

Chapter 5

Small-Employer Plans

Reading this chapter will enable you to:

1–5 *Describe the basic characteristics of retirement plans designed for small employers.*

The small-business owner is usually at a disadvantage when it comes to establishing a qualified retirement plan. High administrative costs and a labyrinth of rules cause the owner of a small business to think twice before adopting a qualified retirement plan. Yet without a qualified plan, the small-business owner is at a disadvantage in hiring and retaining good employees. Congress recognized this dilemma and has made available several plans that are easier to establish and less costly to manage: the simplified employee pension, the savings incentive match plan for employees, the salary reduction SEP, and the Keogh.

The essentials of these small-employer plans are described here. For more details, see Module 3, *SEP, SIMPLE & SARSEP Plans*.

Simplified Employee Pensions

A simplified employee pension (SEP) is a pension plan established by a business on behalf of the employee; contributions are deposited into the employee's IRA. A SEP is a tax-deferred individual plan. It is not a qualified plan. Contributions are tax deductible by the employer and are not considered current taxable income for the employee. Generally, any employer may establish a SEP. SEPs are available to both C and S corporations, partnerships, and sole proprietorships. A sole proprietor

with employees can establish a SEP for the benefit of all eligible employees; he or she is also considered an employee and is eligible to receive a SEP contribution. Because an employer contributes directly to the SEP IRA, no separate pension trust is needed.

A SEP has a higher annual employer contribution and deduction limit than an IRA. For 2010, an employer may contribute and deduct as much as 25% of each employee's annual compensation to a SEP, up to a maximum of \$49,000. The compensation cap for 2010 SEP contributions is \$245,000. Practically speaking, the maximum \$49,000 contribution to a SEP participant's account can be made for individuals who earn at least \$196,000 ($25\% \times \$196,000 = \$49,000$).

Suppose the annual earnings of the owner of a company are \$245,000. Assuming the company has adequate cash flow, it might want to maximize contributions to the owner by contributing 20% of each employee's annual compensation to a SEP. This would provide the maximum \$49,000 contribution to the owner's SEP account.

Advantages

Like other qualified plans, SEPs have certain advantages:

- ***They are easy to establish.*** An employer need only execute a written document, available from the IRS, which includes the employer's name, the requirements for employee participation, the signature of a responsible official, and the definite allocation formula. Each participant must then set up an IRA, to which the employer's contributions are made.
- ***They are easy to administer.*** The paperwork and bookkeeping necessary to start and maintain the plan are minimal. Costs for lawyers, accountants, and actuaries are sharply reduced and often eliminated.

- ***There is no investment responsibility.*** Once contributions are made to an employee's SEP IRA, the employer has no further responsibility for the assets. Participants choose their own investments when they establish IRAs.
- ***Contributions are flexible.*** The employer can contribute any amount up to a maximum set by law. It can even choose not to make a contribution.

Disadvantages

SEPs also have certain disadvantages:

- ***Vesting is immediate.*** A major drawback of SEPs from the employer's viewpoint is that employees are immediately vested. Once funds are placed in the participant's IRA, they are under that person's full control. Thus, the employee has no added incentive to stay with the company.
- ***Contributions may be less than the amount permitted by a defined benefit plan.*** The maximum contribution that an employer may make to a SEP may be less than the maximum allowable under a defined benefit plan. Among other things, the defined benefit maximum depends upon the age and compensation of an employee-participant.

Nevertheless, the maximum contribution that an employer may make to a SEP is equal to the maximum allowable under a profit sharing or money purchase pension plan.

- ***Lump-sum distributions have tax implications.*** SEP IRA distributions are not eligible for forward averaging.
- ***They are subject to eligibility rules.*** Like other qualified plans, SEPs have specific and very liberal eligibility requirements. Many of the

employees who need not be covered under a qualified retirement plan must be covered under a SEP, and this can increase the employer's costs.

- *They are not suited for sophisticated allocation formulas.* Although a SEP's allocation formula may be integrated with Social Security (permitted disparity), age-weighted or cross-tested allocation formulas would not be feasible.

Managing Assets

A SEP must be established with a bank, thrift institution, insurance company, brokerage firm, or other entity that is eligible to serve as an IRA custodian. Each employee who participates in the SEP must set up a personal IRA within which the funds will be placed and managed. If a participant does not have an IRA, the employer must establish one on his or her behalf. Further, the participant has the authority to direct the investment of all funds in his or her IRA. For example, if the IRA is established with a mutual fund family, the participant may choose to allocate monies to one or more different funds in pursuit of diversification.

SIMPLE Plans

A SIMPLE IRA is a tax-deferred individual plan. It is not a qualified plan. In contrast, a SIMPLE 401(k) plan is a qualified plan. SIMPLE retirement plans are designed to offer greater deferral opportunities than ordinary IRAs. They also have fewer restrictions and administrative requirements than traditional pension or profit sharing plans. SIMPLE plans can be structured in either an IRA format or a 401(k) format. Unless otherwise indicated, the same rules (discussed below) apply to both SIMPLE IRAs and SIMPLE 401(k) plans.