 for 2004, $14,000 for 2005 and $15,000 for 2005 and later years. (See IRC section 402(g)(1).) After 2006 the limitation will be adjusted for cost-of-living increases under IRC section 402(g)(4). In the case of a participant who is 50 or older by the end of the year, the limitations are increased by the catch-up contribution limit for the year: $1,000 for 2002, $2,000 for 2003, $3,000 for 2004, $4,000 for 2005 and $5,000 for 2006 and later years. (See IRC section 414(v)(2).) After 2006 the catch-up contribution limit will be adjusted for cost-of-living increases under IRC section 414(v)(2)(C). If the employee has other elective deferrals made under another SARSEP, a section 401(k) plan or a salary reduction agreement used to purchase a section 403(b) annuity, such elective deferrals are added to the elective deferrals under the SARSEP for purposes of the IRC section 402(g) annual limit.

(2) Catch-up contributions are described in IRC section 414(v) as additional elective deferrals of an employee aged 50 or older that exceed a statutory or plan limit on elective deferrals and that are not more than the catch-up contribution limit for the year (discussed above). Of course the SARSEP document must permit catch-up contributions and the employee must have sufficient compensation to defer from. Most catch-up contributions can be determined when made – for example, the regular section 402(g) limit, the section 415 limits and any percentage limit contained in the plan document – and these catch-up contributions are not counted in the deferral percentage test. But the deferral percentage test is also a limit for determining catch-up contributions, so an HCE could have catch-up contributions even if he or she has not reached the limits in the preceding sentence. (See ***Example 6***, below.)

(3) If an employee has more elective deferrals made on his/her behalf for a taxable year than allowed under the applicable section 402(g) limit, the employee must include the excess in income for the taxable year for which the excess deferrals were made. In addition, the excess is included in income a second time when it is distributed from the SEP-IRA unless: (i) the withdrawal occurs on or before April 15 of the year after the taxable year for which the excess was made; and (ii) the withdrawal includes the amount of any earnings attributable to the excess. (See IRC section 402(g)(2)(A).) If elective deferrals in excess of the 402(g) limit have been made to one or more plans (including SARSEPs) of one employer for a year, then, unless the excess plus attributable earnings are distributed by April 15, the plan or plans (including the SARSEPs) do not comply with the Code requirements.

(4) In addition to the deferral percentage test, elective deferrals under a SARSEP are subject to the overall 25% limit applicable to regular SEPs discussed previously.

Example 6: In 2004, HCE A, aged 55, defers 10% of his compensation, or $9,000, under his employer's retirement plan, a SARSEP that provides for catch-up contributions. Since none of the $9,000, prior to the deferral percentage test, are classified as catch-up contributions, all his deferrals are included in the test. After calculating the NHCEs' average deferral percentage for 2004, it is determined that HCE A has deferred $1,125 over the amount permitted under the deferral percentage test. Since none of HCE A's deferrals for 2004 have so far been classified as catch-up contributions, the entire amount of HCE A's excess SEP contributions, $1,250, are classified as catch-up contributions and are not distributed to HCE A. (The catch-up contribution limit for 2004 is $3,000.)

4.72.17.8
(09-12-2006)
Top-Heavy Requirements

(1) Plans that are qualified under IRC section 401(a) that are classified as top-heavy are subject to additional requirements, such as faster vesting and minimum contributions or benefits for participants who are non-key employees. Although SEPs must provide for immediate vesting regardless of the top-heavy rules, a SEP is treated as a defined contribution plan for purposes of the minimum contribution top-heavy requirements under IRC section 416.

(2) However, whereas IRC section 401(a) plans must count account balances or accrued benefits to determine if the plan is top-heavy for a year, a SEP can look to aggregate employer contributions under the SEP to determine if the 60% threshold under IRC section 416(i) has been crossed. (See IRC section 416(i)(6).) But since most SEPs are always top-heavy, SEP plans are usually drafted to operate as if they were always top-heavy, thereby eliminating the need to make the annual 60% determination. The model SARSEP (Form 5305A-SEP) and nearly all prototype SARSEPs are deemed top-heavy.

(3) For purposes of determining if a plan is top heavy under IRC section 416, elective deferrals are considered employer contributions. Elective deferrals may not be used, however, to satisfy the minimum contribution requirements under IRC section 416. For purposes of determining the top-heavy minimum contribution, all elective deferrals made by key employees must be counted, but all elective deferrals made by non-key employees are not counted towards satisfying the minimum contribution.

4.72.17.9
(09-12-2006)
Distributions

(1) A SEP must permit employees to withdraw employer contributions at any time. Employer contributions to an employee's SEP-IRA cannot be conditioned on the retention in such SEP-IRA of any amount contributed. See IRC section 408(k)(4).

(2) Since traditional IRAs are the funding vehicles for SEPs, the rules governing distributions from SEP-IRAs are similar to the rules for other traditional IRAs. See Publication 590 for details on IRA distribution rules.

(3) In a SARSEP, transfer or rollover of contributions is prohibited before a determination as to whether the deferral percentage test has been satisfied. See IRC section 408(d)(7).

4.72.17.10
(09-12-2006)
Notice and Reporting Requirements

(1) The Form 5500 series forms that are required by the Code to be filed by most qualified plans are not filed for SEPs. SEPs are also exempt from the Department of Labor's reporting and disclosure requirements provided the employer satisfies certain employee notice requirements and does not impose investment restrictions on monies contributed to employees' SEP-IRAs. See Department of Labor regulation section 2520.104-48 and -49.

4.72.17.10.1
(09-12-2006)
Disclosure to Employees

(1) Within a reasonable time after a SEP is adopted and, later, after a new employee becomes employed, the employer must furnish the following information to each eligible employee:

a. Notice that the SEP has been adopted,
b. Requirements an employee must meet to receive an allocation,
c. The basis upon which the employer's contributions will be allocated, and
d. Any other information the Commissioner may prescribe.

(2) These requirements are set forth in regulations under IRC section 408(l): proposed regulation section 1.408-9. Failure to furnish the above information within a reasonable time subjects the employer to a $50 penalty per failure, unless the failure is due to reasonable cause. See IRC section 6693(a).

4.72.17.10.2
(09-12-2006)
Annual Statements

(1) Each year the employer must furnish an annual statement to each employee participating in the SEP, showing the amount contributed to the employee's SEP-IRA for that year. See IRC section 408(l) and proposed regulation section 1.408-9.

(2) The annual statement for a calendar year SEP must be furnished no later than January 31, following the calendar year for which the contribution is made, or, if later, 30 days after the contribution.

(3) An employer who makes a contribution on behalf of an employee and fails to furnish an annual statement showing the amount contributed is liable for a $50 penalty for each failure, unless the failure is due to reasonable cause. See IRC section 6693(a).

4.72.17.10.3
(09-12-2006)
General Reporting Requirement

(1) Distributions from a SEP-IRA are subject to the same withholding rules that apply to distributions from other traditional IRAs. See IRC section 3405.

(2) Form 5498, IRA Contribution Information, must be submitted to the Service by the trustee or issuer of a SEP-IRA to report contributions to the SEP-IRA. A separate Form 5498 must be submitted for each SEP participant.

(3) 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.

(4) SEP contributions by corporate employers are deducted on Form 1120. Employers who are sole proprietors deduct contributions on Schedule C of Form 1040 and deduct contributions made for themselves on Form 1040. Partnerships deduct contributions made for common-law employees on Form 1065; but report on Schedule K-1 contributions made for partners, who deduct such contributions on their own returns.

4.72.17.10.4
(09-12-2006)
SARSEP Notice and Reporting Requirements

(1) In addition to the notice and reporting requirements described above, SARSEPs have special notice and reporting requirements when distributions of elective deferrals are made to satisfy the rules in IRC section 408(k)(6). Information on reporting these distributions can be found in Notice 89-32, 1989-1 C.B. 671; Rev. Proc. 91-44, 1991-2 C.B. 733; as well as in the instructions to Form 1099-R.

4.72.17.10.4.1
(09-12-2006)
Failure to Satisfy the Deferral Percentage Test

(1) Amounts in excess of the deferral percentage limits are excess SEP contributions on behalf of the affected HCE(s). (See IRC section 408(k)(6)(C).) The employer must notify each affected HCE, within 2½ months following the end of the plan year to which the excess SEP contributions relate, of any excess SEP contributions to the HCE's SEP-IRA for the applicable year. The notice must specify the amount of the excess SEP contributions, the calendar year in which the contributions are includible in income, and must explain the applicable penalties if the excess contributions are not withdrawn in a timely manner.

(2) If the employer fails to notify any affected HCE within the 2½-month period, the employer must pay a tax equal to 10 percent of the excess SEP contributions. If the employer does not notify its employees by the last day of the 12-month period following the year of excess SEP contributions, the SEP will no longer be considered to meet the requirements of IRC section 408(k)(6). See regulation section 54.4979-1(a)(4).

4.72.17.10.4.2
(09-12-2006)
Failure to Satisfy the 50% Test

(1) If more than half of the eligible employees choose not to make elective deferrals, all elective deferrals made by all employees are considered "disallowed deferrals".

(2) The employer must notify each affected employee within 2½ months following the end of the plan year to which the disallowed deferrals relate, that his or her deferrals are no longer considered SEP-IRA contributions. The disallowed deferrals are includible in the employee's gross income in the calendar year as of the earliest date that any elective deferrals by the employee during the plan year would have been received by the employee had he or she originally elected to receive the amounts in cash. Income allocable to the disallowed deferrals is includible in the employee's gross income in the year of withdrawal from the IRA. See Rev. Proc. 91-44.

4.72.17.11
(09-12-2006)
EPCRS

(1) The Service has a comprehensive system of correction programs for sponsors of retirement plans that are intended to satisfy the applicable Code requirements for a period of time. This system, the Employee Plans Compliance Resolution System ("EPCRS"), permits plan sponsors to correct these failures and thereby continue to provide their employees with retirement benefits on a tax-favored basis.

(2) In Revenue Procedure 2003-44, 2003-25 I.R.B. 1051, correction procedures for employers that sponsor SEPs are explained. Under the revenue procedure, employers can self-correct insignificant SEP failures and can apply to the Service for correction of certain other failures under the procedure called Voluntary Correction with Service Approval ("VCP").

(3) A SEP (or SARSEP) that is eligible for this program that corrects a failure to satisfy the requirements of IRC section 408(k) in accordance with the program will be treated as not failing to meet IRC section 408(k). Depending on the particular circumstances, defects involving form, plan operation, and employer eligibility, among others, may be corrected under the program. Some highlights of the program applicable to SEPs include:

a. Self correction of insignificant operational failures,
b. Voluntary correction with Service approval and payment of a fee, and
c. Audit CAP.

4.72.17.12
(09-12-2006)
Examination Steps

(1) A plan document must be timely adopted, with all of the required terms, and SEP-IRAs should have been established for all eligible employees. If the plan is a SARSEP, check that it was originally set up prior to 1997, e.g., through third-party documentation and/or employees' Forms W-2 showing SARSEP deferrals. Check documentation to verify the establishment of SEP-IRAs and contributions made, such as bank statements, broker statements, etc.

(2) If the SEP/SARSEP uses a model form, check that it meets all of the special requirements and restrictions specified on the form.

(3) Verify that the participation requirements are correctly applied. Check payroll records, dates of birth, hire, participation and termination, and any reason for non-participation, if applicable. Insure that all employees who were required to receive contributions did so.

(4) If the employer is a member of a controlled group, check that all employees who should be included in the SEP are included. For example, if there has been a recent merger involving the employer, changes in the required coverage for the SEP may have occurred, resulting in an increase in participation in the SEP.

(5) Verify that the correct definition of compensation is used in determining the contribution limit under the plan and that compensation in excess of $200,000 (as adjusted) is disregarded

(6) Verify that the nondiscrimination rules were met. Identify highly compensated employees (HCEs, defined at IRC section 414(q)) through payroll and ownership records and insure that the employer has not added contribution conditions that impermissible discriminate in favor of HCEs. There can be no conditions placed on receiving a contribution other than those described in this IRM chapter 17. For example, the SEP could not have a last-day requirement for an allocation or have an allocation formula that provides higher-paid employees a greater allocation when measured as a percentage of compensation, unless the SEP is a SARSEP or is integrated.

(7) If the SEP is integrated, check to determine that (a) it is not a SARSEP, (b) it does not use a model SEP form and (c) contributions to HCEs comply with the reduced limit under IRC section 402(h)(2)(B).

(8) If a self-employed individual has a SEP, check to make sure the special limits on contributions and deductions for the self-employed individual have been met. Pub. 560 has a worksheet that can be used to calculate the proper deduction amount.

(9) Check that all applicable limits have not been exceeded. Note that if the SEP is not a model plan, the employer may maintain another kind of plan and special attention should be paid to verify that IRC section 415 has not been violated on a combined basis. Nondeductible contributions are subject to the 10-percent tax under IRC section 4972. Check the deduction amount on the employer's Form 1120, 1120-A or 1120S, if the employer is a corporation; Form 1065 and Form(s) 1040, if the employer is a partnership; and Form 1040 (and Schedule C if there are common-law employees in the SEP), if the employer is a sole-proprietorship.

(10) If the arrangement is a SARSEP, confirm that the employer is not an ineligible employer (e.g., a tax-exempt entity), did not have more than 25 employees eligible to participate in the year preceding the year under exam, and had at least 50% of employees electing to make deferrals to the SEP in the year under exam.

(11) If a SARSEP, verify that the plan satisfies the deferral percentage test: Each HCE's elective contributions for a year, measured as a percentage of his or her compensation, cannot exceed 1.25 times the average of such percentages for all eligible non-HCEs for the year.

(12) If a SARSEP, confirm that the applicable IRC section 402(g) limit was met.

(13) Determine if the plan is top-heavy or is treated as top-heavy and if so, confirm that top-heavy minimum contributions were made. (Most SEPs are treated as top-heavy and have language that insures non-key employees receive the statutory minimum every year.) If a SARSEP, verify that elective contributions made by non-key employees were not used to satisfy top-heavy minimums, but that elective contributions made by key employees were used to determine the minimum that non-key employees should receive.

(14) Determine if Forms 1099-R were correctly prepared and filed. Verify through third-party documentation. Determine if appropriate information regarding distributions was provided to participants.

4.72.17.13 (1)
(09-12-2006)
Annual Statutory Limits Applicable to SEPs

Year	402(g)	414(v)	408(k)(2)(C)	401(a)(17)	414(q)	415(c)	TWB
2006	15,000	5,000	450	220,000	100,000	44,000	94,200
2005	14,000	4,000	450	210,000	95,000	42,000	90,000
2004	13,000	3,000	450	205,000	90,000	41,000	87,900
2003	12,000	2,000	450	200,000	90,000	40,000	87,000
2002	11,000	1,000	450	200,000	90,000	40,000	84,900
2001	10,500		450	170,000	85,000	35,000	80,400
2000	10,500		450	170,000	85,000	30,000	76,200

1999	10,000		400	160,000	80,000	30,000	72,600
1998	10,000		400	160,000	80,000	30,000	68,400
1997	9,500		400	160,000		30,000	65,400
1996	9,500		400	150,000		30,000	62,700
1995	9,240		400	150,000		30,000	61,200
1994	9,240		396	150,000		30,000	60,600
1993	8,994		385	235,840		30,000	57,600
1992	8,728		374	228,860		30,000	55,500
1991	8,475		363	222,220		30,000	53,400
1990	7,979		342	209,200		30,000	51,300
1089	7,627		327	200,000		30,000	48,000
1988	7,313		313	-		30,000	45,000
1987	7,000		300	-		30,000	43,800