Internal Revenue Service

Tax Exempt and Government Entities

Employee Plans

SARSEP Salary Reduction Simplified Employee Pension

for Small Businesses

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SARSEP Plans for Small Businesses

What is a SARSEP?

A SARSEP is a simplified employee pension (SEP) plan set up before 1997 that permits contributions to be made through employee salary reductions. Under a SARSEP, employees can choose to have the employer contribute part of their pay to their separate individual retirement arrangements (IRAs), referred to as SEP-IRAs. This contribution is called an "employee elective deferral" because employees choose (elect) to set aside the money, and they defer the tax on the money until it is distributed to them. Another term used to describe these contributions is "salary reduction contributions."

In other words, it is the employees who decide whether, and to what extent, money will be paid to IRAs established for them under the SARSEP, rather than money paid to them as compensation. SARSEPs are similar in some respects to 401(k) cash or deferred arrangements.

A SARSEP is a written arrangement (a plan) that allows an employer to make contributions towards its employees' retirement without becoming involved in more complex retirement plans. A self-employed individual may also maintain a SARSEP. The contributions are made to traditional IRAs—not Roth or SIMPLE IRAs—of the plan participants. Under a SARSEP, IRAs are set up for each eligible employee.

Choosing a SARSEP

The Small Business Job Protection Act of 1996 (SBJPA) prospectively repealed SARSEPs. Therefore, no new SARSEPs could have been established after December 31, 1996. However, employers who 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. The introduction of SIMPLE IRA plans under Internal Revenue Code section 408(p) (added to the Code by SBJPA) is intended to fill the need for retirement plans like SARSEPs.

Establishing a SARSEP

Although new SARSEPs could not have been established after 1996, employees hired after 1996 may participate in existing SARSEPs. IRAs need to be established for each participant with a bank, insurance company or other qualified financial institution.

Furthermore, existing plans may need to be amended for current law changes as discussed below.

Operating a SARSEP

Maintaining Your Plan Document

A SARSEP must be part of a written arrangement. As with regular SEPs, SARSEPs can be adopted using a model form, a prototype document or an individually designed document. **Form 5305A-SEP,** *Salary Reduction Simplified Employee Pension—Individual Retirement Accounts Contribution Agreement,* is the model SARSEP issued by the Internal Revenue Service (IRS).

The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) changed many of the requirements and limits for qualified plans and IRAs. In order to maintain tax-advantaged status and benefit under these new provisions, SARSEP prototype and individually designed plans must be amended for current law. In order for employers with model SARSEPs to maintain tax-advantaged status and to avail themselves of new law changes, they must adopt the current version of the model Form 5305A-SEP.

The administrator of an amended SARSEP must furnish each participant—within 30 days of the amendment—a copy of the amendment and an explanation of its effects.

Who Must Be Included in a SARSEP?

All eligible employees must be allowed to participate in a SARSEP. An eligible employee is any employee who:

- is at least 21 years old, and
- has performed "service" for you in at least 3 of the immediately preceding 5 years. Service means any work performed for any period of time, however short.

Less restrictive eligibility requirements can be established, but not more restrictive ones.

If you are a member of an affiliated service group, a controlled group of corporations, or trades or businesses under common control, service includes any work performed for any period of time for any other member of such group, trades, or businesses.

The following employees do not have to be covered by a SARSEP:

- employees covered by a collective bargaining agreement whose retirement benefits were bargained for in good faith by you and their union,
- nonresident alien employees who did not earn U.S. source income from you, and
- employees who received less than $450 (subject to cost-of-living adjustments) in compensation during the year.

Example 1: Employer X maintains a calendar year SARSEP. Under the SARSEP, an employee must perform service 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 2001, 2002, and 2003, but never more than 34 days in any year. In July 2004, Employee A turns 21. In August 2004, Employee A begins working for Employer X on a full-time basis for $20,000 a year. Employee A is an eligible employee in 2004 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 2004.

Example 2: Employer Y designs its SARSEP 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 2004. Employee B is an eligible employee for 2004.

Note: The term "employee" includes a self-employed individual who has earned income.

Enrolling Employees in a SARSEP Plan

Set up a SEP-IRA for Each Employee— A SEP-IRA must be set up by or for each eligible employee. SEP-IRAs may be set up with banks, insurance companies, or other qualified financial institutions.

Giving Employees Information— If you use Form 5305A-SEP, you must give your employees a copy of the form and its instructions. The model SARSEP is not considered "adopted" until each eligible employee is provided these documents and other information as described under **Communicating With Employees** later in this publication. If you use a prototype or individually designed plan, you must give all eligible employees similar information.

25-Employee Rule

Salary reduction contributions cannot be made to a SARSEP for a year if there were more than 25 employees eligible to participate at any time during the preceding year.

The 25-employee rule is a look-back rule, and it is also a year-by-year rule. For example, if you had 23 eligible employees in 2003, but 27 eligible employees in 2004, salary reduction contributions may be made to the SEP-IRAs of the 27 employees for 2004. However, in 2005, no salary reduction contributions may be made for you and your employees.

50 Percent or More of All Eligible Employees Rule

At least 50 percent of your eligible employees must choose to make employee elective deferrals each year. This is a year-by-year rule.

What if less than 50 percent of your eligible employees choose to make employee elective deferrals?

Any year the 50-percent rule is not met, all employee elective deferrals made for that year are disallowed and must be withdrawn from the employees' SEP-IRAs. You must notify each affected employee within 2 1/2 months after the plan year of the following:

1) the amount of disallowed deferrals to his or her SEP-IRA for the preceding year,

2) the year the disallowed deferrals and earnings are includible in gross income,

3) information stating that the employee must withdraw the disallowed deferrals (and earnings) by April 15th following the calendar year of notification, and

4) an explanation of the tax consequences if the employee does not withdraw such amounts.

See the Instructions for Form 5305A-SEP for detailed information on disallowed deferrals for SARSEPs maintained on a calendar-year basis.

Contributions to a SARSEP

Overall Limits on SARSEP Contributions

Employee elective deferrals, when combined with nonelective employer contributions for any participant, cannot exceed the lesser of 25 percent of the employee's compensation or $41,000 for 2004 (subject to cost-of-living adjustments for later years). For calculating the 25-percent limit, compensation does not include employee elective deferrals to a SARSEP or other amounts deferred in certain other employee benefit plans. Catch-up employee elective deferrals are not subject to the 25-percent limit. Contributions to other defined contribution plans (401(k), 403(b), profit-sharing, or money purchase pension) including other SEPs may be required to be taken into account for purposes of these limits.

Employer Contributions

In addition to the employee elective deferrals, employers may make additional contributions under a SARSEP, referred to as employer nonelective contributions. Generally, these contributions do not have to be made every year unless your plan is top-heavy. See **Top-Heavy Requirements** later in this publication. If additional contributions (other than top-heavy contributions) are made, they must be contributed to the SEP-IRAs of all eligible employees who actually performed services during the year for which the contributions are made, even employees who die or terminate employment before the contributions are made.

Contributions may not be made in such a manner as to discriminate in favor of highly compensated employees. Contributions are not considered discriminatory if they bear a uniform relationship to participants' compensation that does not exceed $205,000 in 2004 (subject to future cost-of-living adjustments).

The definition of compensation stated in the plan document must be followed in the operation of the plan. An employee's compensation generally includes the pay the employee received from you for personal services for the year.

There are special rules for self-employed individuals. When figuring the deduction for contributions made to your own SEP-IRA, compensation is the net earnings from self-employment, which takes into account both the following deductions: 1) the deduction for one-half of the self-employment tax; and 2) the deduction for contributions to the self-employed individual's own SEP-IRA. For more information on the deduction limitations for self-employed individuals, see IRS **Publication 560,** *Retirement Plans for Small Business (SEP, SIMPLE, and Qualified Plans).*

Employee Elective Deferrals

How much can be deferred?

The most an employee can choose to defer for the 2004 calendar year is the lesser of:

1) 25 percent of the employee's compensation (limited to $205,000), or

2) $13,000 (section 402(g) limit).

The compensation limit in 1) of $205,000 is subject to future cost-of-living adjustments. The amount in 2) increases to $14,000 for 2005, and $15,000 for 2006. After 2006, the limit is subject to cost-of-living adjustments. For a definition of compensation as it applies to this limit, refer to your plan document.

The $13,000 limit applies to the total employee elective deferrals the employee makes for the calendar year from all employers under any arrangement allowing for elective deferrals including 401(k) and SIMPLE IRA plans.

Additional "catch-up" elective deferral contributions are allowed for employees who have reached age 50. Catch-up contributions are limited to $3,000 for 2004, increasing to $4,000 for 2005, and $5,000 for 2006. After 2006, the limit is subject to cost-of-living adjustments.

If an employee makes elective deferrals in excess of the section 402(g) limit above, the employee must withdraw those excess deferrals, adjusted for earnings, by April 15th of the year following the calendar year in which the excess deferrals occurred. The excess amount is included in gross income for the year the excess occurred. The earnings on the excess amount through the date of correction are included in income in the year distributed.

Average Deferral Percentage (ADP) Test

The amount each highly compensated employee (HCE) may defer is limited.

A HCE is an employee who:

- owned more than 5 percent of your business at any time during the year or the preceding year, or
- for the preceding year, received compensation from you of more than $90,000 and, if specified in your SARSEP plan document, was in the top 20 percent of employees when ranked by compensation.

The ADP test for a SARSEP compares the deferral percentage of each HCE with the average of the deferral percentages of all eligible nonhighly compensated employees (NHCEs).

The ADP test must be performed each year. The deferral percentage limit for your HCEs is computed by first averaging the deferral percentages for the NHCEs for the year and then multiplying this result by 1.25. See the Instructions for Form 5305A-SEP for this computation.

Elective deferrals of HCEs that are more than the amount permitted under the ADP test, are excess contributions. Excess contributions (and earnings) must be withdrawn from the employees' SEP-IRAs. The employer must notify each HCE within 2 1/2 months after the end of the plan year of the following:

1) the amount of excess contributions to his or her SEP-IRA for the preceding year,

2) the year the excess contributions and earnings are includible in gross income,

3) information stating that the employee must withdraw the excess contributions (and earnings) by April 15th following the calendar year of notification, and

4) an explanation of the tax consequences if the employee does not withdraw such amounts.

See the Instructions for Form 5305A-SEP for detailed information on correcting excess contributions for SARSEPs maintained on a calendar-year basis. If you do not notify your employees by 2 1/2 months after the end of the plan year of the excess contributions that must be withdrawn, you are subject to a 10-percent tax on these excess contributions.

The excess contributions are includible in the employees' gross income in the year they were deferred. However, if an employee's excess contributions (not including earnings) are less than $100, they are includible in gross income in the year of notification. Earnings on excess contributions are included in gross income in the year they are withdrawn from the employee's SEP-IRA. For example, if excess contributions occur in calendar year 2003, and the employer provides notification on March 1, 2004, the excess contributions must be withdrawn by April 15, 2005. If an employee withdraws excess contributions (and earnings) from his or her SEP-IRA on April 1, 2005, the excess contributions must be reported as taxable income for 2003. Earnings on the excess contributions must be reported as taxable income for 2005.

Excess contributions not withdrawn by April 15th may be considered excess contributions to the employee's IRA. Employees may be subject to a 6-percent excise tax on these excess contributions. In addition, if the employee is not 59 1/2 years of age or over, the employee may be subject to an additional 10-percent tax on early distributions.

Example: Corporation ABC maintains a SARSEP with a calendar-year plan year. Corporation ABC employs two eligible HCEs (Sue and Joe) and two eligible NHCEs (Mary and Jane) with the following compensation and employee elective deferrals:

Participant	*Compensation*	*Employee Elective Deferrals*	*Deferral Rate*	*Average Deferral Percentage (ADP)*
HCE 1 (Sue)	$100,000	$10,000	10%	
HCE 2 (Joe)	$ 90,000	$ 2,700	3%	
NHCE 1 (Mary)	$ 10,000	$ 200	2%	
NHCE 2 (Jane)	$ 20,000	$ 800	4%	
NHCE ADP				**3%**

The NHCE average deferral percentage is 3 percent (2% + 4% = 6%; 6%/2 = 3%).
Therefore, the most that a HCE can defer is 3% x 1.25 = **3.75%.**

Based on the ADP of the NHCEs, Joe passes; and therefore no correction needs to be implemented for him. However, since Sue is only allowed to defer 3.75 percent of her compensation or $3,750, the amount of $6,250 ($10,000 - $3,750) is considered an excess contribution. Therefore, the employer must notify Sue by March 15th that the excess of $6,250 plus earnings has to be distributed from her SEP-IRA.

Top-Heavy Requirements

A SARSEP is top-heavy for a year when more than 60 percent of all employer contributions, including employee elective deferrals, go to key employees as determined at the end of the preceding year. But since many SARSEPs are always top-heavy, SARSEPs are often drafted to operate as if they were always top-heavy, thereby eliminating the need to make the annual 60-percent determination.

The employer will satisfy the top-heavy requirements by making a minimum contribution each year to the SEP-IRA of each employee eligible to participate in the SARSEP. This minimum contribution is not required for key employees. This contribution, in combination with other nonelective contributions, is equal to the lesser of:

- 3 percent of each eligible non-key employee's compensation, or
- the percentage of compensation at which elective (not including catch-up elective deferral contributions) and nonelective contributions are made under this SARSEP (and any other SEP maintained by the employer) for the year for the key employee with the highest percentage for the year.

Employee elective deferrals may not be used to satisfy the minimum contribution requirements for top-heavy plans. For purposes of determining the top-heavy minimum contribution, all employee elective deferrals made by key employees must be counted, but no employee elective deferrals made by non-key employees are counted towards satisfying the minimum contribution.

A key employee is any employee who, at any time during the preceding year was:

- an officer of the employer with compensation greater than $130,000;
- a 5-percent owner of the employer, as defined in section 416(i)(1)(B)(i); or
- a 1-percent owner of the employer with compensation greater than $150,000.

Example: Below are the employee deferrals under the XYZ Corporation SARSEP. The plan year ends on December 31 and employee elective deferrals are the only contributions made to the plan. Jane is the president of XYZ and is the 100-percent owner of the company. She is a key employee. She started the company and the SARSEP in 1996. During this time, she has had only two employees Bill and Ted, neither of whom are officers nor own any percentage of the company. Therefore, they are considered non-key employees. Is the plan top-heavy for 2003?

Year	*JANE Employee Deferral*	*BILL Employee Deferral*	*TED Employee Deferral*
1996	$7,000	$1,500	$1,500
1997	$7,000	$1,500	$1,500
1998	$7,000	$1,500	$1,500
1999	$7,000	$1,500	$1,500
2000	$7,000	$1,500	$1,500
2001	$7,000	$1,500	$1,500
2002	$7,000	$1,500	$1,500
Total	$49,000	$10,500	$10,500

The answer is yes. The total of the key employee elective deferrals of $49,000 when considered in relation to the total employee elective deferrals of all employees of $70,000 ($49,000 + $10,500 + $10,500) represents $49,000/ $70,000, or 70 percent of the total employee elective deferrals made from 1996-2002. Therefore, the key employee exceeds the 60-percent threshold as of the last day of the preceding plan year (December 31, 2002); and the plan is top-heavy for 2003.

Depositing and Investing Plan Contributions

Employer nonelective contributions must be made by the due date (including extensions) for filing the business's federal income tax return for the year.

The employer must forward the employee elective deferrals to the financial institution as soon as they can be reasonably segregated from the employer's general assets, but in no event later than 15 days following the month they were withheld from the employee's paycheck.

After SARSEP plan contributions are sent to the financial institution where the SEP-IRAs are maintained, that institution will invest the funds. SEP-IRAs can be invested in stocks, bonds, mutual funds, and similar types of investments.

At least once a year, the financial institution provides each participating employee with a statement showing the contributions and earnings to his or her account. Contributions are always immediately 100-percent vested —that is, contributions and all earnings cannot be forfeited.

Deducting Contributions

If your SARSEP is maintained on a calendar-year basis, you deduct contributions made for a year on your tax return for the year with or within which the calendar year ends. If you file your tax return and maintain the SARSEP using a fiscal year, you deduct contributions made for a year on your tax return for that year.

Example: You are a fiscal year taxpayer whose tax year ends June 30th. You maintain a SARSEP on a calendar-year basis. You deduct SARSEP contributions made for calendar year 2003 on your tax return for the tax year ending June 30, 2004.

Deduct the contributions you make for your common-law employees on your business tax return. For example, sole proprietors deduct them on **Schedule C (Form 1040),** *Profit or Loss From Business,* or **Schedule F (Form 1040),** *Profit or Loss From Farming;* partnerships deduct them on **Form 1065,** *U.S. Return of Partnership Income;* and corporations deduct them on **Form 1120,** *U.S. Corporation Income Tax Return,* **Form 1120-A,** *U.S. Corporation Short-Form Income Tax Return,* or **Form 1120S,** *U.S. Income Tax Return for an S Corporation.*

Sole proprietors and partners deduct contributions for themselves on **Form 1040,** *U.S. Individual Income Tax Return.* (If you are a partner, contributions for you are shown on the **Schedule K-1 (Form 1065),** *Partner's Share of Income, Credits, Deductions, etc.,* you get from the partnership.)

Tax Treatment for Employees

Both employer nonelective contributions and employee elective deferrals are excluded from employees' gross income. Employer nonelective contributions are not subject to federal income tax withholding, social security, Medicare, and federal unemployment (FUTA) taxes. Employee elective deferrals are not subject to federal income tax withholding, but are subject to social security, Medicare, and federal unemployment (FUTA) taxes.

Distributions

Participants cannot take loans from their SEP-IRAs.

SARSEP contributions and earnings can be withdrawn at any time. When participants take a distribution, they typically can elect to:

- take a lump sum distribution of their account, or
- rollover their account to another IRA or another employer's retirement plan.

Distributions from a SEP-IRA are generally subject to income tax for the year in which they are received. If a participant takes a withdrawal from a SEP-IRA before age 59 1/2, generally a 10-percent additional tax applies.

SEP-IRA assets may be rolled over tax-free into a traditional IRA, 401(k) (or other plan qualified under Code section 401(a)), a 403(b) plan, or a governmental 457 plan. They may also be rolled into a Roth IRA (a transaction usually referred to as a "conversion"); however, only if modified adjusted gross income for the year of the SEP-IRA owner is less than $100,000 and he/she is not filing as "married filing separately." Remember, amounts rolled over from a SEP-IRA, upon which no income tax has been paid, to a Roth IRA, will be subject to income tax. For additional information, see **Publication 590,** *Individual Retirement Arrangements (IRAs).*

A specific minimum amount of SEP-IRA contributions and earnings is required to be distributed by April 1st of the year following the year the participant reaches age 70 1/2. Also, in this year, and each year thereafter, the participant must receive a required minimum distribution by December 31st of that year. (For further details regarding the required minimum distribution amount, see Publication 590.)

Communicating With Employees

There are key disclosure documents that keep participants informed about the basics of how the plan operates, any changes in the plan's structure and operations, and that provide participants with a chance to make decisions and take timely action with respect to their accounts.

First, you provide employees with the most recent copy of Form 5305A-SEP (if this "model" form is used to establish the SARSEP plan), along with the financial institution's procedures for withdrawals and transfers. This form includes:

1) a statement that IRAs, other than the one the employer contributes to, may provide different rates of return and contain different terms.

2) a statement that the administrator—usually the employer—of the SARSEP will provide a copy of any amendments within 30 days of the effective date along with a written explanation of its effects.

If you use a prototype or individually designed plan, you must make certain that all eligible employees receive similar information.

In addition, every year the trustee will give written notification to the participant of any employer contributions made to a participant's IRA by January 31st of the following year on a **Form 5498,** *Salary Reduction Simplified Employee Pension—Individual Retirement Accounts Contribution Agreement.*

Reporting to the Government

Employers are generally NOT required to file annual financial reports for SARSEPs.

Distributions from IRAs established under the plan are reported by the financial institution making the distribution to both the IRS and the recipients of the distributions on **Form 1099-R,** *Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc.*

The financial institution/trustee handling the SEP-IRAs provides the IRS and participants with an annual statement containing contribution and fair market value information on Form 5498.

Terminating a SARSEP

If the time comes when a SARSEP no longer suits the purposes of the business, consult with a financial institution partner to determine if another type of retirement plan might better suit the needs of the business.

To terminate a SARSEP, notify the financial institution handling the SEP-IRAs that contributions will no longer be made and that the contract or agreement is being terminated.

Upon termination, the account of each participant retains the characteristics of a traditional IRA and is subject to the rules and provisions of IRA accounts.

No notice to the IRS that the SARSEP has been terminated is required.

Correction Programs

The IRS has a comprehensive system of correction programs for sponsors of retirement plans that are intended to satisfy the requirements—but have failed—of the Internal Revenue Code.

This system is called the Employee Plans Compliance Resolution System (EPCRS). It permits plan sponsors to correct retirement plan failures and thereby continue to enjoy tax-favored status for their retirement plans. EPCRS also allows employees to continue accruing retirement benefits on a tax-favored basis.

Under EPCRS, employers can:

- self-correct insignificant failures, or
- apply to the IRS for correction of certain other failures under the Voluntary Correction Program. This application involves the payment of a fee, and the IRS will provide a written approval of the correction method.

(See *Correction* under www.irs.gov/ep for details on the correction program that allows you to maintain the tax-favored status of your SARSEP.)

Resources

For the most up-to-date resources regarding your SARSEP or other IRA-based plans, visit www.irs.gov/ep and click on *Retirement Source for Plan Sponsors/Employers.*

Access IRS forms and publications at www.irs.gov, or order your free copy through the IRS at (800) 829-3676:

Forms

- **FORM 5305A-SEP,** *Salary Reduction Simplified Employee Pension—Individual Retirement Accounts Contribution Agreement*

Publications

- **Publication 560,** *Retirement Plans for Small Business (SEP, SIMPLE, and Qualified Plans)*
- **Publication 590,** *Individual Retirement Arrangements (IRAs)*
- **Publication 3998,** *Choosing a Retirement Solution for Your Small Business*
- **Publication 4286,** *SARSEP Checklist.* It is important to review the operation of your SARSEP every year. This checklist has been designed as a diagnostic tool to help you keep your SARSEP in compliance with important tax rules.
- **Publication 4407,** *SARSEP: Key Issues and Assistance.* An overview of the common problems found with SARSEPs and possible solutions.

Other Resources can be found through the IRS office of Employee Plans at www.irs.gov/ep:

- FAQs regarding SARSEPs. Insights into Salary Reduction Simplified Employee Pension Plans.
- Cost-of-Living Adjustments. Annual dollar limitations on benefits and contributions.

Customer Assistance

If you need more specific guidance or have questions, you can reach us by any of the following methods:

(877) 829-5500

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