

SEPs and SIMPLES – The Basics

Excerpted From IRS Publication 560

Employee retirement accounts such as a Simplified Employee Pension (SEP) and Savings Incentive Match Plan for Employees (SIMPLE) are practical retirement contribution plans offered by employers. In evaluating these plans, an employer should consider which plan will make sense from a perspective of running a business, and also which is most beneficial for the owner. While the employer who wants to maximize contributions to his or her own account might prefer the higher contribution limits of a SEP, a SIMPLE provides an opportunity for the employer to match employee contributions.

SEP- IRA

A simplified employee pension (SEP) is a written plan that allows you to make contributions toward your own retirement (if you are self-employed) and your employees' retirement without getting involved in a more complex qualified plan.

Under a SEP, you make the contributions to a traditional individual retirement arrangement (called a SEP-IRA) set up by or for each eligible employee. A SEP-IRA is owned and controlled by the employee, and you make contributions to the financial institution where the SEP-IRA is maintained.

Contribution Limits. Contributions you make for 2004 to a common-law employee's SEP-IRA cannot exceed the lesser of 25% of the employee's compensation or \$41,000 (\$42,000 for 2005). Compensation generally does not include your contributions to the SEP.

Example. Your employee, Mary Plant, earned \$21,000 for 2004. The maximum contribution you can make to her SEP-IRA is \$5,250 (25% x \$21,000).

Contributions for yourself. The annual limits on your contributions to a common-law employee's SEP-IRA also apply to contributions you make to your own SEP-IRA. However, special rules apply when figuring your maximum deductible contribution.

Annual compensation limit. You cannot consider the part of an employee's compensation over \$205,000 when figuring your contribution limit for that employee. However, \$41,000 is the maximum contribution for an eligible employee. (The annual compensation limit of \$205,000 increases to \$210,000 for 2005.)

More than one plan. If you contribute to a defined contribution plan (defined in chapter 4), annual additions to an account are limited to the lesser of \$41,000 or 100% of the participant's compensation. When you figure this limit, you must add your contributions to all defined contribution plans. Because a SEP is considered a defined contribution plan for this limit, your contributions to a SEP must be added to your contributions to other defined contribution plans.

Tax treatment of excess contributions. Excess contributions are your contributions to an employee's SEP-IRA (or to your own SEP-IRA) for 2004 that exceed the lesser of the following amounts.

- 25% of the employee's compensation (or, for you, 20% of your net earnings from self-employment).
- \$41,000.

Excess contributions are included in the employee's income for the year and are treated as contributions by the employee to his or her SEP-IRA.

SIMPLE - IRA

A savings incentive match plan for employees (SIMPLE plan) is a written arrangement that provides you and your employees with a simplified way to make contributions to provide retirement income. Under a SIMPLE plan, employees can choose to make salary reduction contributions to the plan rather than receiving these amounts as part of their regular pay. In addition, you will contribute matching or nonelective contributions.

Contribution Limits. Contributions are made up of salary reduction contributions and employer contributions. You, as the employer, must make either matching contributions or nonelective contributions, defined later. No other contributions can be made to the SIMPLE IRA plan. These contributions, which you can deduct, must be made timely.

Salary reduction contributions. The amount the employee chooses to have you contribute to a SIMPLE IRA on his or her behalf cannot be more than \$9,000 for 2004 (\$10,000 for 2005). These contributions must be expressed as a percentage of the employee's compensation unless you permit the employee to express them as a specific dollar amount. You cannot place restrictions on the contribution amount (such as limiting the contribution percentage), except to comply with the \$9,000 limit.

If an employee is a participant in any other employer plan during the year and has elective salary reductions or deferred compensation under those plans, the salary reduction contributions under a SIMPLE IRA plan also are elective deferrals that count toward the overall annual limit (\$13,000 for 2004) on exclusion of salary reduction contributions and other elective deferrals.

Catch-up contributions. A SIMPLE IRA plan can permit participants who are age 50 or over at the end of the calendar year to also make catch-up contributions. The catch-up contribution limit for 2004 is \$1,500 (\$2,000 for 2005). Salary reduction contributions are not treated as catch-up contributions for 2004 until they exceed \$9,000. However, the catch-up contribution a participant can make for a year cannot exceed the lesser of the following amounts.

- The catch-up contribution limit.

- The excess of the participant's compensation over the salary reduction contributions that are not catch-up contributions.

Employer matching contributions. You are generally required to match each employee's salary reduction contributions on a dollar-for-dollar basis up to 3% of the employee's compensation. This requirement does not apply if you make nonelective contributions.