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# Simplified Employee Pensions

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High administrative costs and financial commitments of certain qualified retirement plans can cause many small businesses to shy away from establishing such arrangements. However, these business owners also recognize the advantages of providing retirement benefits for their employees and themselves. For many doctors, lawyers, freelance writers, artists, manufacturers, representatives and other self-employed people, Simplified Employee Pensions (SEPs) may be too good a deal to pass up.

Although they are technically a type of Individual Retirement Arrangement (IRA), SEPs seem more like a cross between an IRA and a profit-sharing plan. Like a profit-sharing plan, the employer tax deduction limit is the lesser of 25% of compensation or $40,000. However, note that compensation is capped at $200,000 (as of 2003), which brings down the maximum contribution to $40,000 (25 percent of $200,000). Also like a profit-sharing plan, the employer has complete flexibility (within the above limits) to set the amount contributed. The employer may even skip a year or more if business is bad. Like an IRA, distributions cannot receive lump-sum distribution forward averaging treatment for tax purposes like qualified plans.

A SEP account is very easy to establish and maintain. A SEP may be established by a corporation (S or C), partnership, nonprofit organization or sole proprietor. There is no complicated adoption agreement to complete or file with the IRS. In fact, there's no need to file annual reports (i.e., Form 5500) with the IRS, either. The form establishing a SEP is a very simple, one-page form that should be retained by the employer. A SEP may be "integrated with social security," which has the effect of skewing contributions toward higher paid people (usually, employers). Be careful however, because the standard IRS form does not allow for integration. You must find a prototype that does.

One of the reasons SEPs are so simple is that there are very few choices available to employers. All SEP contributions are always 100% vested in the employees. For example, consider an employer who makes $50,000 per year and has two employees who make $10,000 each. If the employer contributes 10% for himself/herself, they must contribute 10% each for the two employees. If one of the employees quits tomorrow, her or she takes the $1,000 with them.

The eligibility rules on SEPs are fairly strict. First, you cannot exclude employees over age 21. Second, you must cover employees who have worked for the employer in three of the past five years. Note, that means any amount of work (say, one afternoon) counts the same as an entire year's efforts. Third, you must contribute for anyone who meets the other criteria and makes more than a certain amount during the year (around $450). That makes it virtually impossible to exclude part-time people. You should also realize that the same criteria apply to both employer and employees. If the business has only been in existence for one year and the employer wants the maximum exclusion of three out of five years, the employer will have to complete two more years before he/she qualifies.

A couple of other advantages of SEPs should be noted, regarding their tax planning and investment flexibility. SEPs can be established and funded up until the company's tax filing deadline, unlike other qualified plans. Furthermore, since the employees own their accounts, they have and control a wide range of investment choices. SEPs can provide a simple and effective vehicle to provide for employee retirement. Of course, be sure to consult your tax advisor and investment professional before implementing any significant financial planning strategy.

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JULY 2004