"No Fuss" Retirement Plans

Tax Exempt and Government Entities

(TE/GE)

Employee Plans

Your IRS Nationwide Tax FORUM 2004

"No Fuss" Retirement Plans

- 2002 IRS Nationwide Tax Forum
  - Choosing A Retirement Solution for Your Small Business
- 2003 and 2004 IRS Nationwide Tax Forum
  - Establishing and Operating a "No Fuss" Retirement Plan
    - SEP (Simplified Employee Pension)
    - SIMPLE IRA (Savings Incentive Match Plan for Employees of Small Employers)

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Introduce yourself and provide your qualifications for speaking.

At the 2002 IRS Nationwide Tax Forum, Employee Plans' presentation was on "Choosing A Retirement Solution for Your Small Business". During that session, we provided a brief overview of the different types of small business retirement plans available, from the simplest to the most complex.

Last year, as promised, we provided you with a more in-depth look at what is involved in Establishing and Operating the simpler "no fuss" retirement plans that were discussed at 2002's Tax Forum.

Due to the wonderful response that we received from last year's presentation, we will be repeating an updated version today. Today's presentation will be focusing on 2 IRA based plans: **SEPs** - Simplified Employee Pension plans and **SIMPLEs** - Savings Incentive Match Plans for Employees of Small Employers.

Tax Advantages

- Employer
  - Credit for “Start-Up Costs”
  - Deductible Contributions
- Employee
  - “Saver’s Tax Credit”
  - Tax Deferred Savings

Many of your clients may ask, “Why bother with setting up a retirement plan?”

A good reason, there are tax advantages for both the employer and the employee.

A relatively new incentive for the employer is the “**Credit for Start Up Costs**”. This credit is available for plans that become effective after December 31, 2001. The employer may be able to receive **a tax credit of 50% of the first $1,000 of** qualified **startup costs** involved **in setting up a SEP or SIMPLE**.

Qualified startup costs:

- The cost to set up the plan
- The cost to administer the plan
- The cost to educate employees about the plan.

This credit is only available to employers with 100 or fewer employees receiving at least $5,000 of compensation from the employer for the preceding year and at least one participant who is non-highly compensated. Employers use *Form 8881, Credit for Small Employer Pension Plan Startup Costs* to claim this credit.

Another tax advantage is that an employer can deduct its contributions to a SEP or a SIMPLE - within certain limits that we will further discuss later in the presentation.

The Employee also has tax advantages for participating in a retirement plan. Beginning in 2002, retirement plan participants, *including self-employed individuals*, who make contributions to their retirement plan may qualify for the ”**Saver’s Tax Credit**”. The maximum contribution eligible for the credit is $2,000. The amount of the credit is based on the contribution amount and the participant’s “credit rate”. The credit rate ranges from 10% to 50%, depending on the participant’s adjusted gross income and filing status. An employee whose filing status is married filing jointly is eligible for the tax credit if the adjusted gross income shown on the return is not more than $50,000, $37,500 if head of household and $25,000 if single or married filing separately. Employees use *Form 8880, Credit for Qualified Retirement Savings Contributions* with their individual income tax return to claim this credit.

Also, employee contributions - and earnings on those contributions - to a SEP or SIMPLE are tax deferred until withdrawn.

SEP

- What is a SEP?
- Who can have a SEP?
- Where do the contributions go?

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SEP stands for “Simplified Employee Pension”.

A SEP is a written plan that allows an employer to make contributions towards their retirement and their employees’ retirement without getting involved in a more complex plan.

Under a SEP, the employer makes contributions to a traditional IRA (SEP-IRA) set up by or ***for each eligible employee****.* Just who is an eligible employee will be discussed later in the presentation.

A SEP-IRA is owned and controlled by the employee and the employer makes contributions to the financial institution where the SEP-IRA is maintained.

Sole proprietors, partnerships and corporations – including S corporations and LLCs - can set up a SEP.

Salary reduction SEPs, known as SARSEPs, have been replaced by SIMPLEs. No new SARSEPs can be established after December 31, 1996.

Establishing a SEP

- IRS Model Form 5305-SEP
- Prototype or Individually Designed Plan

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There are three basic steps in setting up a SEP:

1) You must execute a formal written agreement to provide benefits for all eligible employees.
2) You must give each eligible employee certain information about the SEP.
3) A SEP-IRA must be set up by or for each eligible employee.

Executing a formal written agreement to provide benefits to all eligible employees can be done in one of three ways:

One way is to adopt an IRS model SEP using *Form 5305-SEP, Simplified Employee Pension-Individual Retirement Accounts Contribution Agreement.* **This form is not filed with the IRS** – the employer keeps the form in its records. The model SEP is considered to be adopted when IRAs have been established for all eligible employees, the form has been completed and specified information has been given to all eligible employees. By using the *Form 5305-SEP*, the employer is usually relieved from filing an annual retirement plan information return with the IRS and Department of Labor.

Model *Form 5305-SEP* may not be used by an employer who:

•Has another qualified retirement plan,
•Uses the services of leased employees,
•Wants a SEP maintained on a fiscal year rather than a calendar year, or
•Wants a contribution formula that takes into account Social Security withholdings

Another way that an employer can establish a SEP **is with a prototype plan**. This can be done through a mutual fund, bank or insurance company. These plans have been reviewed and approved by the Internal Revenue Service.

Finally, an employer can establish a SEP by adopting an individually designed plan.

By using a prototype or individually designed document, rather than a model, the employer can customize a SEP.

The SEP can be set up for a year as late as the due date (including extensions) of the employer's income tax return for that year.

Establishing a SEP cont…

- Eligible Employee
  - Age 21
  - Worked for employer in 3 of 5 years
  - Received at least $450 in compensation

For a SEP, an eligible employee is someone who meets all of the following requirements:

•Has reached age 21.
•Has worked for the employer in at least 3 of the last 5 years. There is no minimum service requirement per year, so part-time and seasonal employees must be included.
•Has received at least $450 in compensation from the employer for the year. This number will change based on cost-of-living increases.

Employers are allowed to use less restrictive eligibility requirements, but not more restrictive. For example, a SEP could cover all employees without restriction. Certain collectively bargained and nonresident alien employees can be excluded from participation in a SEP.

Operating a SEP

- Who contributes?
- Who gets contributions?
- Where do they go?
- Any limits?
- Who owns the contributions?

The SEP rules allow the employer – including self-employed individuals - to contribute a limited amount of money each year to each eligible employee's SEP-IRA.

The employer is not required to make a contribution every year, but when contributions are made, they must be based on a written allocation formula and must not discriminate in favor of highly compensated employees.

Contributions must be:

- In the form of cash, not property,
- Made for all participants who performed services during the year, even terminated employees.
- Made by the due date of the employer's tax return for the year.

The contributions cannot be invested in collectibles such as artwork, stamps, rugs and antiques.

Contributions to an employee's SEP-IRA can not exceed the lesser of 25% of their compensation or $40,000 or $41,000 in 2004. The maximum amount of compensation that can be considered for 2003 is $200,000 and 2004 is $205,000.

If the employer sponsors more than one plan, the contributions to both plans when combined are generally limited to the lesser of $40,000 for 2003 and $41,000 in 2004 or 25% of compensation.

Self-employed individuals must use a special formula to determine their maximum contribution because their maximum contribution is based on net earnings from self-employment. Net earnings from self-employment take into account both the deduction for one-half of the self-employment tax and the deduction for contributions to the SEP-IRA. *Publication 560, Retirement Plans for Small Business* provides a Rate Table and Rate Worksheet to assist in this calculation.

If you have an existing SARSEP that has more than 60% of contributions going to key employees (generally, owners, officers and highly paid individuals) (section 416(i)), then non-key employees are entitled to a minimum contribution (generally 3%).

Employer contributions under a SEP are used to determine if the 60% threshold has been crossed. Keep in mind that if an employer who adopts the IRS Model plan (Form 5305A-SEP) in any year has a key employee make an elective deferral, the plan is deemed to be top-heavy regardless of the 60% threshold.

Contributions to a SEP-IRA are always 100% owned – (often referred to as "100% vested") - by the employee.

IRAs are the investment vehicles for both SEP and SIMPLE IRA plans. Therefore, the required minimum distribution rules apply for each year after the employee turns age 70 ½. The required minimum distribution for each year is calculated by dividing the IRA account balance as of December 31 of the prior year by the applicable distribution period or life expectancy. The applicable distribution period or life expectancy can be determined by using the Tables found in Appendix C of *Publication 590*.

We have received a lot of questions the past couple of years inquiring if the substantially equal payments can be changed with the downtrend in the stock market and not incur the additional 10% tax under Code section 72(t). For those not aware, 72(t) imposes a 10% additional tax for a distribution before age 59 ½. There is an exception to the tax for distributions made as substantially equal payments based on the recipient's life expectancy. Generally, changes would subject the recipient to the 10% additional tax. However, Revenue Ruling 2002-62 provides for a one-time modification. Any later change would trigger the 10% additional tax imposed under section 72(t). **(NOTE: ADDITIONAL EXPLANATION IF TIME ALLOWS)**

Another area that receives a lot of questions is whether or not the employee can get a loan from their SEP-IRA or SIMPLE IRA. The answer is no. IRAs do not allow loans.

A SEP plan can be terminated at any time provided the employees are notified. You can stop funding the plan once it is terminated. You don't need to notify the IRS of the plan's termination.

SIMPLE IRA

- What is a SIMPLE IRA?
- Who can have a SIMPLE IRA?
- Where do the contributions go?

SIMPLE stands for “Savings Incentive Match Plan for Employees of Small Employers”.

A SIMPLE IRA plan is a retirement plan in which a SIMPLE IRA is established **for each eligible employee**. Who is an eligible employee will be discussed later in the presentation.

Only employers with 100 or fewer employees who received $5,000 or more in compensation in the preceding calendar year can set up a SIMPLE IRA plan. All employees employed at any time during the calendar year – not just eligible employees - must be taken into account.

Once an employer sets up a SIMPLE IRA plan, the 100 employee limit must be met each year the plan is maintained.

Once the SIMPLE IRA plan is effective, it generally must be the only retirement plan maintained by the employer.

Most types of employers, including C-corporations, S-corporations, LLCs, partnerships and sole proprietorships, can sponsor a SIMPLE IRA plan.

With a SIMPLE IRA plan, a SIMPLE IRA is established for each eligible employee with a bank, insurance company or other qualified financial institution.

Establishing a SIMPLE IRA

- IRS Model Form 5304-SIMPLE
- IRS Model Form 5305-SIMPLE
- Prototype Plan
- Individually Designed Plan

Form 5304-SIMPLE and *Form 5305-SIMPLE* are model forms for use by employers to establish SIMPLE IRA plans. Which form is used depends on whether the employer or the employees select the financial institution which receives the contributions.

Form 5304-SIMPLE is used if the employer allows plan participants to select the financial institution to receive contributions made under the SIMPLE IRA plan. *Form 5305-SIMPLE* is used if the employer requires that all contributions be initially deposited in a designated financial institution.

As was the case with the SEP plan, the SIMPLE IRA plan is adopted when the form is completed and signed by the employer. **The form is not filed with the IRS** – the employer keeps the form in its records.

Instead of using either of the model forms, an employer can use a prototype document or individually designed plan to establish a SIMPLE IRA plan.

A SIMPLE IRA plan must be maintained on a calendar year basis, regardless of the employer's tax year.

A SIMPLE IRA must be set up for an employee before the first date by which a contribution is required to be deposited into the employee's IRA.

Eligible employees must be given a summary description of the SIMPLE IRA plan and a notice of their right to make elective contributions prior to the beginning of the 60 day election period. The notice requirement can be satisfied using the "Model Notification to Eligible Employees" contained in the model forms.

You can establish a SIMPLE IRA plan effective on any date between January 1 and October 1 of the year for which you make your first contributions. However, if you previously maintained a SIMPLE IRA plan, you can set up a SIMPLE IRA plan effective only on January 1 of the year for which you make your first contributions.

Establishing a SIMPLE IRA cont…

- Eligible Employee
  - SIMPLE IRA
    - Any employee who received at least $5,000 in compensation during any 2 preceding years and is reasonably expected to receive at least $5,000 for the current year.

The definition of an eligible employee for a SIMPLE IRA plan is different from that for a SEP.

For a SIMPLE IRA, an eligible employee is someone who:

•Received at least $5,000 in compensation during any 2 years preceding the current calendar year, and

•Is reasonably expected to receive at least $5,000 during the current calendar year.

Again, the employer is allowed to use less restrictive eligibility requirements, but not more restrictive. For example, a SIMPLE IRA plan could cover all employees without restriction. Certain collectively bargained and nonresident alien employees can be excluded from participation in a SIMPLE IRA plan.

Operating a SIMPLE IRA

- Who contributes?
- Who gets contributions?
- Where do they go?
- Any limits?
- Who owns the contributions?

Contributions to a SIMPLE IRA plan are made up of salary reduction contributions and employer contributions. The employer must make either matching contributions or nonelective contributions.

The employer must provide an election period each year of at least 60 days during which the employee may enter into or modify a contribution election. This 60-day period generally begins November 2nd of the year prior to the beginning of a calendar year for an established plan or 60 days prior to the effective date of a newly established plan. Employees who become eligible after the last regular election period must be given at least a 60-day enrollment period which includes the employee's initial eligibility date.

Every eligible employee must be given the opportunity to make elective contributions under the SIMPLE IRA plan. Elective contributions under a SIMPLE IRA plan are limited to $8,000 for 2003 and $9,000 in 2004.

Participants who are age 50 or over can make a "catch-up" contribution of up to $1,000 in 2003 and $1,500 in 2004. The employer can not place restrictions on the contribution amount, except to comply with the dollar limit amounts just discussed.

Elective contributions are subject to FICA and FUTA.

The employer matching contribution for each employee's salary reduction contribution is generally on a dollar-for-dollar basis up to a limit of 3% of the employee's compensation. The employer may choose to limit matching contributions to less than 3% of employee compensation for a year. However, the employer cannot choose a percentage of less than 3% for more than 2 years during the 5-year period that ends with and includes the year for which the choice is effective. The employees must be notified if the employer chooses to match at less than 3%.

Instead of making matching contributions, the employer can choose to make nonelective contributions of 2% of compensation on behalf of each eligible employee who has at least $5,000 of compensation from the employer for the year. These nonelective contributions must be for all participants, even those who did not make salary reduction contributions. The employees must be notified if the 2% contribution formula is selected.

An employer may not make both matching contributions and nonelective contribution in the same year.

The employer must deliver the salary reduction contributions to each employee's SIMPLE IRA as soon as possible but no later than 30 days after the end of the month in which the amounts would otherwise have been payable to the employee in cash. For example, if your employees would have otherwise received compensation (instead of the elective deferrals) in March, you would have until April 30th to deposit the deferral amounts.

The matching or nonelective contributions must be deposited by the due date (including extensions) for filing the employer's federal income tax return for the year. SIMPLEs are not subject to the top-heavy rules.

The employees are 100% vested in both their salary reduction contribution and the employer contributions, matching or nonelective.

As was the case with SEPs, SIMPLE IRA plan contributions may not be invested in collectibles.

SIMPLE IRAs are maintained and terminated on a calendar year basis. If the employer wishes to terminate his SIMPLE IRA plan he must notify participants this year that the plan will be terminated for the next calendar year. Practically speaking, once the calendar year starts, the employer must fund it for the whole year.

As was the case with SEPs, it is a requirement that employees be notified that the plan will be discontinued. It is not required to inform the IRS of the discontinuance.

Operating a SEP or SIMPLE IRA

- Reporting Requirements
  - Employees
  - IRS
- Amending Your Plan
  - New IRS Guidance
  - Law Changes

A SIMPLE IRA plan offers features similar to a 401(k) plan (e.g., flexibility…)

After a SEP or SIMPLE is adopted and, later, after a new employee becomes employed, the employer must furnish the following information to each eligible employee:

•Notice that the SEP or SIMPLE has been adopted.
•Requirements an employee must meet to receive an allocation and
•The basis upon which the employer's contributions will be allocated.

All three of these are met if the employer provides a copy of the model or prototype document.

Each year the employer must furnish a statement to each SEP or SIMPLE participant, showing the amount contributed to the employee's SEP-IRA or SIMPLE IRA for the year.

Generally, the statement needs to be furnished to the employee before the following January 31 for calendar year plans.

The *Form 5500* series forms that are required to be filed by most qualified plans are not filed for SEPs or SIMPLEs. Most SEPs and SIMPLEs are also exempt from the Department of Labor's reporting and disclosure requirements.

From time to time the IRS publishes guidance on SEPs and SIMPLEs. When this happens, plans may need to be amended to reflect this guidance.

The Economic Growth and Tax Relief Reconciliation Act of 2001 "EGTRRA" made several changes to the Internal Revenue Code, affecting SEPs and SIMPLEs, that are effective beginning January 1, 2002.

All prototype sponsors of currently approved prototype SEPs and SIMPLE IRA plans had to amend these documents and submit an application for opinion letters on the amended documents no later than December 31, 2002.

Pre-2002 model SEP and SIMPLE IRA plan forms may not be used to establish new SEPs or SIMPLEs. An employer using a pre-2002 model SEP who wanted to take advantage of the the 2002 EGTRRA changes to such plans for the first plan year beginning after

December 31, 2001, must have adopted a revised model plan or appropriate amended prototype plan by the end of such first plan year. An employer using a pre-2002 model SIMPLE IRA plan must adopt a revised model plan or an appropriate amended prototype plan by the end of 2002.

An employer using a pre-2002 approved prototype SEP who wanted to take advantage of the EGTRRA changes to such plans for the first plan year beginning after December 31, 2001 must have adopted the prototype sponsor's amended document within 180 days after the date the Service issued a favorable EGTRRA opinion letter on the amended document. An employer using a pre-2002 approved prototype SIMPLE IRA plan must have adopted the prototype sponsor's amended document within 180 days after the Service issued a favorable opinion letter on the amended document.

If you’re using Model plans, you should have already adopted an updated Model plan by the end of 2002.

If you’re using prototype plans, you will receive amended plans from the financial institution that provided you with the plan. If for some reason you don’t receive (or haven’t received) a new plan document, please contact your financial institution.

While the financial institution may provide many administrative services for your plan, it is the responsibility of the employer to ensure that the plan is kept up to date with current law.

Failure to amend for law changes often leads to non-compliance … which brings us to …

Compliance

- Common Problems
  - Incorrect Employer Contributions
  - Excess Employee Deferrals
  - Not Covering Eligible Employees
  - Fiduciary Problems

IRS e-file
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There are several types of errors that occur commonly:

EP field offices conducted SEP/SARSEP examinations during fiscal year 2002. The goal of the project was to research, select and study a statistically reliable sample of plans from the SEP plan universe identified for the 2000 year. Code F in box 13 on the W-2 indicates that an employee has made a salary reduction contribution to a SARSEP. The EP personnel encountered various issues in their examination of these project cases.

The most important issues are:

1) top-heavy failure;

2) lack of documentation for the plans due to no filing requirements;

3) in SARSEPs, failure to satisfy the 50% participation rule for eligible employees; and

4) in SARSEPs, failure of the 25 employee rule.

One error which seems simple, but occurs frequently is simply a failure to complete the eligibility requirements on the SEP or SIMPLE documents. Meaning this is basically a fill-in-the-blank problem. For example, if you want to exclude employees younger than age 21 from a SEP you must complete the appropriate check box in the document.

Another common error is using qualified plan criteria, for example requiring 1,000 hours of service or requiring the employee to be employed on the last day of the plan year to be considered an eligible employee. Remember that the employee only needs to be employed for an instant during a year in order to be considered employed for that year.

In addition, we have seen both leased employees and employees of affiliated employers ignored for eligibility purposes. These employees need to be considered.

Another common area deals with eligible employer issues:

Effective December 31, 1996, salary reduction SEPs, or SARSEPs, were no longer allowed to be established. We are finding that employers are still attempting to establish this type of plan.

As we discussed earlier, an employer who adopts the Form 5305-SEP, cannot maintain another plan. Although companies that adopt a prototype SEP may maintain another type of plan, those that use the 5305-SEP can not. The IRS has been finding that quite a few companies that use the 5305-SEP are maintaining other plans.

The most common problem we find with SIMPLEs is the failure by the employer to make the required matching or nonelective contributions. In some instances the contributions are not made timely. In some instances they are not made at all.
The following is a list of the issues uncovered by the revenue agents working the project cases.

•Lack of written documentation regarding timely establishment of a SARSEP
.
•Violation of <25 eligible employee rule. 408(k)(6)(B)

•Violation of 50% rule. 408(k)(6)(A)(ii)

•Required top-heavy minimum contributions not made by the employer.

•Employers who adopt the IRS model 5305A-SEP, but then do not follow the deemed top-heavy provisions when a key employee makes elective deferrals.

•Providing top heavy minimum contributions to non-key employees who are making the maximum deferral allowed causing the total contributions to exceed the plan's contribution limits (15% before 2001 and 25% after 2001).

•Failure of the deferral percentage test or not performing the test. 408(k)(6)(A)(iii)

•Allowing deferrals by key employees to exceed the 15% limit.

•Improperly excluding eligible employees from participation. An eligible employee is an individual who meets the following requirements:**a) has attained age 21; b) has performed services for the employer (can be 1 hour) in at least 3 of the last 5 years; and c) has received at least $450 in compensation. The plan can have more liberal requirements.**

So what do you do if you find a problem with the form or operation of your SEP or SIMPLE?

Got A Problem?

- IRS
  - EPCRS - Employee Plans Compliance Resolution System
- DOL
  - VFCP - Voluntary Fiduciary Correction Program

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.

The system – called the **Employee Plans Compliance Resolution System** or “EPCRS” - 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. In early June, 2003 the IRS came out with a new Rev. Proc. (2003-44) that details the corrections allowable to maintain your deduction for contributions to a SEP or SIMPLE IRA.

Under EPCRS, employers can:

1.Self-correct insignificant SEP failures, or

2.Apply to the IRS for corrections of certain other failures under the “Voluntary Correction of SEP Failures”. This application involves a payment of a fee and the IRS will provide a written approval of the correction method.

Applications to the Service can also be made for correction of SIMPLE IRA plan failures.

The Department of Labor’s Employee Benefits Security Administration, EBSA, (formerly known as Pension Welfare Benefits Administration, or PWBA) has a correction program, the Voluntary Fiduciary Correction Program. You can visit their website for additional information on this program.

Need Help?

- IRS
  - www.irs.gov/ep
  - 1-877-829-5500: Customer Account Services
  - Retirement Plan Correction Programs
    - CD-ROM
- DOL
  - www.dol.gov/ebsa

This presentation provided you with a more in-depth analysis of the requirements for establishing and operating SEPs and SIMPLEs.

If you have any additional questions, please visit our website at www.irs.gov/ep.

In addition, we have a booth in the exhibit hall with trained and experienced IRS agents who are available to answer your questions. We have forms, publications and CD-ROMs available for you.

Please stop by and see us.