

CHAPTER 15-SIMPLIFIED EMPLOYEE PENSIONS (SEPs)

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TABLE OF CONTENTS

INTRODUCTION	3
TECHNICAL OVERVIEW	3
WHO CAN ESTABLISH A SEP?	4
WHEN CAN A SEP BE ESTABLISHED?	4
OBJECTIVES	4
PART I: SEP REQUIREMENTS	5
WRITTEN ARRANGEMENT	5
COVERAGE AND PARTICIPATION REQUIREMENTS	6
MEMBER OF CONTROLLED GROUP, ETC.	7
LEASED EMPLOYEES	7
EXCLUDIBLE EMPLOYEES	8
NONDISCRIMINATION REQUIREMENTS	8
PART II: SEP CONTRIBUTIONS AND DEDUCTIONS	10
CONTRIBUTIONS	10
CONTRIBUTION LIMIT	10
SPECIAL RULES FOR SELF-EMPLOYED INDIVIDUALS	11
EMPLOYER DEDUCTION	12
PART III: SARSEPS	12
SPECIAL REQUIREMENTS FOR SARSEPS	12
INELIGIBLE EMPLOYER	13
NONDISCRIMINATION TEST FOR ELECTIVE DEFERRALS	13
LIMITS ON DEFERRALS	14
PART IV: TOP HEAVY REQUIREMENTS	15
PART V: DISTRIBUTIONS	15
PART VI: NOTICE AND REPORTING REQUIREMENTS	16
DISCLOSURE TO EMPLOYEES	16
ANNUAL STATEMENTS	16
GENERAL REPORTING REQUIREMENTS	17
SARSEP NOTICE AND REPORTING REQUIREMENTS	17
FAILURE TO SATISFY THE DEFERRAL PERCENTAGE TEST	17
FAILURE TO SATISFY 50% TEST	18

Employee Plans CPE Topics For 2002

PART VII: EPCRS	18
PART VIII: EXAMINATION STEPS	19
ANNUAL STATUTORY LIMITS APPLICABLE TO SEPS	20
FY 2002 SEP SARSEP PROJECT CASE	21
FY 2002 SEP (SIMPLIFIED EMPLOYEE PLAN) PROJECT	22
CASE CONTROL OF SEP ON EPIC	22
FY 2002 SEP (SIMPLIFIED EMPLOYEE PLAN) PROJECT	23
SEP SIGNIFICANT ISSUES OF CONCERN & OCEP EXAM	23
FY 2002 SEP (SIMPLIFIED EMPLOYEE PLAN) PROJECT	25
LOCATING THE TAXPAYER PHONE NUMBER	25
SEP/SARSEP CHECKSHEET, FY 2002 PROGRAM	26
EP PROJECT PLANNING PROCESS	30

INTRODUCTION

This chapter is intended to serve as a technical reference for simplified employee pensions (SEPs). The eight numbered parts of this chapter follow Internal Revenue Manual ("IRM") 4.72.17, Simplified Employee Pensions (SEPs) and Salary Reduction Simplified Emp. Pensions (SARSEPs). The chapter provides guidance on law changes enacted by the Small Business Job Protection Act of 1996 (SBJPA), where that law directly affects the rules relating to SEPs.

SEPs were authorized by Congress in 1978 to provide employers with a simpler, less complicated manner of providing retirement benefits for themselves and their employees. Section 408(k)(1) of the Internal Revenue Code defines a SEP as an individual retirement account or individual retirement annuity with respect to certain participation, contribution, discrimination and withdrawal requirements being met.

EP Field Offices conducted SEP pilot examination programs nationwide during fiscal year 1997. In conducting these examinations, EP field personnel encountered several obstacles that impeded the smooth examination of SEPs. Two major obstacles encountered were: 1) the difficulty in determining which employers maintained a SEP, because there are no independent filing or reporting requirements for SEPs; and 2) the EP specialists' lack of training on SEPs.

Since 1996, there has been a checkbox added to Form 5498, Individual Retirement Arrangement (IRA) Information to indicate if the IRA is part of a SEP. This enables the Service to match this information with an IRA owner's W-2 to identify employers maintaining SEPs.

To address the EP specialists' lack of training on SEPs, this chapter contains a technical discussion of SEP requirements.

TECHNICAL OVERVIEW

A SEP is a written arrangement (a Plan) that allows an employer (including a self-employed individual) to make contributions towards its employees' retirement without becoming involved in more complex retirement plans. A SEP must satisfy the requirements set forth in Internal Revenue Code (IRC) section 408(k), as well as the top-heavy requirements of IRC section 416 and the limitations on annual additions under IRC section 415. The contributions are made to traditional Individual Retirement Arrangements (not Roth or SIMPLE IRAs) of the

plan participants. Under a SEP, IRAs are set up for each eligible employee.

Simplified Employee Pensions with a Salary Reduction Arrangement (SARSEPs) are defined in 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 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.

WHO CAN ESTABLISH A SEP?

Only an employer can set up a SEP. A self-employed individual may establish a SEP for himself/herself and his/her employees. A sole proprietor (an individual who owns the entire interest in an unincorporated trade or business) may establish a SEP for himself/herself. A partnership may establish a SEP because the partnership is treated as the employer of each partner. Compensation would include the earned income of the sole proprietor (or partner).

WHEN CAN A SEP BE ESTABLISHED?

SEPs can be established for a particular year after that year has ended. They can be established as late as the latest time prescribed by law for making deductible employer contributions (that is, no later than the due date, including extensions, of the employer's return for the year). This 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.

OBJECTIVES

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

1. Discuss the basic requirements for a SEP.
2. Determine whether SEP contributions and deductions are within applicable limits.
3. Determine whether an employer meets applicable SARSEP requirements.

4. Determine whether notice and reporting, top heavy and distribution requirements are met.

PART I: SEP REQUIREMENTS

Section 408(k)(1) of the Code defines a SEP as an individual retirement account or individual retirement annuity if the requirements of paragraphs (2), (3), (4) and (5) of IRC section 408(k) are met. The IRAs used in a SEP can be individual retirement accounts or individual retirement annuities qualified under IRC sections 408(a) or 408(b), respectively. Typically, an employer will choose a particular institution to act as the trustee or custodian of newly established IRAs, one IRA being established for each eligible employee.

WRITTEN ARRANGEMENT

The SEP (or SARSEP) must be part of a written arrangement. Proposed Income Tax Regulations (IT Reg.) section 1.408-7(b) (Proposed) provides that the employer must execute a written instrument within the time prescribed for making deductible contributions. The written instrument must include: the name of the employer, the requirements for employee participation, a definite allocation formula, and the signature of a responsible official.

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

Model SEP (or SARSEP)

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

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

The model forms may not be used by an employer who maintains any other qualified retirement plan (except for another SEP or SARSEP), uses the services of leased employees, wants a plan other than a calendar year plan, or wants an integrated SEP.

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.

Prototype SEP

A sponsor (usually a mutual fund or a bank) can request an opinion letter for a prototype SEP from the Service. 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-SEP. The Service has prepared a Listing of Required Modifications (LRM), or sample language, to assist sponsors in drafting an acceptable prototype SEP.

An employer using a prototype document, rather than a model, to establish a SEP can: use a plan year (which may be other than a calendar year) that is the same as the employer's taxable year; use an integrated allocation formula; or contribute top-heavy minimum only when the plan is actually top-heavy.

Individually Designed SEP

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.

COVERAGE AND PARTICIPATION REQUIREMENTS
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All eligible employees must be allowed to participate. An eligible employee is an employee who is at least 21 years old, has performed service for the employer in at least 3 of the immediately preceding 5 years, and has received at least \$450 in compensation (as adjusted under section 408(k)(8) for the 2000 plan year) from the employer for the current year.

An employer may establish less restrictive eligibility requirements than those noted in the preceding paragraph. Also note that "service" (as previously noted) 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 only one day, he or she is eligible, assuming the employee met the other 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 1998, 1999 and 2000, but never more than 34 days in any year. In July 2001, Employee A turns 21. In August 2001, Employee A begins working for Employer X on a full-time basis, earning \$8,000. Employer X makes a contribution to the SEP for eligible employees for 2001. Employee A is an eligible employee in 2001 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 2001.

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 2000. Employer Y must make a contribution for Employee B for 2000.

<i>MEMBER OF CONTROLLED GROUP, ETC.</i>
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IRC sections 414(b), (c) and (m) provide, in relevant part, that for purposes of IRC 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.

<i>LEASED EMPLOYEES</i>

The person or firm for whom services are performed may have to include any leased employee who is treated as an employee of the recipient in a SEP. 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).

EXCLUDIBLE EMPLOYEES

In addition to employees who do not meet the minimum age, service and compensation requirements, the following employees do not have to be covered: employees covered by a collective bargaining agreement whose retirement benefits were bargained for in good faith by the employer and the union, and employees who are nonresident aliens who did not earn U.S. source income from the employer.

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.

NONDISCRIMINATION REQUIREMENTS

IRC section 408(k)(3) imposes two nondiscrimination requirements that apply to employer's contributions to SEPs. The first nondiscrimination requirement, under IRC section 408(k)(3)(A), is that employer contributions must not discriminate in favor of highly compensated employees (HCEs). The definition of a highly compensated employee is the same used to test for discrimination in IRC section 401(a) qualified plans (see IRC section 414(q), Notice 97-45, 1997-2 C.B. 296, IRM 4.72.17.5 (2)).

The second nondiscrimination requirement, under IRC section 408(k)(3)(C), is that employer contributions must bear a uniform relationship to participants' compensation that does not exceed \$150,000 (IRC section 401(a)(17), as indexed for inflation-\$170,000 for the year 2000).

A rate of contribution that actually decreases as compensation increases 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.

Example 3

Penny Big Dollar Store adopts a SEP with a contribution formula providing for an allocation of 15 percent of an employee's first \$15,000 in compensation, plus 10 percent of all compensation between \$15,000 and \$150,000 (as adjusted for inflation under IRC section 401(a)(17)). The Penny Big Dollar Store's SEP will not be considered discriminatory because the rate of contribution decreases as compensation increases.

EXAMPLE 4:

Bob is a sole proprietor who employs Barbara as his only common-law employee. Bob can make a SEP contribution to his IRA only if the SEP allocates the employer's contribution equally between his IRA and Barbara's IRA when expressed as a percentage of his earned income and Barbara's compensation. If his earned income is \$80,000 and Barbara's compensation is \$20,000, then in order for Bob to be able to allocate \$8,000 to his IRA (10% of his earned income), Barbara's IRA must be allocated at least \$2,000 (10% of her compensation).

Permitted disparity (integration) is an exception to the nondiscrimination rules discussed above. A SEP is permitted to provide a 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 with a contribution that is a higher percentage of their compensation than the percentage provided for employees earning less than the taxable wage base. Note that salary reduction contributions may not be integrated with social security.

EXAMPLE 5:

Penny's Dollar Store adopts a SEP that has a contribution formula providing for an allocation of 10 percent of compensation to each employee who has completed 5 or fewer years of service and 12 percent of compensation to each employee who has completed more than 5 years of service. Penny's SEP will be considered discriminatory, because the rate of contributions do not bear a uniform relationship to each employee's compensation.

PART II: SEP CONTRIBUTIONS AND DEDUCTIONS

The amounts contributed under a SEP by an employer on behalf of an employee are not taxable to the employee in the year they are contributed. The contribution is not treated as being distributed to an employee nor as being made available to the employee, despite the employee's ability to withdraw the funds from the SEP at any time.

Contributions to a SEP are deductible by an employer only up to 15 percent of the total compensation paid to employees who are participants in the SEP. Total compensation is compensation paid to employees who are SEP participants during the year. If the SEP is maintained on a calendar year basis, compensation is determined for the calendar year ending with or within the employer's taxable year. If the SEP is maintained on the employer's fiscal year, total compensation is compensation paid during the employer's taxable year.

CONTRIBUTIONS

Under IRC section 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. 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.

CONTRIBUTION LIMIT

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:

- ❑ \$30,000 (as adjusted under IRC section 415(c)-\$30,000 for 2000) or
- ❑ 25% of a participant's compensation.

All an employer's defined contribution plans must be aggregated for purposes of these limits.

Under IRC section 404(h)(1)(C), an employer cannot deduct contributions that exceed 15% 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 15% of compensation. For these reasons, SEP documents limit contributions to 15%-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 15% becomes a qualification limit.

The compensation upon which the 15% is based cannot exceed \$150,000 (as adjusted under IRC section 401(a)(17)-\$170,000 for 2000) and the employer's contribution to the employee's SEP is ignored (IRC section 402(h)(2)).

EXAMPLE 6:

Employee A earns \$100,000 in compensation from Employer X during the year. Employer X could contribute 15% of \$100,000, or \$15,000 (as the limit applies to \$100,000, not \$115,000).

<i>SPECIAL RULES FOR SELF-EMPLOYED INDIVIDUALS</i>

In the case of self-employed individuals, in determining the 15% of compensation limit on contributions, compensation means "net earnings from self-employment." 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 can present 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.

Allowable deductions include contributions to common-law employees' SEPs. Allowable deductions also take into account the deduction allowed for ½ of the self-employment tax. For more information on the deduction limitations for self-employed individuals, see Publication 590, Individual Retirement Arrangements (IRAs), and Publication 560, Retirement Plans for Small Business.

EMPLOYER DEDUCTION

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

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).

PART III: SARSEPs

SPECIAL REQUIREMENTS FOR SARSEPs

Salary reduction SEPs (SARSEPs) are similar, in some respects, to IRC section 401(k) plans. A SARSEP is a SEP that accepts contributions made pursuant to a salary reduction arrangement. Employees can choose to have the employer make contributions to their SEP-IRAs instead of paying them the equivalent amount as salary (see IRC section 408(k)(6)). As in section 401(k) plans, contributions funded through salary reduction elections are called "elective deferrals" because the contributions are made at the election of the employees and because the principal tax effect is to defer payment of income taxes until actually distributed to the employee from the SEP-IRA.

Section 1421(c) of the 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.

As with regular SEPs, SARSEPs could be adopted using a model form, a prototype document or an individually designed document. Form 5305A-SEP was 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 Revenue Procedure 91-44, 1991-2 C.B. 733, the Service provided a model amendment for SEP prototype plans that would turn the SEP into a SARSEP if it was adopted. This same revenue procedure set forth the requirements for obtaining opinion letters on prototype SARSEPs.

INELIGIBLE EMPLOYER

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.

An employer cannot maintain a SARSEP if it has more than 25 employees who were eligible to participate (or would have been required to be eligible to participate if a plan was maintained) at any time during the preceding year.

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.

EXAMPLE 7:

Employer X established a SARSEP in 1995. In 1996, the employer expanded its business and hired new employees. In 1999, under the terms of the SARSEP, more than 25 employees were eligible to participate in the SEP. In 2000, Employer X is ineligible to sponsor the SARSEP, since it had more than 25 employees eligible to participate in the preceding year.

NONDISCRIMINATION TEST FOR ELECTIVE DEFERRALS

SARSEPs are subject to a nondiscrimination test similar to the test imposed on section 401(k) plans, but which is 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").

This test is different from 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 other employees, whereas the ADP test compares the average of the deferral percentages of **all** HCEs with the average of all other employees. Further, unlike section 401(k) cash or deferred arrangements, nonelective contributions from the employer cannot be used to help the SARSEP satisfy the test.

The employer must notify each affected HCE within 2 ½ 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 IT Reg. section 54.4979-1(a)(4).

Compensation in excess of \$150,000 (as adjusted for inflation, under IRC section 401(a)(17)-\$170,000 for 2000) cannot be considered in determining an employee's deferral percentage. See IRC sections 408(k)(6)(D) and 408(k)(8).

<i>LIMITS ON DEFERRALS</i>

In general, the total income that can be deferred under a salary reduction arrangement included in a SEP and certain other elective deferral arrangements is limited to \$7,000 (as adjusted for inflation, under IRC section 402(g)-\$10,500 for 2000). This limit applies only to the amounts that represent a reduction from the employee's salary, not to any nonelective employer contributions. No employee may have more than this IRC section 402(g) annual limit in elective deferrals per taxable year made on his or her behalf. If the employee has other elective deferrals made under another SARSEP, a section 401(k) plan, a salary reduction agreement used to purchase a section 403(b) annuity, or a SIMPLE IRA under section 408(p), then such elective deferrals are added to the elective deferrals under the SARSEP for purposes of the section 402(g) annual limit.

If an employee has more than the section 402(g) limit in elective deferrals made on his or her behalf for a taxable year, the employee must include in income the excess over the section 402(g) limit for the taxable year for which the excess deferral was made. In addition, the excess is included in income a second time when it is distributed from the SEP, 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.

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.

Elective deferrals, not exceeding the deferral percentage test, made by the employer to the SARSEP, are subject to the overall 15%/\$30,000 limit applicable to regular SEPs, discussed previously.

PART IV: TOP HEAVY REQUIREMENTS

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.

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. 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.

For purposes of determining if a plan is top heavy under IRC section 416, elective deferrals are considered employer contributions. However, elective deferrals may not be used, 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.

PART V: DISTRIBUTIONS

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.

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

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).

PART VI: NOTICE AND REPORTING REQUIREMENTS

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.

DISCLOSURE TO EMPLOYEES

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: notice that the SEP has been adopted, requirements an employee must meet to receive an allocation, the basis upon which the employer's contribution will be allocated, and any other information the Commissioner may prescribe.

These requirements are set forth in proposed regulation I.T. Reg. 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).

ANNUAL STATEMENTS

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).

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

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.

GENERAL REPORTING REQUIREMENTS

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

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 under a SEP plan. A separate Form 5498 must be submitted for each SEP participant.

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.

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.

SARSEP NOTICE AND REPORTING REQUIREMENTS

In addition to the notice and reporting requirements described above, SARSEPs have special notice and reporting requirements when the IRC section 408(k)(6) limits on elective deferrals are not satisfied. Notice 89-32, 1989-1 C.B. 671, sets forth the reporting requirements in these situations.

FAILURE TO SATISFY THE DEFERRAL PERCENTAGE TEST

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), which references IRC section 401(k)(8)). The employer must notify each affected HCE, within 2 ½ 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.

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 IT Reg. Section 54.4979-1(a)(4).

FAILURE TO SATISFY 50% TEST

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.”

The employer must notify each affected employee (within 2 ½ 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.

PART VII: EPCRS

The Service has a comprehensive system of correction programs for sponsors of retirement plans that are intended to satisfy the requirements of IRC section 401(a), 403(a), or 403(b), but have not met these 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.

In Revenue Procedure 2001-17, 2001-7 I.R.B. 589, this system was expanded to add new procedures designed for employers that sponsor SEPs. Under the revenue procedure, employers can self-correct insignificant SEP failures and can apply to the Service for corrections of certain other failures under the procedure called Voluntary Correction of SEP Failures (“VCSEP”).

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

self correction of insignificant operational failures, voluntary correction with Service approval and payment of a fee, and Audit CAP.

PART VIII: EXAMINATION STEPS

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 set up before 1997.

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

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.

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 merger of two employers recently, changes in the required coverage for the existing SEP may have occurred, resulting in an increase in participation in the SEP.

Verify that the correct definition of compensation is used in determining the contribution limit under the plan and that compensation in excess of \$150,000 (as adjusted) is disregarded.

Verify that the nondiscrimination rules were met.

If the SEP is integrated, check to determine that (a) it is not a SARSEP and (b) it does not use a model SEP form.

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. Publication 590 has a worksheet that can be used to calculate the proper deduction amount.

Check that all applicable limits have not been exceeded. Note that if the SEP is not a model plan, the employer may maintain another plan and special attention should be paid to verify that IRC section 415 has not been violated.

If the arrangement is a SARSEP, confirm that the employer is not an ineligible employer, did not have more than 25 employees eligible to participate in the preceding year, and has at least 50% of employees electing to make deferrals to the SEP.

If a SARSEP, verify that the plan satisfies the deferral percentage test, keeping in mind the differences between this test and the IRC section 401(k) ADP test.

If a SARSEP, confirm that the \$150,000 compensation limit (as adjusted for inflation under IRC section 401(a)(17)-\$170,000 for 2000) and the IRC section 402(g) limit (\$10,500 for 2000) were met.

Determine if the plan is top-heavy or is treated as top-heavy and, if so, confirm that top-heavy minimum contributions were made. 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.

See if the appropriate Forms 941 and 940 (as applicable) were filed. Also check to see if the W-2 and W-3 forms were correctly prepared and timely filed.

Determine if Forms 1099-R were correctly prepared and filed. Verify with any cancelled checks, wire transfers, etc. Determine if appropriate information regarding distributions was provided to participants.

If the employer is self-employed and files Form 1040, verify the amount deducted.

Check documentation that would verify the establishment of IRAs, or amounts of contributions made, such as a copy of bank statements, broker statements, etc.

Annual Statutory Limits Applicable to SEPs

Year	402(g)	408	401(a)(17)	414(q)	415(c)	TWB
2002	11,000	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	35,000	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	80,000	30,000	65,400
1996	9,500	400	150,000		30,000	62,700
1995	9,240	400	150,000		30,000	61,200

FY 2002 SEP SARSEP PROJECT CASE

PROJECT CODE 100

ACTIVITY CODE 367

CASE CONTROL ON EPIC

FY 2002 SEP (Simplified Employee Plan) Project

CASE CONTROL OF SEP ON EPIC

- 1) Case control of non-return unit SEP examinations need to be done on the EPIC inventory system since there is no AIMS record.
- 2) SEP plan examinations should be charged on EPIC and ETS as Project Code 100 and Activity Code 367.
- 3) EPIC fields for Organ/Taxpayer, City, TIN, Plan Number (will need to use a dummy plan number), year, ZIP, MFT/ACT, Return Code (use "4"), status code, source code, special project code, case grade (11), normal statute date (use 12/31/2000), statute update date, assigned to group, assigned to agent, closed to EPP, grade of case, and disposal code, will need to be completed.
- 4) Mailing the closed case file: The closed case file with the completed SEP checksheet should be sent with a computer generated Form 3210 to the attention of IRS, Exam Special Support, Attention: Yvonne Renwicks, 31 Hopkins Plaza, Room 1542, Baltimore, MD, 21201. The case should be updated on EPIC as per usual. The AIMS unit will close per usual; sending the appropriate examination report/closing letter, selecting those cases needed for TEQMS, and forwarding the checksheets to Mr. Robert CreMeens, 1100 Commerce Street, Dallas, TX, 75242, MC 4910- DAL.
- 5) The AIMS unit will then retire the examination file to the Ogden Service Center.

FY 2002 SEP (Simplified Employee Plan) Project

SEP SIGNIFICANT ISSUES OF CONCERN & OCEP EXAM

This program is intended to look at 2000 tax year issues for SARSEP. These issues do not take into account the Economic Tax Relief Reconciliation Act of 2001 changes to SEP, which were significant.

- 6) Participation & Coverage: Contributions to a SEP must be made for all employees who satisfy the definition of qualified employee. Unlike qualified plans, there are no exclusions or percentages of employees that have to be covered. All qualifying employees must be covered, and receive the appropriate contribution. Also leased employees must be covered by the plan and members of a controlled group must be included for participation.
- 7) Contribution Amount: An employer may contribute and deduct each year participating employee's SEP-IRA up to 15% of the employees' compensation. See IRC 404(h)(1)(C).
- 8) Written Plan: The employer is required to have a written plan document in order to have a qualified SEP plan and a definite allocation formula for contributions. Section 1.408-7(b) of proposed I.T. Regs. and IRC 408(k)(5)
- 9) Restrictions on Elective Contributions and plan eligibility for SARSEP plans:
 - a. at least 50% of employees eligible to participate must choose elective deferrals;
 - b. an employer cannot adopt or maintain a SARSEP if it has more than 25 employees eligible to participate
 - c. the amount deferred each year by each eligible highly compensated employee as a percentage of pay is no more than 125% of all other eligible employees (ADP test). Generally, compensation in excess of \$150,000 cannot be considered in figuring an employee's deferral percentage. See IRC 408(k)(6)(A).
- 10) Top Heavy Requirements: For smaller plans this is always an issue. Elective deferrals are considered employer contributions. Elective deferrals may not be used, however, to satisfy the minimum contribution requirements under IRC 416.
See IRC 416(i)(6).

- 11)Limits on Deferrals: In general, the total income that can be deferred under a salary reduction agreement included in a SEP and certain other elective deferral arrangements is limited to \$10,500 (adjusted for inflation) in the year 2000. See IRC 402(g)(1) and 408(k)(6)(A)(iv).
- 12)If the employer is self-employed and files Form 1040, verify the proper amount deducted and that there is not a dual deduction on the front of Form 1040 and Schedule C. Also, verify that in the case of self-employed individuals in determining the proper amount of contributions they are using "net earnings from self-employment" which must take into account deductions for contributions to the self-employed individuals own SEP. See Pub 590
- 13)These examinations may be worked as OCEP Office/ Correspondence Examination Program by letter correspondence as outlined in IRM Part 7 Chapter 6 Section 7.6.5 If the case is worked as an OCEP it needs to be limited in scope to no more than three or four issues.
- 14)These SEP examinations are entitled to use the **EPCRS** and **Audit CAP** programs to correct deficiencies as recently stated in Rev. Proc. 2001-17, Part 1 Section 2, .01
- 15) Agents working these cases need to complete the attached SEP checksheet and
attach them to the closed case examination file.

FY 2002 SEP (Simplified Employee Plan) Project

LOCATING THE TAXPAYER PHONE NUMBER

Agents for the SEP examination program will be given a listing that includes the taxpayer name, EIN, address, zip code, contribution, and participation information obtained from W-2 item 13F. The agent will not have a copy of a 5500 return to review since SEP Plans are not required to file a return. Instead the agent, using the taxpayer name and address will need to do **local research** to locate the taxpayer and a contact phone number. It is advised that agents working on this project send the taxpayer an initial examination appointment letter and make phone contact with the taxpayer to set up the appointment, verify correctness of the address, and other plan sponsor information. The following steps can be taken to find the taxpayers phone number.

- Local phone directories.
- Local directory assistance.
- IRS approved Internet online research using the search capabilities of such public records search services such as www.switchboard.com and www.infobel.com which can be used by agents with documented approved Internet access. These two sites are just examples of search services that can be used.
- IDRS modules ENMOD or EMFOL-L may give the taxpayer phone number or plan sponsor phone contact.

Other useful IDRS research command codes that can be used as pre-examination tools.

- a) INOLE-X for related returns filed
- b) BMFOL-R for business return transcripts of 1120, 1120S and 1065 returns

If a taxpayer address comes back as not correct, a postal tracer can be done with the postal service by completing Form 4759 with "agency return address" filed out on the form.

If the taxpayer can still not be contacted, the agent needs to review the "no-contact" case with their manager and decide if any additional appropriate action can be taken. If it is finally determined that the case is a no-contact case, the file should be sent back to the Examination Planning and Program staff on a manual Form 3210 to the attention of IRS, Robert CreMeens, 1100 Commerce St., Dallas, TX 75242, MC 4910 DAL. No AIMS account are required, but the case needs to be established on the EPIC system appropriately.

SEP/SARSEP Checksheet, FY 2002 Program

SEP Financial Institution Name _____

Address of the Financial Institution _____

1. Employer Name _____
2. Employer EIN _____
3. Plan Name _____
4. Plan year Ends _____
5. Plan Year(s) under exam _____
6. Type of SEP. Prototype approved by National Office _____
Individually designed plan _____
Model SEP _____
7. If prototype SEP, Type of sponsoring organization:
 - a. Bank
 - b. Insurance Company
 - c. Trade or professional Org.
 - d. Savings and Loan that qualifies as a bank
 - e. Required Investment Co.
 - f. Approved non-bank trustee
 - g. Federally Insured Credit Union
8. Are all IRA accounts maintained at the same institution?
9. Is there a plan document? Yes() No()
10. Does the employer maintain any other plan? Yes() No()
11. Name(s) and plan no.(s) of other plans(s) _____

12. Was an account set up for each eligible employee that: ()Yes ()No
 - a. Is at least 21 years old
 - b. Has performed service for the employer in at least 3 of the immediately preceding 5 years, and
 - c. Has received at least \$300 in compensation (as adjusted under section 408(k)(8) from the employer for the current year.

Employee Plans CPE Topics For 2002

13. Participation Requirements:

Age_____Service_____Compensation_____

Other_____

14. Excludible Employees:

() Yes () No

15. Contribution Limit: \$_____ %_____

Cannot exceed \$30,000 as adjusted for inflation and 25% of the participants compensation. Also under IRC 404(h)(1)(C) an employer cannot deduct contributions that exceed 15% of employee's compensation. In addition there is a 6% excise tax on excess contributions made to an IRA, which include SEP, IRC 4973(a), 4973(b).

16. Does the employer sponsor a qualified plan? () Yes () No

If no, skip to question # 18. If yes, has section 415 been satisfied? () Yes () No

Was there a prior terminated defined benefit plan? () Yes () No

17. Eligibility:

a. Are rules for common law employees identical to owners? () Yes () No

b. Are common law employees tested correctly? () Yes () No

c. Are common law employees required to be employed at the end of the year or some specified date? () Yes () No

d. Are there leased employees? () Yes () No

e. If yes, are leased employees treated correctly? () Yes () No

18. Compensation:

Is earned income for self-employed/partners calculated correctly? () Yes () No

a. After FICA/Medicare, employee cost, employer contribution? () Yes () No

b. Family aggregation rules? () Yes () No

c. Limited to \$150,000? () Yes () No

d. Is earned income from all business under common control limited to \$150,000 in total? () Yes () No

Briefly state if any problems. _____

19. Does the plan allow for permitted disparity? () Yes () No

a. Is the permitted disparity calculated properly? () Yes () No

b. Is the plan top heavy? () Yes () No

c. If yes, have minimum contributions been made to satisfy section IRC 416?
() Yes () No

20. Distributions Limitations: Were distributions conditioned on keeping funds in the SEP-IRA? () Yes () No

21. Were there any excess contributions? () Yes () No

Reporting Requirements for Excess Contributions: If excess contributions were made, did the employer satisfy the requirements of Notice 89-32, 1989-1 C.B. 671?

22. Were excess contributions made on behalf of highly compensated employees?

If there were SEP contributions on behalf of highly compensated employees, was each such employee notified within 2 ½ months following the end of the plan year to which the excess contributions relate? ()Yes ()No

These questions are specifically for SARSEP SEP:

23. 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.

Did the SEP SARSEP meet the 50% rule? ()Yes ()No

24. An employer cannot adopt or maintain a SARSEP if it has more than 25 employees who were eligible to participate (or would have been required to participate if a plan was maintained) at any time during the preceding year.

Did the SEP SARSEP meet the 25 employee rule? ()Yes ()No

25. SARSEP's 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)(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).

Did the plan meet the deferral percentage test required for SARSEP? ()Yes ()No

If not, explain how were correction corrections were made. _____

26. Did the plan meet the IRC 402(g) limit for elective deferrals? ()Yes ()No

If no, explain how corrections were made. _____

27. Top Heavy: Are Top Heavy 416 requirements computed correctly? ()Yes ()No

End of SASEP Questions

28. Plan assets on deposit in (Answer to the extent information is available)

a: Custodial Account IRA: \$ _____

b: Annuity Contract IRA: \$ _____

c: Other IRA \$ _____

d: Total Assets (not required to be reconciled) \$ _____

29. How was the examination resolved?

30. Specify the type of tax assessed and the gross amount of judgement or the closing

Employee Plans CPE Topics For 2002

agreement sanction. (If applicable)

1040 \$ _____ 5330 \$ _____

1140 \$ _____ CAP \$ _____

31. Briefly discuss any problems encountered in collecting data during the examination.

32. Discuss any problems encountered in setting up the examination.

33. Was this examination worked as an OCEP? ()Yes ()No

If so, list the issues the examination was limited to?

EP PROJECT PLANNING PROCESS

File Name : SEP Nation Wide Program FY 2002
Project Code # 100

Title of Project : SEP Nation Wide Sample
EP Market Segment Number : (1.5) Other Benefit Plans
Planning Start Date : November 1, 2001
Assigned Date : November 12, 2001
Expected Completion Date: April 30, 2003

Contact Person : Robert CreMeens
Symbols: T:EP:E:PR:P Phone #: 214-767-3005

I. OBJECTIVE/GOAL OF PROJECT :

The objective is to research, select and study a statistically reliable sample of plans from the SEP plan universe identified from year 2000 filed W-2 form item #13(f). The item 13(f) indicates that an employee made a salary reduction contribution deferral to the employers SEP plan sometimes referred to as a SARSEP. The plans reviewed in this program will be at the grade 9 and 11 level. Examinations from this program could be done as OCEP correspondence for the selected issues such as plan deductions, participation-eligibility, the ACP deferral percentage limits of IRC 408(k)(6), 50% test for number of eligible employees participating and prohibited transactions.

II. EMPLOYEE SUPPORT AND COORDINATION :

Training - An instructional memorandum will be issued to employees participating in this program outlining issues to look for, applicable tax law, audit guidelines, fact sheets and a checksheet to complete. Agents working

these

cases should be allowed 4-5 hours of training time
to go
through these materials

Resources - Based on the information available,
there are sufficient resources in most posts of duty
to work this program. Also examinations can be done
by OCEP correspondence.

Employee Responsibility & Support - Support is
needed by Examination Planning and Program staff to
identify the universe of SARSEP from current W-2
information on RICS. Also to issue tax law
information regarding SEP plans to agents involved
in the program and develop a checksheet to gather
information of results on examination.

Coordination - Coordination is needed for
Examination

Planning and Program staff to send lists of sampled
SEP
entities to Area Managers for agents in their areas
to make
contact with and work.

IRM Guidelines or procedural changes needed - No
changes anticipated.

III. HOW WILL THE PROJECT BE CONDUCTED ?

The program will be worked as a nationwide sample of
SEP plans. Currently on RICS the SARSEP plan
universe identified on line item 13(f) of the year
2000 form W-2 is 99,257 plans. A sample size of
approximately 330 plans reviewed will give a
Confidence Factor of 95% with a margin of error of
approximately +/- 5%. 420 entities (70 per TEGE
area) will be selected due to a certain percentage
anticipated as "no contact" cases since these
entities are not required to file a return.

A sample will be selected and lists sent to

appropriate area managers. The agents involved will need to do research on their area SEP lists for contact phone number and to schedule examinations.

IV. HOW WILL THE RESULTS OF THE PROJECT BE MEASURED ?

Checksheets will be used to monitor and analyze the workplan objectives of the project.

The project will be evaluated through the collection of data/information on the project checksheets. If problems are indicated, we will either follow-up on this project to perform more in depth analysis or develop an educational initiative. A written checksheet will be in the file to capture results.

The compliance level and reasons for noncompliance will be determined by analyzing the project checksheets.

Since SEP plans have no filing requirements a DLN is not assigned to the case file. As a result closed case files will not be able to be sent to the Federal Records Center for storage after closure. Therefore once the examination files are received in EPP with checksheets verified to be correctly completed, these examination files of non-return units will need to be stored in a central location.

Project Approved by :

Date: