Chapter 5: Retirement Plans for Small Businesses

5

Please note. Corrections for all of the chapters are available at **www.TaxSchool.illinois.edu.** For clarification about acronyms used throughout this chapter, see the Acronym Glossary at the end of the Index.

For your convenience, in-text website links are also provided as short URLs. Anywhere you see **uofi.tax/xxx**, the link points to the address immediately following in brackets.

About the Author

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When a small business client asks for advice on choosing appropriate retirement plans, the tax practitioner may immediately think of a SEP IRA or SIMPLE IRA. However, there are several other retirement plan alternatives to consider, including the following.

- Solo 401(k) plan
- Safe harbor 401(k) plan
- SIMPLE 401(k) plan
- Traditional IRA
- Roth IRA

The tax practitioner faces a challenge in providing advice on the right plan or combination of retirement plans that best meets the client's needs. In this chapter, each of the above-mentioned retirement plans is considered in detail and compared with other plans. This chapter discusses factors that influence the decisions about the optimal plan for a business including available tax credits. Decision flowcharts are also provided that tax practitioners can use to guide their clients in making appropriate retirement plan selections.

Note. A recent article in the *Journal of Accountancy* compares four small business retirement plans (SEP, SIMPLE IRA, 401(k), and Solo 401(k)).[1] While less detailed than this chapter, this article provides useful supplementary information on this subject.

Regular 401(k) plans are not analyzed in this chapter because they are subject to greater reporting requirements and potentially onerous nondiscrimination testing. Additionally, this chapter does not include a detailed analysis of retirement plan distributions or rollovers.

SEP IRA PLAN[2]

A simplified employee pension (SEP) plan allows the employer to create SEP IRAs for the business and its eligible employees. Generally, only the employer contributes to this type of plan. Under a salary reduction simplified employee pension (SARSEP) plan, employees have the option to make voluntary contributions. However, a SARSEP plan cannot be established after 1996.

SEP IRAs do not permit loans to plan participants.[3]

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1. *Help small businesses choose the right employee retirement plans*. Williams, Jimmy J. Feb. 1, 2018. Journal of Accountancy. [www.journalofaccountancy.com/issues/2018/feb/small-business-employee-retirement-plans.html] Accessed on Feb. 1, 2018.
2. IRC §408(k); IRS Pub. 560, *Retirement Plans for Small Business (SEP, SIMPLE, and Qualified Plans).*
3. *IRA FAQs — Loans*. Aug. 12, 2017. IRS. [www.irs.gov/retirement-plans/retirement-plans-faqs-regarding-iras-loans] Accessed on Feb. 2, 2018.

ESTABLISHING A SEP IRA PLAN

Most employers, including self-employed individuals, can establish SEP plans. SEPs have low start-up and operating costs and, in most cases, can be established by adopting an IRS-model SEP using Form 5305-SEP, *Simplified Employee Pension — Individual Retirement Accounts Contribution Agreement*.

If an employer adopts an IRS-model SEP using Form 5305-SEP, no prior IRS approval or determination letter is required. The employer keeps the Form 5305-SEP and does not file it with the IRS. Using Form 5305-SEP usually provides relief to the employer from annual filing requirements for retirement plan information returns.

An employer **cannot use** Form 5305-SEP if any of the following applies.

1. The employer currently maintains another qualified retirement plan other than another SEP.
2. The employer has eligible employees for whom IRAs were not set up.
3. The employer uses the services of leased employees who are not the employer's common-law employees.
4. The employer is a member of any of the following unless all eligible employees of all the members of these groups, trades, or businesses participate under the SEP.
    a. An affiliated service group as described in IRC §414(m)
    b. A controlled group of corporations as described in IRC §414(b)
    c. Trades or businesses under common control as described in IRC §414(c)
5. The employer does not pay the cost of the SEP contributions.

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The employer must give each eligible employee a copy of Form 5305-SEP, its instructions, and the other information listed in the Form 5305-SEP instructions. An IRS-model SEP is not considered adopted until the employer provides this information to each employee.

A SEP IRA must be set up by or for each eligible employee. A SEP IRA can be established with a bank, insurance company, or other qualified financial institution. The employer sends SEP contributions to the financial institution at which the SEP IRA is maintained.

The employer can establish a SEP for any year as late as the due date (including extensions) of its income tax return for that year.

ELIGIBLE EMPLOYEES

The most significant downside to a SEP plan is that it has broad eligibility requirements. The plan **must** cover all employees who:

1. Are at least 21 years of age,
2. Were employed by the employer for three of the last five years, and
3. Received compensation of $600 or more during the year (2017 or 2018).[4]

An employer can use less restrictive participation requirements than these but **not more** restrictive requirements.

Any employee who meets these three requirements during the year **must** be covered regardless of whether they were temporary, part-time, or **not** employed at yearend.[5] This includes employees who are over age 70½.

4. IRS News Release IR-2017-177 (Oct. 19, 2017).

5. *SEP Plan Fix-It Guide - Eligible employees were excluded from participating*. Jan. 19, 2018. IRS. [www.irs.gov/retirement-plans/sep-fix-it-guide-the-plan-excluded-eligible-employees-from-participating-in-the-sep] Accessed on Feb. 2, 2018.

The following employees **can be excluded** from coverage under a SEP.

- Employees covered by a union agreement and whose retirement benefits were bargained for in good faith by the employees' union and the employer
- Nonresident alien employees who have received no U.S. source wages, salaries, or other personal services compensation from the employer

CONTRIBUTIONS

The employer must contribute a uniform percentage of pay for each employee but the **employer is not required to make contributions to the plan every year**. Because the employer can decide how much to put into a SEP each year, this plan gives the company the flexibility to deal with fluctuating business conditions.

The employer has until the due date of the tax return, **including** extensions, to make contributions to the plan. The contributions are deductible for the designated tax year, even if the employer uses cash basis for tax reporting.

Employer contributions are not taxable to the employee until withdrawn. In addition, they are **not reported** on the employee's Form W-2, *Wage and Tax Statement;* although the "retirement plan" box (box 13 on the 2017 Form W-2) must be checked.

Elective deferrals by an employee in a SARSEP plan reduce the wages reported in box 1 of Form W-2 and are reported in box 12 using code "F."[6]

Employer contributions for 2018 to an employee's SEP IRA are limited to the **lesser** of:[7]

- 25% of the employee's compensation (up to $275,000 of compensation), or
- $55,000.

Employees are immediately vested in contributions to SEP IRA accounts.[8]

Limits for Self-Employed Individuals

Self-employed taxpayers must make a special calculation to determine the maximum amounts of their elective deferrals and nonelective contributions. When calculating such a contribution, the compensation amount used is the taxpayer's earned income, which is defined as net earnings from self-employment (SE) after deducting both of the following.

- One-half of the SE tax
- Contributions for the self-employed taxpayer

The compensation amount and the amount of the taxpayer's plan contribution depend on each other (i.e., this is a circular calculation). One way to make the calculation is to use a reduced plan contribution rate, which is calculated by dividing the plan contribution rate by the sum of 100% plus the plan contribution rate.[9] This means that a self-employed taxpayer is effectively limited to a nonelective contribution rate of 20% of compensation (25% maximum contribution rate ÷ (100% + 25% contribution rate)).

A worksheet in IRS Pub. 560, *Retirement Plans for Small Business (SEP, SIMPLE, and Qualified Plans),* can also be used to determine the maximum deductible contribution for a self-employed taxpayer.

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6. General Instructions for Forms W-2 and W-3.
7. *SEP Plan FAQs — Contributions.* Oct. 25, 2017. IRS. [www.irs.gov/retirement-plans/retirement-plans-faqs-regarding-seps-contributions] Accessed on Feb. 2, 2018.
8. *Operating a SEP*. Oct. 25, 2017. IRS. [www.irs.gov/retirement-plans/operating-a-sep] Accessed on Feb. 2, 2018.
9. *Self-Employed Individuals — Calculating Your Own Retirement-Plan Contribution and Deduction*. Oct. 24, 2017. IRS. [www.irs.gov/retirement-plans/self-employed-individuals-calculating-your-own-retirement-plan-contribution-and-deduction] Accessed on Feb. 2, 2018.