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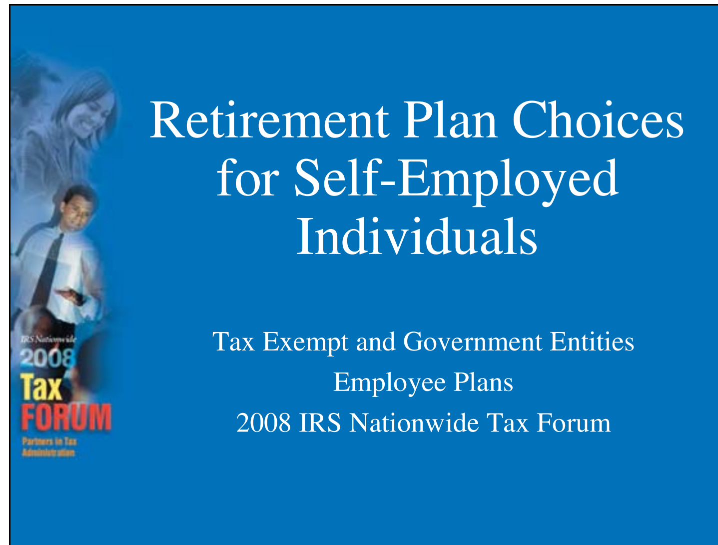

Good afternoon.

Introduce yourself and provide your qualifications for speaking.

Today we are going to talk to you about the different retirement plan options for self-employed individuals. We will be looking at this from the standpoint of a sole proprietor, as well as an 1120 employer, both with and without a few employees. We would like you to walk away from this presentation knowing that one size does not fit all when it comes to choosing a retirement plan and that employers need to look at many different factors when deciding which retirement plan option to choose for themselves and their business.

This presentation, along with the notes, will be posted to our web site, www.irs.gov/ep, in September after the final Tax Forum in San Diego. So if you miss anything during my discussion, please visit our web site to view the presentation.

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So why offer a retirement plan? It can provide important tax advantages to a business owner. Contributions to the plan may be deducted when contributed, so less tax will be paid. Employer contributions, employee contributions, if permitted under the plan, and earnings on the contributions are not taxed until they are distributed to the employee, and then the employee pays the taxes on the distribution.

An exception to the second bullet is a Roth IRA or a designated Roth account. With a designated Roth account, the employee makes contributions with after-tax dollars. All qualified distributions from Roth accounts are tax-free, including the earnings on the account. Designated Roth accounts in a 401(k) plan will be discussed in more detail later in the presentation.

Today, there are more incentives to start and participate in a retirement plan. Recent tax law changes have increased the contribution amounts that are deductible for 401(k) plans and IRAs, for example. Participants age 50 or older can save additional amounts to help "catch up" on their savings as they near retirement.

In addition to being able to deduct contributions, small employers can claim tax credits for the cost of setting up certain plans.

Tax credits for low- and moderate-income savers are available based on a person’s adjusted gross income. This is sometimes called the “Saver’s Credit.”

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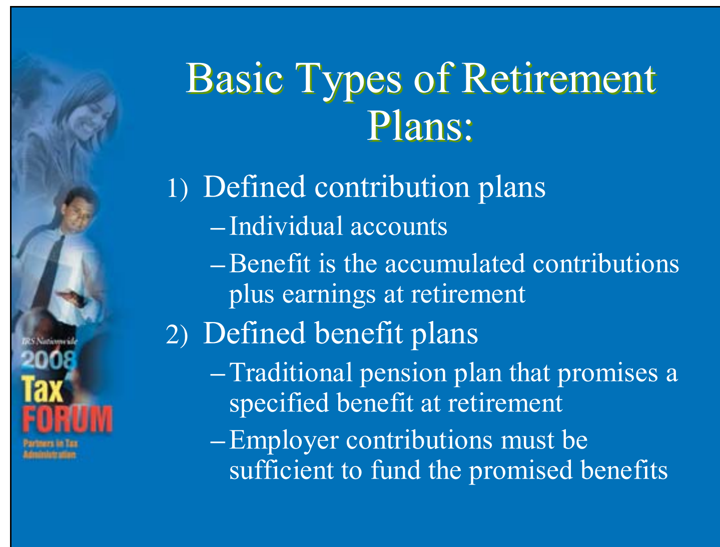

There are two basic types of retirement plans: defined contribution plans and defined benefit plans.

The first group we will discuss today is defined contribution plans. Defined contribution plans are the most common plans today. The ultimate retirement benefit in these plans depends on the amount of contributions that are made to the plan - either employer contributions or employee salary deferrals - and the investment returns of the individual accounts in the retirement trust. In this type of plan, each year's contribution will be defined in the plan document. It may be a fixed dollar amount or a specified percentage of compensation or of the company's profits. Most defined contribution plans state that the employer will contribute a discretionary amount to the plan and whatever amount is contributed will be allocated to each participant's account under a definite allocation formula. The investment risk lies with the employees. Examples of types of defined contribution plans are profit-sharing plans, 401(k) plans, and IRA-based plans such as SEPs and SIMPLE IRA plans.

SEPs have only employer contributions and SIMPLE IRA plans have a combination of employer and employee contributions. These plans use IRAs to hold plan contributions and generally have lower administrative costs than other plan types. They don't have a lot of flexibility in plan design. Because the IRA-based plans use IRAs, none of them can allow for participant loans. Also, you cannot have Roth-type contributions with any of the IRA-based plans. Generally, none of these IRA-based plans are required to file an annual Form 5500 return with the Federal government.

Other defined contribution plans generally have more administrative costs than the IRA-based plans, but also can provide greater flexibility for the employer to design the plan for their particular retirement goals. With profit-sharing or 401(k) plans, the plan sponsor/administrator is generally required to file a Form 5500 or, for one-participant plans, the Form 5500-EZ. No filing is required for one-participant plans that have $250,000 or less in plan assets.

Defined benefit plans provide an annual stated benefit commencing at retirement age. For example, the plan could provide a benefit formula of 75% of the average compensation earned in the 3 final years of employment. The amount of contribution that the employer must make is dependent upon the composition of the workforce, the benefits promised, and investment returns. In this type of plan, the investment risk lies with the employer. An enrolled actuary must determine the amount of the required contribution each year. The contribution that is needed to fund the benefit of the plan must be made, regardless of employer profits. If the contribution is not made, the employer must pay an excise tax. This type of plan generally has a higher administrative cost than the other plan types and a Form 5500/5500-EZ with a Schedule B must be filed each year.

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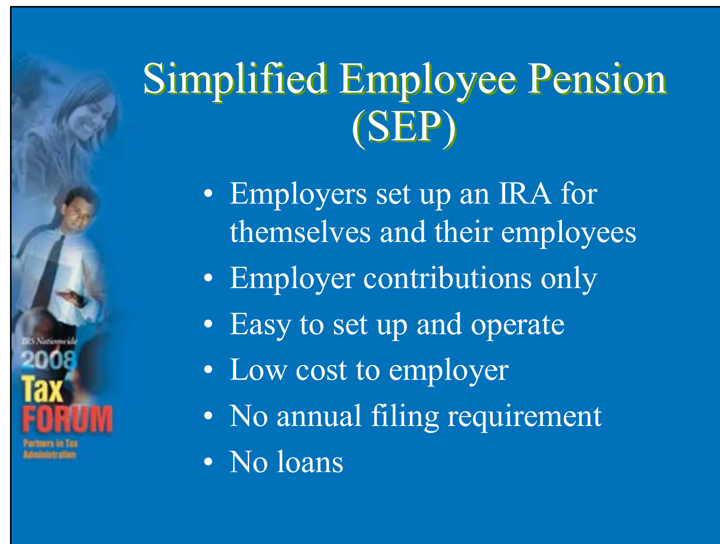

Next, I'd like to go through some of the differences between the types of plans.

First, I'd like to discuss one type of IRA-based plan: the Simplified Employee Pension plan, or SEP.

A SEP must be established by adopting a formal plan document. This can be done in one of two ways:

One way is to adopt an IRS Model SEP using Form 5305-SEP, *Simplified Employee Pension-Individual Retirement Accounts Contribution Agreement.* This form is not filed with the IRS – the employer keeps the form in its records. The model SEP is considered to be adopted when IRAs have been established for all eligible employees, the form has been completed, and specified information has been given to all eligible employees.

Model Form 5305-SEP may <u>not</u> be used by an employer who:

● Has another qualified retirement plan,
● Uses the services of leased employees,

● Wants a SEP maintained on a fiscal year rather than a calendar year, or
● Wants a contribution formula that takes into account Social Security withholdings

Another way that an employer can establish a SEP is with a prototype plan. This can be done through a mutual fund, bank, or insurance company. These plans have been reviewed and approved by the Internal Revenue Service. By using a prototype document, rather than a model, the employer can customize a SEP.

The SEP can be set up for a year as late as the due date (including extensions) of the employer's income tax return for that year.

One thing to remember is that once a Form 5305-SEP is adopted, it must be updated from time to time. For example, when compensation limitations were increased under the law known as EGTRRA in 2002, it was necessary to adopt a new Form 5305-SEP if the plan sponsor wanted to take advantage of the increased limits. We have found this to be a big problem in our audits of SEPs. If you have clients who have SEPs, please ensure that their plan documents are up to date. The current document is dated December 2004.

A SEP allows any employer to set up an IRA for themselves and their employees. If desired, participants can be limited to employees who are at least 21 years of age, employed by the employer for 3 of the last 5 years, and who earned $500 or more during the year. There is no hours of service requirement for this type of plan. Employees who meet the other eligibility requirements must be allowed to participate, regardless of the number of hours worked.

Employers must contribute a uniform percentage of pay for each employee who has met the eligibility requirements. The plan has flexible contribution requirements – that is, the employer is not locked into making contributions each year. If your client's business has fluctuating income, this type of plan gives

them flexibility from year to year. However, if contributions are made, they must be allocated to employees based on a written formula and must not discriminate in favor of highly compensated employees.

The maximum employer contribution to a SEP in 2008 is limited to the lesser of 25% of compensation or $46,000. Generally, the employer can deduct the contributions made to the SEP-IRAs of his employees, including himself. A self-employed individual's maximum deduction must be made with a special calculation, which can be complicated. Refer to IRS Publication 560, which includes step-by-step instructions on this calculation. This publication can be viewed at the IRS web site www.irs.gov/ep.

This plan is funded by employer contributions only. We get a lot of questions asking if an employee can make catch-up contributions to this type of plan. Because this plan does not require or allow employee contributions, catch-up contributions cannot be made to SEPs.

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The second IRA-based retirement option is the Savings Incentive Match Plan for Employees, or SIMPLE IRA plan. This plan is available to any employer (including self-employed individuals) with 100 or fewer employees that does not currently maintain another retirement plan. The plan can be easily established by adopting IRS Model Form 5304-SIMPLE or 5305-SIMPLE. The type of model form used depends on whether or not the employer wants to designate the financial institution that receives the contributions to the plan or if they want to allow the employees to designate the financial institution. Similar to the issue found in the audits of SEPs, the IRS has encountered a common mistake where employers were using an older model SIMPLE IRA plan that had not been revised for the provisions of EGTRRA. This is the number one issue found in examining SIMPLE IRA plans. Remember, if an employer is using the Model Form 5304-SIMPLE or 5305-SIMPLE, then adopting or amending one is as easy as going to irs.gov, finding the form, downloading it, and then signing and dating it.

A SIMPLE IRA plan must be offered to all employees who have compensation of at least $5,000 in any prior 2 years, and who are reasonably expected to earn at

least $5,000 in the current year. There is no hours-of-service requirement in this type of plan.

Employees can contribute a percentage of their pay to the plan through payroll deduction, up to $10,500 in 2008. Employees who are age 50 or older may make an additional catch-up contribution of up to $2,500 in 2008. Roth-type contributions are not allowed under a SIMPLE IRA plan.

Employers are required to make an annual contribution using one of two formulas: matching employee contributions dollar-for-dollar up to 3% of pay; or making a fixed contribution of 2% of pay to all eligible employees, even those who do not elect to defer.

Both employer and employee contributions are immediately 100% vested.

This is a good plan if the employer wants employees to help share responsibility for their retirement without the added complexity of some of the other plans.

Key advantages of the SIMPLE IRA plan are: less administrative paperwork, low administrative expenses, and, generally, no filing requirements. The financial institution maintaining the arrangement handles most of the paperwork.

As this is an IRA-based plan, participant loans are not permitted.

Before I leave the discussion of IRA-based plans, I was asked to relay some not-so-good breaking news about our recent examinations of SARSEPs. As in our examinations of SARSEPs in 2003, we are finding massive non-compliance in our examinations of these plans. We have about 80 examinations in process this year and plan on examining 250 next year. We ask that you spread the word to your peers and your clients that we are coming out to examine these plans.

The main areas of non-compliance are mostly due to plan sponsors not performing the tests required, such as the ADP/ACP tests and the top-heavy tests. This is a concern; however, what we are finding during our examinations is more of a concern. When we find errors on exam, the taxpayers don't seem to have enough incentive to perform/correct the tests. Taxpayers just want to discontinue the plans and walk away from them and let the employees suffer the tax consequences on their retirement accounts and earnings. Employees that have salary deferrals don't realize that their employers are not running these plans correctly and they find that out later when they are required to amend their Form 1040. That is not the answer we want to hear and I am in doubt that news makes employees happy.

We would like to curb this trend. We ask again that you forward the following message to your peers and clients:

- We will be examining SARSEPs for the next couple of years.
- If a plan sponsor is in the situation described above, terminate the plan or switch to a SIMPLE or a Payroll Deduction IRA.
- To terminate a SARSEP, notify the financial institution that you chose to handle the SARSEP that you will no longer be making contributions and that you want to terminate the contract or agreement with it. You must also notify your employees that the SARSEP has been discontinued.
- You do not need to give any notice to the IRS that the SARSEP has been terminated.

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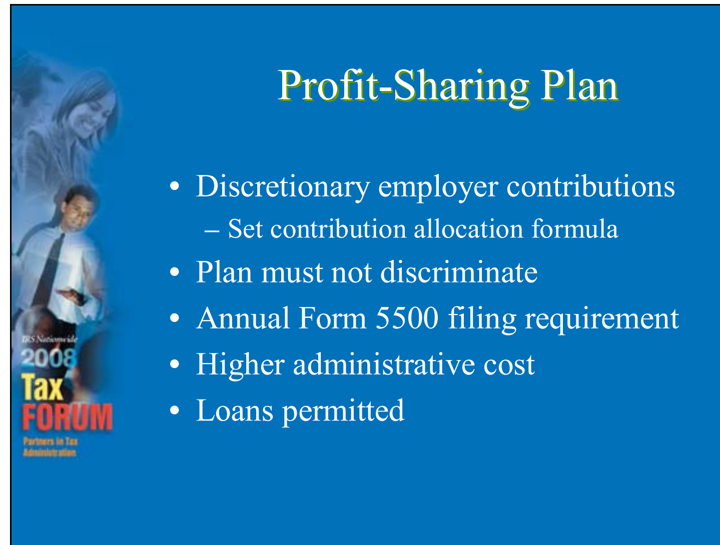

A profit-sharing plan is, as its name suggests, a way for an employer to share the company profits with the employees who help make the company successful. However, it is not necessary for the plan sponsor to make a profit to provide a contribution to the plan. Any employer with one or more employees can offer this plan and it generally must be offered to all employees at least 21 years of age who worked at least 1,000 hours in a previous year. Employer contributions are discretionary. Since profits vary from year to year, there is no set annual employer contribution. If the employer does make contributions, the plan document must indicate the formula that is used to determine how contributions are allocated to plan participants. Employer contributions are limited to the lesser of 100% of compensation or $46,000 per employee in 2008. However, the employer can only deduct amounts that do not exceed 25% of aggregate compensation for all participants. As was the case with a SEP, a self-employed individual's maximum deduction must be made with a special calculation, which can be complicated. Refer to IRS Publication 560, which includes step-by-step instructions on this calculation. This publication can be viewed at the IRS web site www.irs.gov/ep.

If these limits sound familiar, it is because they are similar to those provided for in a SEP. If a self-employed individual was only looking at the contribution limits, then there would be no difference between these two types of plans. However, there are many differences that need to be considered.

Profit-sharing plans require more involved administration and management than the IRA-based plans. However, there are many financial institutions and plan professionals ready to assist or handle the plan management for a plan sponsor. In many cases, the service provider uses an IRS-approved prototype plan.

Keep in mind that although contributions are discretionary, when they are made, they must be non-discriminatory. There are tests that allocations within a profit-sharing plan must pass. Generally, an employer cannot give more to higher-paid employees than to lower-paid employees. If the employer chooses a complex allocation formula, then he must show that the contribution doesn't benefit the higher-paid people more than the lower-paid people. Due to this testing and the requirement for annual filing of the Form 5500 return, administrative costs can be higher than for less complex plans. On the flip side, this type of plan allows the employer great flexibility.

Loans and directed investments may be permitted with a profit-sharing plan.

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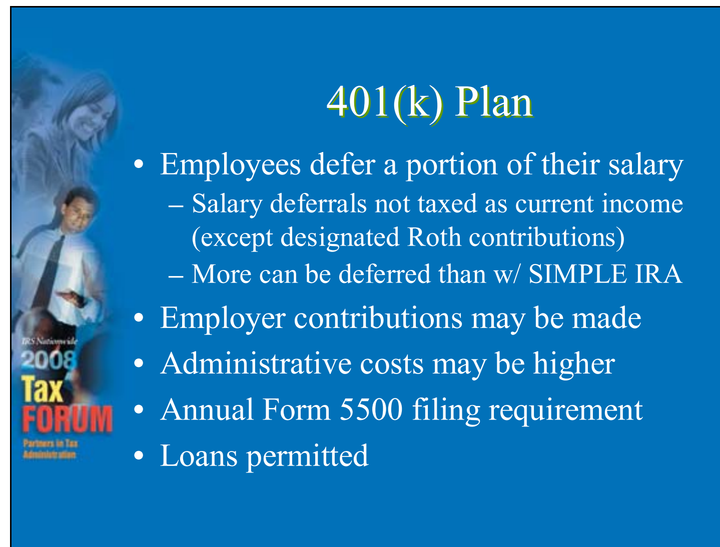

A 401(k) plan is a profit-sharing plan that includes a cash or deferred arrangement feature described in Internal Revenue Code section 401(k). Traditional 401(k) plans are the most common retirement plan offered today. Any employer can offer this plan and it generally must be offered to all employees at least 21 years of age who worked at least 1,000 hours in a previous year.

There is no IRS model form to adopt for this type of plan, but there are IRS pre-approved plans available called prototype plans.

In a 401(k) plan, employees defer a portion of their salary to be put in a separate individual account in the plan. The maximum amount that an employee may defer in 2008 is $15,500. If the participant is age 50 or over, an additional $5,000 catch-up contribution is allowed, if the plan permits. Taxes on the contributions and earnings are deferred until distributed from the plan. An exception to this is salary contributed to a designated Roth account, which will be discussed later in the presentation.

An employer may provide a matching contribution, a nonelective contribution, or any combination of the two. The combination of the employer and employee contribution is limited to the lesser of 100% of the employee's compensation or $46,000 for 2008. The employer can deduct matching and nonelective contributions that do not exceed 25% of aggregate compensation for all participants (the 25% deductible limit does not apply to salary deferrals).

Realizing 401(k) plan tax benefits requires that plans provide substantive benefits for rank-and-file employees, not just for business owners and managers. These requirements are referred to as nondiscrimination rules and cover the level of plan benefits for rank-and-file employees compared to owner/managers.

A traditional 401(k) plan that provides for both salary deferrals and matching contributions is subject to special nondiscrimination tests: the actual deferral percentage and actual contribution percentage tests commonly referred to as the ADP and ACP tests. This means that the plan has to provide comparable benefits to all employees – rank-and-file employees and highly compensated employees. A highly compensated employee is an individual who owned more than 5% of the capital or profits interest in the business at any time during the current or preceding year, or who received compensation from the employer of more than $105,000 (in 2008) in the prior year and, if the employer chooses, was in the top 20% of employees when ranked by compensation. The tests are mathematical tests that limit the amount that highly compensated employees can defer or receive under the plan when compared to the non-highly compensated employees. Traditional 401(k) plans must meet these nondiscrimination rules each year. Safe harbor 401(k) plans and automatic enrollment safe harbor 401(k)s, which we will discuss later in the presentation, are not subject to these tests.

401(k) plans do, as it might appear from the description, require a greater level of administration.

Key advantages of 401(k) plans are that they permit higher levels of salary deferrals than SIMPLE IRA plans and, as with most defined contribution plans, employees may direct their investments. While other defined contribution plans may also permit employees to direct their investments, this feature is one that has contributed to the plans' popularity. However, plan sponsors must file an annual Form 5500 return, the plan is subject to nondiscrimination testing, and advice from consultants may be necessary to properly design, implement, and maintain the plan. So administrative costs may be higher than with other retirement plans, depending on the complexity of the plan adopted.

With a 401(k) plan, both the employer and the employee have greater flexibility in contributions. This plan is a good choice if cash flow is an issue.

The employee can contribute more with this type of plan than with the IRA-based plans. If the plan allows, the employee can designate whether his or her deferral is pre-tax or after-tax (designated Roth contributions). Employee deferrals are always 100% vested, or owned by the employee.

The 401(k) plan has additional features not available in IRA-based plans – participant loans, hardship withdrawals, and designated Roth accounts. However, while these features add additional flexibility for the employee, they add additional administration for the employer. These features are optional. The employer can elect to include them in the 401(k) plan.

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A safe-harbor 401(k) plan is similar to a traditional 401(k) plan. The difference is this type of plan requires that the employer make a contribution: either to match each participant's contribution, dollar-for-dollar, up to 3% of the employee's compensation and 50 cents on the dollar for the employee's contribution that exceeds 3%, but not 5%, of the employee's compensation; or to make a nonelective contribution equal to 3% of compensation to each eligible employee's account. These are the minimum contributions required. A plan can be more generous than this. All employer and employee contributions are 100% vested, or owned by the employee.

The selling point of a safe-harbor 401(k) plan is that the employer is not required to perform the annual nondiscrimination testing, therefore decreasing administrative costs as compared to a traditional 401(k) plan. This is significant because the higher-paid employees can then defer the maximum allowed under the law without being tied to the deferral rates of the lower-paid employees.

I'd like to spend a little time talking about a relatively new feature that can be added to any kind of 401(k) plan and that is designated Roth accounts. A plan

may permit an employee who makes elective contributions under a 401(k) plan to designate some or all of those contributions as Roth contributions. These designated Roth contributions are currently includible in gross income. Additionally, a “qualified distribution” of designated Roth contributions (including earnings) is excludable from gross income.

Designated Roth contributions sound similar to the more familiar Roth IRAs. However, the law provides several significant differences. First, there are no income limits for a designated Roth contribution. Therefore, employees who were unable to make contributions to a Roth IRA because their modified adjusted gross income exceeded the limits imposed under the Code can designate some or all of their 401(k) contributions as Roth contributions. This may be an advantage for those individuals not able to contribute to a Roth IRA due to their income levels. Another significant difference is that traditional IRAs can be converted to Roth IRAs. This conversion is not permitted between designated Roth accounts and pre-tax elective deferral accounts. Once designated as either a pre-tax elective deferral or a designated Roth contribution, conversions between the two is not permitted.

One thing that we would like to make clear is that the plan document has to provide for designated Roth accounts. Also, if the plan is going to offer designated Roth accounts, it must also allow for pre-tax elective deferrals. It cannot provide for only designated Roth contributions. If designated Roth accounts are going to be offered, there must be a separate accounting of designated Roth contributions and of gains, losses, and other credits or charges attributable to those contributions. Forfeitures may not be allocated to designated Roth accounts. Matching contributions are not permitted to be allocated to a designated Roth account.

Designated Roth contributions are subject to the immediate vesting and the distribution restrictions that apply to pre-tax elective contributions. They are

taken into account under the ADP test, just like pre-tax elective contributions. Also, designated Roth contributions may be treated as catch-up contributions and serve as the basis for a participant loan.

As you can see, permitting designated Roth contributions in a 401(k) plan may have advantages for the employees, but there will be increased administration for the employer.

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Defined benefit plans, often referred to as traditional pension plans, provide a fixed, pre-established benefit for employees. Any employer can offer this plan, and it generally must be offered to all employees at least 21 years of age who worked at least 1,000 hours in a previous year. There are a number of business advantages for employers. Employees value the fixed benefit and this benefit is often larger than that provided by a defined contribution plan. The employer may be able to contribute and deduct more than under a defined contribution plan.

However, defined benefit plans are more complex and are costly to maintain. There are funding requirements because the employer is promising a set benefit and thus bears the financial burden. Also, poor investment returns can result in higher funding requirements. Note that the employer usually must hire a number of professionals to administer this kind of plan. Filing of the annual return/report (Form 5500) is required, an enrolled actuary must determine the employer's annual contribution and advice from other consultants may be necessary to properly design, implement, and maintain the plan, so administrative costs are higher than with other plans.

Defined benefit plans and funding problems of corporate America regularly appear in news articles and magazines these days. You may be wondering who would want to set up a defined benefit plan. This is the only type of plan that will provide for a guaranteed retirement income. It is also the type of plan for an employer who is close to retirement and does not have enough years remaining to accumulate adequate retirement benefits under a defined contribution plan may want to adopt. Depending on the funding requirements, large sums of money may be set aside in a very short period of time to provide for a substantial retirement benefit.

An employer contribution is required each year with a defined benefit plan. There is an excise tax if a company does not meet the funding obligation under its defined benefit plan.

The benefit that an employee will receive at retirement can be calculated by the benefit formula provided in the plan document. The employee can count on the specified benefit.

The plan must be nondiscriminatory. It must not favor highly compensated employees.

Distributions are generally not allowed until retirement. Participant loans are permitted.

This is probably the least flexible of the plans.

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401(k) Plans for Self-Employed Individuals

Example: Maximum contribution based on $184,000 W-2 comp, employee age 50

Plan Type	Contribution			
	EE	Catch-up	ER	Total
401(k)	$15,500	$5,000	$30,500	$51,000
SEP	$ 0	$ 0	$46,000	$46,000
SIMPLE	$10,500	$2,500	$5,520	$18,520

To make things clearer, this example is based on a W-2 self-employed person, rather than a Schedule C individual. I know that this isn't exactly real world. Not many self-employed folks get a W-2. Bear with me here. Our point is to show the differences between these three types of plans using the same compensation. Schedule C sole-proprietors must do an added calculation starting with earned income to determine their maximum deductible contribution. We don't have the time during this presentation to walk you through the steps of the added calculation. A step-by-step worksheet for this calculation can be found in Pub 560 and many tax software products do the calculation automatically.

Let's compare the maximum deductible contribution for a self-employed person, age 50, with W-2 compensation in the amount of $184,000. I'm not going to include defined benefit plans in the mix. Even though, for 2008, compensation is limited to $230,000, the Code section 415 limit of $46,000 means that the maximum contribution for most plans is achieved with compensation of $184,000 ($46,000/25%).

At compensation above this amount, the results between a 401(k) and a SEP plan will not change – for an individual UNDER age 50. There is no difference between the two plans at and above the $184,000 compensation amount. In the 401(k) plan, the contribution is made up of the employee deferral ($15,500 plus the $5,000 catch-up contribution) and the employer contribution, which is limited to the individual section 415 limitation of $46,000 minus the non-catch-up employee deferral of $15,500, or $30,500. Note that the employer contribution could have been $46,000 and catch-up $5,000 for the same maximum.

The key point is that the only difference between the 401(k) and the SEP is the age 50 catch-up. If the individual was under age 50, there would be no difference between the maximum under the two plans.

Again, note the disparity between the SIMPLE IRA plan and both the 401(k) and SEP plans.

The $18,520 SIMPLE calculation is based on the maximum elective deferral of $10,500 plus the maximum age 50 catch-up of $2,500 and the required employer contribution of 3% of $184,000, or $5,520. (There is a difference, however, in the SIMPLE plan in that as compensation increases beyond $184,000, the 3% employer contribution will also increase as it is based on total compensation and is not limited by the Code section 401(a)(17) limits.)

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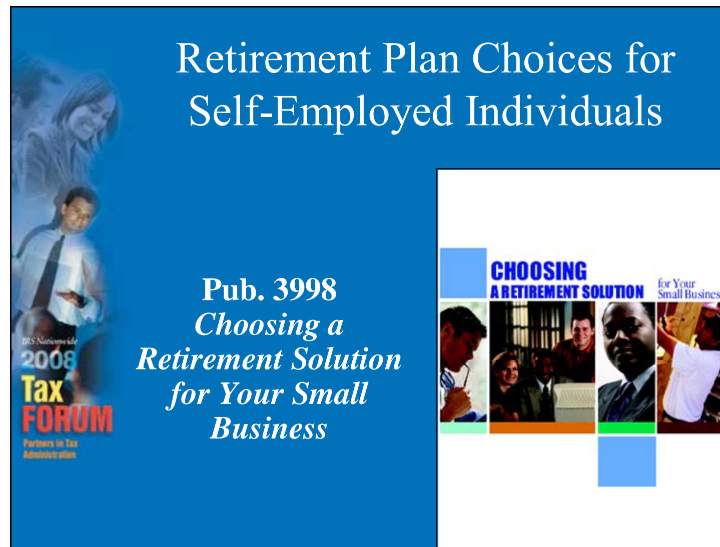

We have a publication, *Choosing a Retirement Solution for Your Small Business*, that is included in the CD you received in your registration package. This publication will give you more in-depth information on the differences between the types of plans we have discussed in today’s presentation. If you want a hard copy of the publication, please stop by the TE/GE booth and pick up a copy.

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We at the IRS have developed many tools to assist you and your clients in the retirement plan area, whether your question is "How do I choose a retirement plan?" or "How much money can I contribute to my retirement plan?" or "This plan isn't working for me anymore. How do I terminate it?"

You can visit our web site at www.irs.gov/ep. The Retirement Plans Community web page can be found on the main www.irs.gov landing page. You will find information for "Benefits Practitioner," "Plan Participant/Employee," and "Plan Sponsor/Employer." The pages are populated with all of the retirement plan information that you have come to expect from EP. You will find many 401(k) plan resources on our web pages, including our 401(k) checklist, joint publication with the Department of Labor, *401(k) Plans for Small Businesses*, and Designated Roth Accounts publication. These can all be found at our booth in the Exhibit hall as well.

There are two different ways that you can discuss your questions with a retirement plan specialist. You can call our Customer Account Services at (877)

829-5500. This is a toll-free number. The call center is open 8:30 a.m. to 4:30 p.m. Eastern Time.

If you would prefer, you can e-mail your questions to RetirementPlanQuestions@irs.gov. All questions submitted via e-mail must be responded to via telephone, so please remember to include your phone number in your message and a customer service representative will call you with the answer to your questions.

Finally, we have two free newsletters that you can subscribe to. The first is the *Employee Plans News*. This newsletter is geared toward the practitioner community and is more technical and involved than our newsletter geared toward plan sponsors, *Retirement News for Employers*. Each is an electronic newsletter and is posted on our web site as a PDF document each quarter. Being a web-based product, the newsletters make an excellent reference guide, as they are chock-full of embedded links to guidance sources, products, and other sites.

Subscribing to these newsletters will keep you and your clients abreast of all the latest news regarding retirement plans, legislation, trends, and tips on various subjects, as well as keeping you informed of the latest product releases from the office of Employee Plans Customer Education & Outreach!

Subscribing is easy. Just go to "Newsletters" under our web page, www.irs.gov/ep, click on "Employee Plans News" or "Retirement News for Employers," click on "Subscribe," then provide us with your e-mail address. That's all it takes.

You will receive a message in your e-mail inbox alerting you to when our latest issues or Special Editions are posted on our web page with a link directing you to the newsletter when you are ready to read it.

Please be sure to attend our presentation on “401(k) Plans for Self-Employed Individuals,” which will discuss in greater detail the different rules relating to one-participant 401(k) plans.

Thank you for your attention and please stop by the TE/GE booth for additional retirement plan information.