

# SARSEP CHECKLIST



This checklist is *not* a complete description of all plan requirements, and should *not* be used as a substitute for a complete plan review.

## For Business Owner's Use

(DO NOT SEND THIS WORKSHEET TO THE IRS)

Every year it is important that you review the requirements for operating your Salary Reduction Simplified Employee Pension (SARSEP) plan. Use this checklist to help you keep your plan in compliance with many of the important rules. Click on "[More](#)" in any of the following questions for additional information (including examples) on how to find, fix and avoid each mistake. See [www.irs.gov/ep](http://www.irs.gov/ep) for online versions of the checklists, Fix-It Guides and other resources for SARSEPs and other plan types.

**1. Was your SARSEP established prior to January 1, 1997, and subsequently amended for current law?** Yes  No

No new SARSEPs can be established after 1996, however, existing plans need to be updated for new law.

[\(More\)](#)

**2. Do you have 25 or fewer eligible employees?** Yes  No

Only businesses with 25 or fewer eligible employees can contribute to a SARSEP.

[\(More\)](#)

**3. Are all eligible employees (those who are at least age 21, worked for you in at least 3 of the last 5 years and have received at least \$550 during the year in compensation) participating in the plan?** Yes  No

Employees of other businesses you and/or your family members own may have to be treated as employees when determining who is an eligible employee under the SARSEP.

[\(More\)](#)

**4. Are you determining each eligible employee's compensation using the definition in your SARSEP document?** Yes  No

A plan's definition of compensation must satisfy applicable rules for determining the amount of contributions.

[\(More\)](#)

**5. Are all employee elective deferrals within the appropriate limit as defined under IRC §402(g) for the calendar year (\$16,500 in 2009 and 2010) and have any excess deferrals been distributed ?** Yes  No

Employees age 50 or over may also make additional catch-up contributions of up to \$5,500 for 2009 or 2010.

[\(More\)](#)

**6. Do 50% or more of all eligible employees make employee elective deferrals?** Yes  No

At least half of your eligible employees must make employee elective deferrals to the SARSEP.

[\(More\)](#)

**7. Are total contributions (employee elective deferrals and nonelective employer contributions) limited as required by the Internal Revenue Code?** Yes  No

For 2009 and 2010 contributions are limited to the lesser of 25% of compensation or \$49,000. SARSEPs do not permit employers to make matching contributions to participants' accounts.

[\(More\)](#)

**8. Did you deposit employee elective deferrals timely?** Yes  No

Employee elective deferrals must be remitted to the appropriate financial institution as soon as possible but, in any event, no later than 15 days following the month in which the employee would have otherwise received the money.

[\(More\)](#)

**9. Did you pass the annual deferral percentage test?** Yes  No

The amount deferred each year by each highly compensated employee as a percentage of pay (the deferral percentage) cannot exceed 125% of the average deferral percentage of all eligible nonhighly compensated employees.

[\(More\)](#)

**10. Have you made required top-heavy minimum contributions to the SARSEP?** Yes  No

Refer to your plan document for information. Most plans are deemed top-heavy, but some plans require annual testing.

[\(More\)](#)

**If you answered "No" to any of the above questions, you may have a mistake in the operation of your SARSEP. This list is only a guide to a more compliant plan, so answering "Yes" to each question may not mean your plan is 100% compliant. Many mistakes can be corrected easily, without penalty and without notifying the IRS.**

■ [contact your tax advisor](#)

■ [visit the IRS at www.irs.gov/ep](http://www.irs.gov/ep)

■ [call the IRS at \(877\) 829-5500](tel:8778295500)

# SARSEP Plan Fix-It Guide

Common Problems, Real Solutions

-----Trends-----	-----Tips-----			
Potential Mistake	How to Find the Mistake	How to Fix the Mistake		How to Avoid the Mistake
		Corrective Action	Correction Program(s) Available	
1) Was your SARSEP established prior to January 1, 1997, and subsequently amended for current law? <a href="#">(More)</a>	Determine if your Form 5305A-SEP or prototype is the <a href="#">current revision</a> . <a href="#">(More)</a>	EPCRS Adopt a current IRS Model Form 5305A-SEP or IRS-approved SARSEP prototype. <a href="#">(More)</a>	VCP Audit CAP <a href="#">(More)</a>	Maintain regular contact with the company that set you up with the plan. <a href="#">(More)</a>
2) Do you have 25 or fewer eligible employees? <a href="#">(More)</a>	Review payroll and plan document eligibility requirements for the prior year. If more than 25 employees were eligible to participate in the plan, no employee elective deferrals may be accepted in the current year. <a href="#">(More)</a>	EPCRS Two correction methods for Excess Amounts under SARSEPs allowed: a. Distribution Method b. Retention Method <a href="#">(More)</a>	SCP* VCP Audit CAP <a href="#">(More)</a>	If more than 25 employees become eligible during any year, cease withholding employee elective deferrals in the first pay period of the subsequent year and notify all employees of the situation. <a href="#">(More)</a>
3) Are all eligible employees (those who are at least age 21, worked for you in at least 3 of the last 5 years and have received at least \$550 during the year in compensation) participating in the plan? <a href="#">(More)</a>	Review the section of your plan document concerning eligibility and participation. Check when employees are entering the plan. <a href="#">(More)</a>	EPCRS You must make a fully vested contribution to the plan on behalf of the omitted employee that compensates for the missed contribution. <a href="#">(More)</a>	SCP* VCP Audit CAP <a href="#">(More)</a>	Plan sponsors need to monitor census information and apply participation requirements. <a href="#">(More)</a>
4) Are you determining each eligible employee's compensation using the definition in your SARSEP document? <a href="#">(More)</a>	To determine if you are using the proper compensation for allocations, you'll need to review the plan document. <a href="#">(More)</a>	EPCRS Correction is based upon the terms of the plan and other applicable information at the time of the mistake. <a href="#">(More)</a>	SCP* VCP Audit CAP <a href="#">(More)</a>	When calculating allocations, it is important to carefully review the plan terms to ensure that the correct amount of compensation is being considered. <a href="#">(More)</a>
5) Are all employee elective deferrals within the appropriate limit as defined under IRC §402(g) for the calendar year (\$16,500 in 2010) and have any excess deferrals been distributed? <a href="#">(More)</a>	Inspect deferral amounts for plan participants to ensure that limits have not been exceeded. <a href="#">(More)</a>	EPCRS Two correction methods for Excess Amounts under SARSEPs allowed: a. Distribution Method b. Retention Method <a href="#">(More)</a>	SCP* VCP Audit CAP <a href="#">(More)</a>	Employers should ensure they have sufficient payroll information to verify that the deferral limitations of §402(g) were satisfied. <a href="#">(More)</a>

-----Trends-----	-----Tips-----			
Potential Mistake	How to Find the Mistake	How to Fix the Mistake		How to Avoid the Mistake
		Corrective Action	Correction Program(s) Available	
6) Do 50% or more of all eligible employees make employee elective deferrals? <a href="#">(More)</a>	Review payroll records and ensure that 50% of eligible employees are actually making employee elective deferrals annually. <a href="#">(More)</a>	EPCRS Two correction methods for Excess Amounts under SEPs allowed: a. Distribution Method b. Retention Method <a href="#">(More)</a>	SCP* VCP Audit CAP <a href="#">(More)</a>	Annually review plan document for eligibility requirements and payroll records for participating employees. <a href="#">(More)</a>
7) Are total contributions (employee elective deferrals and nonelective employer contributions) limited as required by the Internal Revenue Code? <a href="#">(More)</a>	Calculate 25% of each employee's compensation and compare the total contribution made for the employee to the lesser of that amount or the dollar limitation for that year (\$49,000 in 2010). <a href="#">(More)</a>	EPCRS Two correction methods for excess contributions amounts under SEPs allowed: a. Distribution Method b. Retention Method <a href="#">(More)</a>	SCP* VCP Audit CAP <a href="#">(More)</a>	After the initial calculation of allocations based on the terms of the plan, you should check to make sure none of the proposed allocations would violate the Code. <a href="#">(More)</a>
8) Did you deposit employee elective deferrals timely? <a href="#">(More)</a>	Review employee data and payroll remittances to ensure amounts were properly withheld and timely deposited. <a href="#">(More)</a>	EPCRS You must make a contribution on behalf of each participant. <a href="#">(More)</a>	SCP* VCP Audit CAP <a href="#">(More)</a>	Review the SARSEP plan rules concerning the timing of employer contributions and adopt administrative procedures to implement proper timing. <a href="#">(More)</a>
9. Did you pass the annual deferral percentage test? <a href="#">(More)</a>	Perform and review the test for each year in which deferrals were made. <a href="#">(More)</a>	EPCRS Two correction methods for excess contribution amounts under SEPs are allowed. <a href="#">(More)</a>	SCP* VCP Audit CAP <a href="#">(More)</a>	Communicate with plan administrator to ensure proper employee classification. Ensure both you and the plan administrator are familiar with the terms of the plan. Consider converting to a SIMPLE IRA plan. <a href="#">(More)</a>
10. Have you made required top-heavy minimum contributions to the SARSEP? <a href="#">(More)</a>	Review the rules and definitions for top-heavy found in your plan document. Make a determination whether your plan is top-heavy or not for each plan year. <a href="#">(More)</a>	EPCRS Appendix A (section .02) Properly contribute and allocate the required top-heavy minimum, adjusted for earnings, to the affected non-key employees. <a href="#">(More)</a>	SCP* VCP Audit CAP <a href="#">(More)</a>	Perform a top-heavy test each year. If your plan is top-heavy or deemed top-heavy, ensure that you have made all top-heavy minimum contributions. <a href="#">(More)</a>

**\* In order to utilize SCP, you must have established practices and procedures reasonably designed to promote and facilitate overall compliance with applicable Internal Revenue Code requirements. Also, you need to make an analysis of whether mistakes in the aggregate are significant or insignificant. If insignificant, correction generally can be made at any time. However, if the mistakes are significant in the aggregate, then you must use VCP to correct the mistake.**

## SARSEP Plan - Overview

A **SARSEP** is a **Salary Reduction Simplified Employee Pension** plan. It is a Simplified Employee Pension (SEP) plan set up before 1997 that permits an employee to contribute through employee salary reductions, also referred to as “employee elective deferrals.”

Under a SARSEP, employees and employers make contributions to traditional Individual Retirement Arrangements (IRAs) set up for eligible employees, subject to certain percentage-of-pay and dollar limits. Each employee is always 100% vested in (or, has ownership of) all money in his or her SEP-IRA.

### To have a SARSEP, you:

- Must have established the SARSEP before 1997.
- Need to keep the plan amended for current law changes (see [Question 1, below](#)).
- Must meet the following participation requirements annually based on all eligible employees (even those hired after 1996).
  - At least 50% of your employees eligible to participate must choose to make employee elective deferrals for the year.
  - You must have no more than 25 employees who were eligible to participate in the SARSEP at any time during the preceding year.

Employers who established SARSEPs prior to January 1, 1997, can continue to maintain them and new employees hired after December 31, 1996, can participate in the existing SARSEP.

**Formal written agreement.** You must maintain a formal written agreement to provide benefits to all eligible employees under a SARSEP. You can satisfy the written agreement requirement with the IRS Model SARSEP using [Form 5305A-SEP, Salary Reduction Simplified Employee Pension—Individual Retirement Accounts Contribution Agreement](#).

**Use of prototype SARSEPs.** Financial institutions and other approved sponsoring organizations can sponsor a prototype SARSEP document. The IRS issues opinion letters approving prototypes. You can use individually designed documents, but the IRS has not established an approval process for these.

**Information you must give to employees.** If you use the Model SARSEP, you must give each eligible employee a copy of Form 5305A-SEP, its instructions and the other information listed in the Form 5305A-SEP instructions. An IRS Model SARSEP is not considered adopted until you give each employee this information. If you adopt a prototype SARSEP, you must give each eligible employee similar information.

**Setting up the employee’s SEP-IRA.** A SEP-IRA must be set up by or for each eligible employee. SEP-IRAs can be set up with banks, insurance companies or other qualified financial institutions. You send SARSEP contributions to the financial institution where you maintain the SEP-IRA.

### Who is eligible to participate?

Generally, any employee who performs services for your business must be included in a SARSEP. However, there are some exceptions to this general rule. Among the employees that you may exclude from a SARSEP are those who:

- Have not worked for the company during three out of the last five years.
- Have not reached age 21 during the year for which you make contributions.
- Are employees who are covered by a union agreement and whose retirement benefits were bargained for in good faith by you and the employees’ union.

- Are nonresident alien employees who have received no U.S. source wages, salaries or other personal services compensation from you.
- Received less than \$550 in compensation (subject to [cost-of-living adjustments](#)) during the year. Generally, W-2 compensation will satisfy the definition of “compensation.”

Only employers with 25 or fewer eligible employees in the prior year can permit employee elective deferrals in the current year. If you have more than 25 eligible employees this year, but had less than 25 employees in the preceding year, employees can make elective deferrals this year. For example, if you had 23 eligible employees in 2009, but 27 eligible employees in 2010, those 27 employees may make elective deferrals to their SEP-IRAs for 2010. However, in 2011, no employee elective deferrals may be made by you or your employees.

### **What are the participation rules?**

Note that at least 50% of all eligible employees must make employee elective deferrals each year. If less than 50% of your eligible employees choose to make employee elective deferrals to the SARSEP for a year, all employee elective deferrals made by other eligible employees for that year are disallowed and must be withdrawn from the employees' SEP-IRAs.

### **What are the contribution requirements?**

By establishing a SARSEP, you have adopted a plan that requires a SEP-IRA to hold the contributions made on behalf of each of the eligible employees. A SARSEP is funded by money that employees elect to defer from their salaries. Employer contributions are also allowed, but only in the form of “nonelective” contributions. Nonelective contributions are employer contributions made to each eligible employee's SEP-IRA - regardless of whether, or how much, the employee deferred into the SEP-IRA. Your SARSEP plan document will specify the nonelective contributions, if any, required under the plan. The law does not permit matching contributions in a SARSEP.

Total contributions to each employee's SEP-IRA cannot exceed the lesser of \$49,000 for 2010 (subject to [cost-of-living adjustments](#) for later years) or 25% of pay. (Employee elective deferrals are subject to lower limits imposed by IRC §402(g) (see [Question 5, below](#)). Contributions made under the SARSEP - both employee elective deferrals and employer nonelective contributions - are 100% vested (or owned by) the employees. [Publication 560, Retirement Plans for Small Business \(SEP, SIMPLE, and Qualified Plans\)](#), helps self-employed individuals determine the amount of their maximum contribution.

Contributions must be in the form of money (cash, check or money order). You cannot contribute property, except in a rollover. See [Publication 590, Individual Retirement Arrangements \(IRAs\)](#), for more information about rollovers.

After you send the SARSEP contributions to the financial institution you selected, it will manage the funds. Depending on the financial institution, participants can invest SARSEP contributions in stocks, mutual funds and other, similar types of investments.

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](#).

### **Do SARSEPs have anti-discrimination tests?**

**SARSEP DP test.** The employee elective deferrals of your [highly compensated employees \(HCEs\)](#) must meet the SARSEP DP (deferral percentage) test. Under the SARSEP DP test, the amount deferred each year by each eligible HCE, as a percentage of pay (the deferral

percentage), cannot be more than 125% of the DP of all eligible nonhighly compensated employees (NHCEs).

**Deferral percentage.** Each employee's deferral percentage is the ratio of his/her elective deferrals for a year divided by his/her compensation for the same year.

You must compute the deferral percentage limitation each year. The instructions for [Form 5305A-SEP](#) have a worksheet you can use to determine whether the elective deferrals of your HCEs meet the SARSEP DP test.

**Top-heavy contributions.** A SARSEP is top-heavy when more than 60% of all contributions go to key employees. Many SARSEPs are drafted to operate as if they were always top-heavy, thereby eliminating the need to make the annual 60% determination. When a SARSEP is top-heavy, non-key employees must receive a minimum employer contribution of up to 3% of pay. Check your SARSEP plan document.

### **What are the basic distribution/withdrawal rules?**

Employees can withdraw their SARSEP contributions and earnings at any time. A withdrawal is taxable in the year received. If an employee makes a withdrawal before he or she is age 59½, generally a 10% additional tax applies. Employees may roll over SARSEP contributions and earnings tax-free to other IRAs and retirement plans.

SARSEP contributions and earnings must eventually be distributed. The law requires a specific minimum amount be distributed by April 1 of the year following the year the employee reaches age 70½. (For further details regarding the required minimum distribution amount, see [Publication 590](#).)

### **What are the filing requirements?**

A SARSEP plan sponsor generally has no filing requirements. The annual reporting required for qualified plans (Form 5500 series) is normally not required for SARSEPs. The financial institution that holds the plan's SEP-IRAs handles most of the other paperwork.

## Employee Plans Compliance Resolution System (EPCRS) – Overview

If you make mistakes with respect to your SARSEP plan, you may utilize the IRS's Employee Plans Compliance Resolution System (EPCRS) to remedy your mistakes and avoid the consequences of plan disqualification. A correction for a mistake should be reasonable and appropriate. The correction methodology should resemble one already provided for in the Code and you should consider all applicable facts and circumstances. [Rev. Proc. 2008-50, I.R.B. 2008-35, 464](#) sets forth the EPCRS. There are three components of EPCRS:

- 1) **Self-Correction Program (SCP)** - permits a plan sponsor to correct certain plan failures without contacting the IRS.
- 2) **Voluntary Correction Program (VCP)** - permits a plan sponsor to, any time before audit, pay a fee and receive the IRS's approval for correction of plan failures.
- 3) **Audit Closing Agreement Program (Audit CAP)** - permits a plan sponsor to pay a sanction and correct a plan failure while the plan is under audit.

Below is a general description of each component of EPCRS:

### SCP:

- In order to be eligible for SCP, the plan sponsor or administrator of a plan must have established practices and procedures (formal or informal) reasonably designed to promote and facilitate overall compliance with applicable Code requirements. A plan document alone does not constitute evidence of established procedures.
- SCP is available for correcting operational problems only – that is, the failure to follow the terms of your plan. SCP is not available for other types of problems, such as the failure to keep your plan document up to date to reflect changes in the law.
- The plan sponsor effects correction using the General Correction Principles set forth in Rev. Proc. 2008-50, section 6, and the more specific principles set forth in section 8.
- A plan sponsor that corrects a mistake listed in, and in accordance with, the correction methods included in Appendix A or Appendix B of Rev. Proc. 2008-50 may be certain that the correction effected is reasonable and appropriate for the failure.
- If needed, the plan sponsor effects changes to its administrative procedures to ensure the mistakes do not recur.
- The SCP may be used if, considering all of the facts and circumstances, the mistakes, in the aggregate, are insignificant operational failures.
- When using SCP, the plan sponsor should maintain adequate records to demonstrate correction in the event of an audit of the plan.
- There is no fee for self-correction.

### VCP:

- The plan sponsor identifies the mistakes.
- The plan sponsor proposes correction using the General Correction Principles set forth in Rev. Proc. 2008-50, section 6.
- The plan sponsor proposes changes to its administrative procedures to ensure the mistakes do not recur.
- The plan sponsor pays a compliance fee of \$250.
- The IRS issues a Compliance Statement with respect to the plan detailing the qualification mistakes identified by the plan sponsor and the applicable correction methods approved by the IRS.
- The plan sponsor corrects the identified mistakes within 150 days of the issuance of the Compliance Statement.
- Employee Plans will not examine the plan while the submission is pending, except under unusual circumstances.

**Audit CAP:**

- The plan sponsor or plan is under examination.
- The plan sponsor enters into a Closing Agreement with the IRS.
- The plan sponsor effects correction prior to entering into the Closing Agreement.
- The plan sponsor pays a sanction negotiated with the IRS.
- The sanction paid under Audit CAP should be greater than the fee paid under VCP.
- For plans intended to be qualified, the sanction under Audit CAP is a negotiated percentage of the Maximum Payment Amount (MPA) based on the sum for all open taxable years of the:
  - 1) Additional income tax resulting from income inclusion of disallowed elective deferrals and any employer contributions for employees in the plan (Form 1040), including the tax on plan distributions that have been rolled over to other IRAs and eligible retirement plans (and any interest and penalties applicable to the employees' tax returns).
  - 2) Additional tax resulting from the 6% tax imposed under §4973 of the Code on excess contributions to IRAs.

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-----Trends-----	-----Tips-----			
Potential Mistake	How to Find the Mistake	How to Fix the Mistake		How to Avoid the Mistake
		Corrective Action	Correction Program(s) Available	
1) Was your SARSEP established prior to January 1, 1997, and subsequently amended for current law? <a href="#">(More)</a>	Determine if your Form 5305A-SEP or prototype is the <a href="#">current revision</a> . <a href="#">(More)</a>	EPCRS Adopt a current IRS Model Form 5305A-SEP or IRS-approved SARSEP prototype. <a href="#">(More)</a>	VCP Audit CAP <a href="#">(More)</a>	Maintain regular contact with the company that set you up with the plan. <a href="#">(More)</a>

### 1) Was your SARSEP established prior to January 1, 1997, and subsequently amended for current law?

The Small Business Job Protection Act of 1996 (SBJPA) prospectively repealed SARSEPs. Therefore, employers cannot establish new SARSEPs after December 31, 1996. However, employers that 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 (Code) §408(p) (added to the Code by SBJPA) is intended to fill the need for retirement plans like SARSEPs.

Laws related to retirement plans change frequently. There are statutory deadlines for which many provisions must become effective. The IRS generally establishes a firm deadline for adopting these changes. These law changes might mean employers can simplify some areas of plan administration or improve benefits. Employers need to change its plan language and operation to keep the plan within the law and to take advantage of increased benefit limits.

The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) changed many of the Code's requirements and limits for qualified plans and IRAs. In order to benefit under these new provisions, employers must amend their SARSEP prototype and individually designed plans for current law. In order for employers with model SARSEPs to avail themselves of the latest law changes, they must adopt the latest Model [Form 5305A-SEP](#) (for EGTRRA it must have a revision date of March 2002 or later).

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

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#### How to Find the Mistake:

At some point in the plan's existence, you may be asked to demonstrate your plan has complied with current and prior law. This request may come from a financial institution, third-party administrator (TPA) or other plan service provider, or it may come from the IRS during an audit.

You may have a written plan document that is a Model SARSEP ([Form 5305A-SEP](#), *Salary Reduction Simplified Employee Pension - Individual Retirement Accounts Contribution Agreement*) or a [pre-approved plan](#). The IRS has already favorably reviewed a Model SARSEP and a pre-approved plan.

**If your plan is a Model SARSEP ([Form 5305A-SEP](#)) that is the current revision (June 2006), you can be assured that it complies with the law.** If your plan is a pre-approved plan, you have a level of assurance that the plan is written in compliance with the law. You must update individually designed SARSEPs for law changes. If you have this situation, consult your tax advisor.

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### **How to Fix the Mistake:**

#### **Corrective Action:**

If you find your plan hasn't been amended timely for the various law changes you should adopt amendment(s) for the law changes you have missed. You may be able to utilize model or sample amendments published by the IRS that apply to your SARSEP plan. You will need to confirm that the operation of the plan is consistent with the terms of the plan.

#### **Example:**

Employer Y established a SARSEP in 1995 using a prototype plan and never subsequently amended for any law changes. Starting in 2002, the plan began using the increased limits of EGTRRA.

Due to the changes made by EGTRRA (e.g., increased contribution limits) and the revised minimum distribution regulations under §401(a)(9) of the Code, the IRS issued revised Model SARSEP documents in 2002. If an employer is using a pre-EGTRRA Model SARSEP and wanted to take advantage of the EGTRRA changes in 2002, it would have had to adopt the revised model document (or an appropriate revised prototype document) by the end of 2002. If an employer is using a prototype SARSEP and wanted to take advantage of the EGTRRA changes in the 2002 plan year, the employer had to adopt an EGTRRA-revised prototype document within 180 days after the IRS issued the favorable EGTRRA opinion letter to the sponsoring organization of the prototype SARSEP.

Employers had to notify employees who participate in these plans of the increased EGTRRA contribution limits no later than October 1, 2002. See [Rev. Proc. 2002-10](#) (as modified by [Announcement 2002-49](#)) for details. Individually designed SARSEPs that have received a ruling from the IRS should use the procedures listed in Section 4.07 of Rev. Proc. 2002-10. Any other SARSEP outside of the correction periods discussed above should have amended their plan and given proper notice to participants before the new limits were used.

The employer in the above example would have to adopt an EGTRRA-revised document within 180 days after the IRS issued a favorable EGTRRA opinion letter to the sponsoring organization of the prototype SARSEP. If any of these conditions were not satisfied, then EPCRS would have to be used to correct the mistake by adopting the proper document.

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### **Correction Program(s) Available:**

#### **SCP:**

This type of mistake may not be corrected under SCP. As stated above, SCP is limited to operational problems, and this mistake is the result of the failure to keep the plan language up to date. In order to retain plan qualification, this mistake must be corrected under VCP.

#### **VCP:**

The plan sponsor makes a VCP submission to the IRS pursuant to Rev. Proc. 2008-50 identifying the failure. The fee for this mistake would be \$250.

**Audit CAP:**

If this mistake is discovered on audit, it may be corrected under Audit CAP. Correction of the mistake under Audit CAP should be very similar to correction under VCP. The sanction under Audit CAP is a percentage of the [Maximum Payment Amount \(MPA\)](#).

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**How to Avoid the Mistake:**

There are a number of ways to avoid this mistake:

- Do an annual review of your plan document.
- If you amend your plan document, check the language against the old plan document, noting any differences.
- We recommend you maintain contact, on at least a yearly basis, with the company that set you up with the plan. If the company sends you a set of amendments to formally adopt, make certain you timely execute the documents per their instructions. Keep signed and dated copies of your plan document and any amendments for your records.
- Check the IRS Web site for updated Model SARSEP forms.

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-----Trends-----	-----Tips-----			
Potential Mistake	How to Find the Mistake	How to Fix the Mistake		How to Avoid the Mistake
		Corrective Action	Correction Program(s) Available	
2) Do you have 25 or fewer eligible employees? <a href="#">(More)</a>	Review payroll and plan document eligibility requirements for the prior year. If more than 25 employees were eligible to participate in the plan, no employee elective deferrals may be accepted in the current year. <a href="#">(More)</a>	EPCRS Two correction methods for Excess Amounts under SARSEPs allowed: a. Distribution Method b. Retention Method <a href="#">(More)</a>	SCP* VCP Audit CAP <a href="#">(More)</a>	If more than 25 employees become eligible during any year, cease withholding employee elective deferrals in the first pay period of the subsequent year and notify all employees of the situation. <a href="#">(More)</a>

## 2) Do you have 25 or fewer eligible employees?

Employees cannot make elective deferrals to a SARSEP for a year if there were more than 25 employees who were eligible to participate at any time during the preceding year.

The 25-employee rule is a look-back rule. It is a year-by-year rule. For example, if you had 23 eligible employees in 2009, but 27 eligible employees in 2010, the 27 employees may make elective deferrals to their SEP-IRAs for 2010. However, in year 2011, no elective deferrals may be made.

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### How to Find the Mistake:

Review payroll and the section of your plan document concerning eligibility and participation requirements for the prior year. If more than 25 employees were eligible to participate in the plan, you may not accept any employee elective deferrals in the current year.

- Make a list of all employees who are eligible to participate in the plan.
- If in any prior year you have 26 or more eligible employees then you must suspend all elective deferrals until the year after the number of eligible employees drops below 26 again.
- Review payroll records to ensure no salary deferrals are made in any of the pay periods of the suspended year(s).

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### How to Fix the Mistake:

#### Corrective Action:

Generally, if you permitted employee elective deferrals in years that they should not have been permitted due to exceeding the 25-eligible-employee rule, the errant salary deferrals should be withdrawn from the participants' IRAs with interest prior to April 15 of the following year. If not, you must correct the excess using one of the two methods discussed below.

#### Example:

An employer operates a SARSEP established prior to 1997. All 18 eligible employees have made employee elective deferrals to the plan since 1997. As the business has prospered, the number of eligible employees increased to 27 in 2007 and 2008. In all other years, the number of eligible employees was less than 25. All newly eligible employees have participated by making employee elective deferrals each year. Each year the employer has also made a 5% employer nonelective contribution to the plan based on each eligible employee's compensation.

The 25-or-fewer-eligible-employees rule is a look-back rule. The law allows deferrals for any year if the prior year had only 25 or fewer eligible employees. In the example above, the employer should not have allowed any deferrals in 2008 or 2009. Section 6.10 of Rev. Proc. 2008-50 allows two correction methods for excess amounts under SARSEPs:

- a. *Distribution Method.* This method of correcting an excess amount is to effect distribution for the excess amount, as adjusted for earnings (See section 6.10(5)(a) of Rev. Proc. 2008-50). When the excess amount is attributable to elective deferrals, the amount may be distributed and reported ([Form 1099-R](#)) as taxable for the year in which the distribution is made. When the excess amount is attributable to employer contributions, the excess amount may be distributed to the plan sponsor rather than to the participants. If an excess amount attributable to employer contributions is distributed to the plan sponsor, it is still reported on a Form 1099-R issued to the participant, but the taxable amount is zero.
- b. *Retention Method.* In lieu of making a corrective distribution, excess amounts may be retained in the SEP-IRA. If the retention method is used, the plan sponsor is subject to a special fee of at least 10% of the excess amount (see section 12.05(2) of Rev. Proc. 2008-50). The special fee is in addition to the VCP submission fee.
- c. *De minimis excess amounts.* If the total excess amount is \$100 or less, distribution is not required and the special fee does not apply if the excess amount is retained.

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### **Correction Program(s) Available:**

#### **SCP:**

The example illustrates an operational problem, in that the employer failed to follow the terms of the plan by allowing employees to make elective deferrals when there were more than 25 eligible employees. Therefore, if the other eligibility requirements of SCP are satisfied, the employer may use SCP to correct the mistake.

- No fees for self-correction.
- Practices and procedures must be in place.

#### **VCP:**

The plan sponsor makes a VCP submission to the IRS pursuant to Rev. Proc. 2008-50 identifying the failure. The fee for this mistake would be \$250 if the distribution method is used to correct. If the retention method is used the plan sponsor is subject to a special fee of at least 10% of the excess amount. The special fee is in addition to the VCP submission fee.

#### **Audit CAP:**

If this mistake is discovered on audit, it may be corrected under Audit CAP. Correction of the mistake under Audit CAP should be very similar to correction under VCP. The sanction under Audit CAP is a percentage of the [Maximum Payment Amount \(MPA\)](#).

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### **How to Avoid the Mistake:**

You should review the participation status of all employees at the end of each year to determine whether you had more than 25 eligible employees during the year. If more than 25 employees were eligible, you should cease withholding employee elective deferrals in the first pay period of the subsequent year and notify all employees of the situation.

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-----Trends-----	-----Tips-----			
Potential Mistake	How to Find the Mistake	How to Fix the Mistake		How to Avoid the Mistake
		Corrective Action	Correction Program(s) Available	
3) Are all eligible employees (those who are at least age 21, worked for you in at least 3 of the last 5 years and have received at least \$550 during the year in compensation) participating in the plan? <a href="#">(More)</a>	Review the section of your plan document concerning eligibility and participation. Check when employees are entering the plan. <a href="#">(More)</a>	EPCRS You must make a fully vested contribution to the plan on behalf of the omitted employee that compensates for the missed contribution. <a href="#">(More)</a>	SCP* VCP Audit CAP <a href="#">(More)</a>	Plan sponsors need to monitor census information and apply participation requirements. <a href="#">(More)</a>

### 3) Are all eligible employees (those who are at least age 21, worked for you in at least 3 of the last 5 years and have received at least \$550 during the year in compensation) participating in the plan?

You must allow all eligible employees to participate in the SARSEP, including part-time employees, seasonal employees and employees who die or terminate employment during the year.

An eligible employee is an employee who:

- a) Is at least 21 years of age.
- b) Has performed service for you in at least 3 of the immediately preceding 5 years.

The term “employee” includes a self-employed individual who has earned income and a working business owner. You must treat certain leased employees as “employees.”

Your SARSEP document can provide for less restrictive eligibility requirements (but not more restrictive ones). “Service” means any work performed for you for any period of time, however short. A SARSEP may not impose an hours-of-service requirement.

**Excludable employees:** You do not need to cover the following employees under a SARSEP:

- Employees covered by a union 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.
- Employees who received less than \$550 in compensation during the year. This amount is subject to [cost-of-living adjustments](#) after 2010.

“Employees” for purposes of determining who is an eligible employee under a SARSEP includes all employees of all related employers. Related employers include controlled groups of corporations that include your business, trades or businesses under common control with your business and affiliated service groups that include your business. This means, for example, that if you and/or your family members own a controlling interest in another business, employees of that other business are “employees” for purposes of determining who is eligible to participate in a SARSEP.

#### **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. Joe worked for Employer X during

his summer breaks from school in 2007, 2008 and 2009, but never more than 34 days in any year. In July 2010, Joe turns 21. In August 2010, Joe begins working for Employer X on a full-time basis, earning \$12,000 in 2010. Joe is an eligible employee in 2010 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 2010.

**Example 2:**

Employer Y designs its SARSEP to provide for immediate participation regardless of age, service or compensation. Sue is age 18, and begins working part-time for Employer Y in 2010. Sue is an eligible employee for 2010.

**Example 3:**

Alex owns Business A, a computer rental agency that has 4 eligible employees. Alex also owns Business B, which repairs computers, and has 3 eligible employees. Alex is the sole owner of both businesses. For purposes of the SARSEP rules, all 8 employees (including Alex) are treated as employed by a single employer.

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**How to Find the Mistake:**

Review the section of your plan document concerning eligibility and participation. Check when employees are entering the plan.

- Make a list of all employees who received a W-2.
- Compare their dates of hire and annual compensation against the eligibility and participation requirements in the plan document.
- Determine the date that each employee is entitled to become a participant in the plan according to the plan document.
- Inspect payroll and plan records to make certain the employees timely entered the plan.

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**How to Fix the Mistake:**

**Corrective Action:**

Generally, if you did not provide an employee the opportunity to participate in your SARSEP plan, you must make a fully vested contribution to the plan on behalf of the employee that compensates for the missed employer contribution and “missed deferral opportunity.” The corrective contribution is an employer contribution that is intended to place the employee in the same position had s/he participated in the plan timely.

**Example:**

In 2008, Company X failed to include Jan in its SARSEP plan. Jan had met the age, service and earnings requirements for the SARSEP. Jan is a nonhighly compensated employee and earned \$10,000. Company X had two other NHCEs who had deferral percentages of 3% and 5%. In addition, Company X’s SARSEP plan provides for discretionary employer contributions. The plan provides that the employer’s contributions be allocated to account balances in the ratio that each eligible employee’s compensation for the year bears to the compensation of all eligible employees for the year. For 2008, Company X contributed a fixed dollar amount to the plan. Jan did not receive an allocation of the contribution. The contribution resulted in an allocation on behalf of each of the eligible employees, other than Jan, equal to 10% of compensation. Most of the employees who received allocations under the plan for the year of the mistake were NHCEs. If Jan had shared in the original allocation, the allocation made on behalf of each employee would have equaled 9% of compensation.

### **Reasonable Correction:**

If you did not provide an employee the opportunity to elect and make elective deferrals, you must make a 100% vested contribution to the plan on behalf of the employee that compensates for the “missed deferral opportunity.” The missed deferral opportunity is equal to 50% of the employee’s “missed deferral.” The missed deferral is determined by multiplying the average deferral percentage for the employee’s group in the plan (either highly compensated or nonhighly compensated) for the year of exclusion by the employee’s compensation for that year. The contribution required to compensate the employee for the missed deferral opportunity for the year of exclusion is adjusted for earnings until the corrective contribution is made on behalf of the affected employee. For the example above, Company X would have to make a contribution in the amount of \$200 adjusted for earnings to Jan’s account. This is calculated by taking Jan’s compensation (\$10,000) times the average of the deferral percentages of the NHCEs ( $3\% + 5\% / 2 = 4\%$ ) times 50%.

Section 2.02(2) of Appendix B to Revenue Procedure 2008-50 provides two different methods for correcting the exclusion of eligible employees. Only the contribution method, and not the reallocation method, is proper for SARSEPs. The contribution method requires you to make a corrective contribution to the plan. The corrective contribution is determined taking into account the excluded employees’ compensation. You must adjust this amount for earnings. No adjustments are made to the employees who shared in the prior allocation, even though their allocations would have been different had the excluded employee not been excluded. For the above example, the employer would contribute an amount that equals 10% of the excluded employee’s compensation for the 2008 year (adjusted for earnings), and does not adjust the 10% allocations that were made to the other employees.

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### **Correction Program(s) Available:**

#### **SCP:**

The example illustrates an operational problem, in that the employer failed to follow the terms of the plan by excluding eligible employees from participating in the plan. Therefore, if the other eligibility requirements of SCP are satisfied, the employer may use SCP to correct the mistake.

- No fees for self-correction.
- Practices and procedures must be in place.

#### **VCP:**

Under VCP, correction is the same as described above under “Reasonable Correction.” Company X makes a VCP submission in accordance with Rev. Proc. 2008-50. The fee for the VCP submission is \$250.

#### **Audit CAP:**

Under Audit CAP, correction is the same as described above under “Reasonable Correction.” Company X and the IRS enter into a Closing Agreement outlining the corrective action and negotiate a sanction based on the [Maximum Payment Amount \(MPA\)](#).

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### **How to Avoid the Mistake:**

You should monitor census information and the participation status of all employees at least once a year. The person assigned the task should have a good understanding of the eligibility requirements and have access to the employment records necessary to make eligibility decisions for all employees.

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-----Trends-----	-----Tips-----			
Potential Mistake	How to Find the Mistake	How to Fix the Mistake		How to Avoid the Mistake
		Corrective Action	Correction Program(s) Available	
4) Are you determining each eligible employee's compensation using the definition in your SARSEP document? <a href="#">(More)</a>	To determine if you are using the proper compensation for allocations, you'll need to review the plan document. <a href="#">(More)</a>	EPCRS Correction is based upon the terms of the plan and other applicable information at the time of the mistake. <a href="#">(More)</a>	SCP* VCP Audit CAP <a href="#">(More)</a>	When calculating allocations, it is important to carefully review the plan terms to ensure that the correct amount of compensation is being considered. <a href="#">(More)</a>

#### 4) Are you determining each eligible employee's compensation using the definition in your SARSEP document?

A plan's definition of compensation must satisfy applicable rules for determining the amount of contributions. The amount of compensation taken into account under the plan cannot exceed \$245,000 in 2010 and is subject to [cost-of-living adjustments](#) for later years.

You must follow the definition of compensation stated in the plan document in the operation of your plan. Compensation generally includes the pay an employee received from you for personal services for a year including:

- Wages and salaries.
- Fees for professional services.
- Other amounts received (cash or non-cash) for personal services actually rendered by an employee, including, but not limited to, the following items:
  - Commissions and tips.
  - Fringe benefits.
  - Bonuses.

Compensation generally does not include any employer SARSEP contributions, including elective deferrals.

Compensation, for purposes of the \$550 rule, is the same, except it includes deferrals made to the SARSEP and any amount not includible in gross income under §§125 (cafeteria plans) or 132(f)(4) (certain qualified fringe benefits).

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#### How to Find the Mistake:

To determine if you are using the proper compensation for allocations, you'll need to review the plan document.

You may not be aware your plan contains different definitions of compensation when calculating the [DP test](#). In some cases, you or the plan administrator may use the incorrect definition of compensation when determining the compensation eligible for the employee to defer or the plan administrator may fail to limit compensation to \$245,000 as required by the Code.

Review the plan section that deals with allocations and deferrals. This section will have language that says, for example, "Employees may defer up to 15% of their Compensation." You then have to go to the plan section containing definitions and find the "Compensation" definition.

Spot-check allocations to see if you are using the correct compensation. Some of these definitions can get very complicated with expense reimbursements, car allowances, bonuses, commissions and overtime pay that is included or not included in the definition of compensation. If you have a plan with a complicated definition of compensation, develop a worksheet to calculate the correct amounts. If you are using the Form 5305A-SEP, make sure you base allocations on total compensation.

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### **How to Fix the Mistake:**

#### **Corrective Action:**

If you have improperly determined elective deferrals by including compensation not allowed for by the plan, you have excess amounts that you should correct as shown in [Potential Mistake #2](#), above. If you have improperly determined elective deferrals and employer contributions by excluding required compensation, you would make a contribution equal to (a) 50% of the employee's salary deferral percentage under the plan times the excluded compensation (Note: unlike the mistake in #3, above, in this case, the participant's salary deferral election is known) and (b) the employer's original contribution rate under the plan times the excluded compensation. You must adjust the amounts contributed for earnings to the date of correction.

#### **Example:**

Susan elected to make an elective deferral equal to 5% of compensation to the SARSEP plan. The terms of the plan require that the employer contributes 2% of compensation on behalf of each employee. Furthermore, the plan's definition of compensation does not exclude deferrals. However, when determining the elective deferral contribution and the required employer contribution, Susan's employer did not include \$1,000 of overtime income. Thus, Susan was not able to make elective deferral contributions (based on her election of 5% of compensation) on overtime income, and her employer ignored overtime income for the purpose of determining the employer contribution that Susan was entitled to under the terms of the SARSEP plan.

#### **Reasonable Correction:**

The required corrective employer contribution must replace Susan's missed opportunity to make elective deferral contributions with respect to the overtime income and any employer contributions that Susan would be entitled to under the terms of the plan.

- 1) Missed deferral opportunity. Susan's missed deferral, based on her election is 5% times \$1,000 or \$50. The required corrective employer contribution to replace Susan's missed deferral opportunity, before adjusting for earnings, is 50% of \$50 or \$25.
- 2) Employer contributions. Under the terms of the plan, Susan was also entitled to receive an employer contribution equal to 2% of compensation, and the overtime income of \$1,000 should have been included in the determination of compensation. Thus, to replace the missed employer contribution with respect to overtime income, the required corrective employer contribution is 2% times \$1,000 or \$20. The corrective contribution must also be adjusted for earnings.

The total corrective employer contribution on behalf of Susan is equal to the corrective contributions required under 1) above to replace Susan's missed deferral opportunity with respect to overtime compensation (\$25 adjusted for earnings) and 2) above to replace the employer contributions that Susan would have been entitled to under the terms of the plan (\$20 adjusted for earnings).

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## **Correction Program(s) Available:**

### **SCP:**

The example illustrates an operational problem, in that the employer failed to follow the terms of the plan by failing to include overtime income in compensation used to determine allocations under the plan. Therefore, if the other eligibility requirements of SCP are satisfied, the employer may use SCP to correct the mistake.

- No fees for self-correction.
- Practices and procedures must be in place.

### **VCP:**

Under VCP, correction is the same as described above under "[Corrective Action](#)." The employer makes a VCP submission in accordance with Rev. Proc. 2008-50. The fee for the VCP submission is \$250.

### **Audit CAP:**

Under Audit CAP, correction is the same as described above under "[Corrective Action](#)." The employer and the IRS enter into a Closing Agreement outlining the corrective action and negotiate a sanction based on the [Maximum Payment Amount \(MPA\)](#).

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## **How to Avoid the Mistake:**

When calculating allocations, it is important that you carefully review the plan terms to ensure that you are considering the correct amount of compensation. If necessary, you may wish to include in your payroll program an account that accumulates the proper compensation figures for all employees.

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-----Trends-----		-----Tips-----		
Potential Mistake	How to Find the Mistake	How to Fix the Mistake		How to Avoid the Mistake
		Corrective Action	Correction Program(s) Available	
5) Are all employee elective deferrals within the appropriate limit as defined under IRC §402(g) for the calendar year (\$16,500 in 2010) and have any excess deferrals been distributed? <a href="#">(More)</a>	Inspect deferral amounts for plan participants to ensure that limits have not been exceeded. <a href="#">(More)</a>	EPCRS Two correction methods for Excess Amounts under SARSEPs allowed: c. Distribution Method d. Retention Method <a href="#">(More)</a>	SCP* VCP Audit CAP <a href="#">(More)</a>	Employers should ensure they have sufficient payroll information to verify that the deferral limitations of §402(g) were satisfied. <a href="#">(More)</a>

**5) Are all employee elective deferrals within the appropriate limit as defined under IRC §402(g) for the calendar year (\$16,500 in 2010) and have any excess deferrals been distributed?**

**Limit on employee elective deferrals:** The most a participant can choose to defer for the 2010 calendar year is the lesser of:

- 1) 25% of the participant's compensation or
- 2) \$16,500.

The dollar limitation in (2) (\$16,500) is subject to [cost-of-living adjustments](#). The \$16,500 limit applies to the total employee elective deferrals the employee makes for the year to a SARSEP and any of the following:

- Cash or deferred arrangement (401(k) plan).
- Salary reduction arrangement under a tax-sheltered annuity plan (403(b) plan).
- SIMPLE IRA plan.

**Catch-up contributions:** For tax years beginning after 2001, a plan may permit participants who are age 50 or over at the end of the calendar year to make additional elective deferrals. These additional contributions (commonly referred to as “catch-up contributions”) are not subject to the above general limits. You are not required to provide for catch-up contributions in any of your plans. However, if your plan does allow catch-up contributions, it must allow **all** eligible participants to make the same election with respect to catch-up contributions.

The limit on catch-up elective deferral contributions for 2010 is the lesser of \$5,500 or the excess of the employee's compensation over elective deferrals that are not catch-up contributions. After 2010, the \$5,500 amount may be increased for [cost-of-living adjustments](#).

**Excess deferrals:** The law considers amounts deferred for a year in excess of the above limit “excess elective deferrals” that are subject to the rules described below. An employee may have excess elective deferrals even if the amount deferred under this SARSEP alone does not exceed the applicable limit. If an employee who elects to defer compensation under a SARSEP of one employer and any other SARSEP or employee elective deferral arrangement of the same or other employer has made excess elective deferrals for a calendar year, the employee must withdraw those deferrals by April 15 following the calendar year to which the deferrals relate.

Deferrals not withdrawn by April 15 - the SARSEP contributions will be subject to the IRA contribution limits (\$5,000 in 2010; \$6,000 if age 50 or over) and may be considered excess contributions to the employee's IRA. For the employee, these excess elective deferrals are subject to a 6% tax on excess contributions under §4973. Income on excess elective deferrals is includible in the employee's income in the year it is withdrawn from the IRA. The income must be withdrawn by April 15, following the calendar year for which the deferrals were made. If the income is withdrawn after that date and the recipient is not 59½ years of age, it may be subject to the 10% tax on early distributions under §72(t).

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### **How to Find the Mistake:**

Inspect deferral amounts for plan participants to ensure that they have not exceeded the limits by reviewing year-end payroll records and ensuring that none of the employees' salary deferrals exceeded the limits discussed above for the calendar year.

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### **How to Fix the Mistake:**

#### **Corrective Action:**

When there is a deferral in excess of the §402(g) or 408(k)(6)(A)(iii) limit, you have until April 15 of the calendar year after the end of the year in which the excess occurred to make correction. After that, you must use VCP. To correct, you, as the plan sponsor, may effect distribution of the excess amount, adjusted for earnings through the date of correction, to the affected participant. The amount distributed to the affected participant is includible in gross income in the year of distribution. The distribution is reported on Form 1099-R for the year of distribution with respect to each participant receiving the distribution. In addition, you must inform affected participants that the distribution of an excess amount is not eligible for favorable tax treatment accorded to distributions from a SARSEP plan (and, specifically, is not eligible for tax-free rollover).

As an alternative, you may use the Retention of Excess Amounts method. If you retain an excess amount in the SARSEP plan, a special fee, under section 6.10(5) of Rev Proc 2008-50, in addition to the VCP submission fee, will apply. See section 12.05(2) of Rev Proc 2008-50 for the special fee. You are not entitled to a deduction for an excess amount retained in the SARSEP plan.

If the total excess amount in your SARSEP plan, whether attributable to elective deferrals or employer contributions, is \$100 or less, you are not required to distribute the excess amount and the special fee described in section 12.05(2) of Rev Proc 2008-50 does not apply.

#### **Example:**

Employer X maintains a SARSEP. For calendar year 2008, Bill defers \$17,500 to the plan. Bill is under age 50 so he is not eligible to make catch-up contributions. Bill has excess deferrals of \$2,000 because \$15,500 is the §402(g) maximum amount permitted for 2008 (\$17,500 - \$15,500 = \$2,000). Employer X did not discover this mistake until after April 15, 2009. On November 1, 2009, X effected distribution of the excess deferral (plus applicable earnings of \$100, totaling \$2,100) to Bill.

#### **Reasonable Correction:**

For 2008 (year of deferral), Bill must include the \$2,000 in gross income. For 2009 (year of distribution), Bill must include the \$2,100 distribution in gross income. This amount would be shown on a Form 1099-R and Bill must pay the 10% premature distribution excise tax under IRC §72(t).

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### **Correction Program(s) Available:**

#### **SCP:**

When correction occurs timely, SCP may be used provided the other eligibility requirements of SCP were satisfied and practices and procedures were in place. The example above illustrates a situation in which SCP may not be used because correction did not occur within the period required by the Revenue Procedure and VCP must be used to correct the mistake.

#### **VCP:**

Under VCP, correction is the same as described above under Reasonable Correction. Employer X makes a VCP submission in accordance with Rev. Proc. 2008-50. The fee for the VCP submission is \$250.

#### **Audit CAP:**

Under Audit CAP, correction is the same as described above under Reasonable Correction. Employer X and the IRS enter into a closing agreement outlining the corrective action and negotiate a sanction based on the [Maximum Payment Amount \(MPA\)](#).

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### **How to Avoid the Mistake:**

You should ensure that you have sufficient payroll information to verify that the deferral limitations of §402(g) were satisfied. Determine the 402(g) limits for each year and monitor deferrals throughout the year to ensure that no excess amount is placed into a participant's IRA.

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-----Trends-----	-----Tips-----			
Potential Mistake	How to Find the Mistake	How to Fix the Mistake		How to Avoid the Mistake
		Corrective Action	Correction Program(s) Available	
6) Do 50% or more of all eligible employees make employee elective deferrals? <a href="#">(More)</a>	Review payroll records and ensure that 50% of eligible employees are actually making employee elective deferrals annually. <a href="#">(More)</a>	EPCRS Two correction methods for Excess Amounts under SEPs allowed: a. Distribution Method b. Retention Method <a href="#">(More)</a>	SCP* VCP Audit CAP <a href="#">(More)</a>	Annually review plan document for eligibility requirements and payroll records for participating employees. <a href="#">(More)</a>

## 6) Do 50% or more of all eligible employees make employee elective deferrals?

Each year at least 50% of your eligible employees must choose to make employee elective deferrals into the SARSEP. If fewer than 50% of the eligible employees choose to make employee elective deferrals to the SARSEP for a year, the law disallows all employee elective deferrals made for that year and they must be withdrawn from the employees' SEP-IRAs. By 2 ½ months (March 15 for calendar-year plans) of the following year, you must notify each affected employee of:

- 1) The amount of the 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 excess contributions (and earnings), 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 how to treat disallowed deferrals.

This is a year-by-year rule. Each year the 50% rule is not met, employee elective deferrals for that year cannot remain in the employees' SEP-IRAs.

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### How to Find the Mistake:

Review the plan document and determine how many employees are eligible to participate in the plan. Review payroll records to ensure that of the eligible employees at least 50% of them are making elective deferrals each year.

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### How to Fix the Mistake:

#### Corrective Action:

Generally, if you permitted employee salary deferrals in years they should not have been allowed due to not having 50% or more of all eligible employees make employee elective deferrals, the elective deferrals should be withdrawn from the employees' IRAs with interest

prior to April 15 of the year following the year of notification. If not, you must correct the excess using one of the two methods discussed in [Potential Mistake #2](#), above.

**Example:**

In 2007 and prior years, 3 of the 4 employees eligible to make employee elective deferrals were contributing to the ABC SARSEP plan. In 2008, one of the contributing employees separated from service from ABC. In the same year, two other employees became eligible to make employee elective deferrals, but opted not to contribute to the plan. Thus, in 2008 and 2009, only 2 of the 5 eligible employees were making employee elective deferrals.

**Correction Program(s) Available:**

**SCP:**

The example illustrates an operational problem, in that the employer failed to follow the terms of the plan by allowing employees to make elective deferrals when fewer than 50% of the eligible employees were making elective deferrals. Therefore, if the other eligibility requirements of SCP are satisfied, the employer may use SCP to correct the mistake.

- No fees for self-correction.
- Practices and procedures must be in place.

**VCP:**

Under VCP, correction is the same as described above under “Corrective Action.” ABC makes a VCP submission in accordance with Rev. Proc. 2008-50. The fee for the VCP submission is \$250.

**Audit CAP:**

Under Audit CAP, correction is the same as described above under “Corrective Action.” ABC and the IRS enter into a Closing Agreement outlining the corrective action and negotiate a sanction based on the [Maximum Payment Amount \(MPA\)](#).

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**How to Avoid the Mistake:**

Annually review the plan document for eligibility requirements and payroll records for participating employees. Review plan and personnel files annually to ensure that when you do not meet the 50% rule you send out notices timely.

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-----Trends-----	-----Tips-----			
Potential Mistake	How to Find the Mistake	How to Fix the Mistake		How to Avoid the Mistake
		Corrective Action	Correction Program(s) Available	
7) Are total contributions (employee elective deferrals and nonelective employer contributions) limited as required by the Internal Revenue Code? <a href="#">(More)</a>	Calculate 25% of each employee's compensation and compare the total contribution made for the employee to the lesser of that amount or the dollar limitation for that year (\$49,000 in 2010). <a href="#">(More)</a>	EPCRS Two correction methods for excess contributions amounts under SEPs allowed: a. Distribution Method b. Retention Method <a href="#">(More)</a>	SCP* VCP Audit CAP <a href="#">(More)</a>	After the initial calculation of allocations based on the terms of the plan, you should check to make sure none of the proposed allocations would violate the Code. <a href="#">(More)</a>

### 7) Are total contributions (employee elective deferrals and nonelective employer contributions) limited as required by the Internal Revenue Code?

All contributions made to a SARSEP (including employee elective deferrals) are employer contributions for purposes of the Code.

Contributions made to each employee's SEP-IRA cannot exceed the lesser of \$49,000 in 2010 (subject to [cost-of-living adjustments](#) for later years) or 25% of the eligible employee's compensation. The amount of compensation taken into account is limited to \$245,000 in 2010 (subject to [cost-of-living adjustments](#) for later years). If your SARSEP plan document specifies lower contribution limits, then the lower limits control.

There are special rules if you are a self-employed individual. When calculating the deduction for contributions made to your own SEP-IRA, compensation is your net earnings from self-employment, which takes into account both the deduction for one-half of your self-employment tax and the deduction for contributions to your own SEP-IRA. For this reason, you determine the deduction for contributions to your own SEP-IRA indirectly by reducing the contribution rate called for in your plan. For more information on the deduction limitations for self-employed individuals, see [Publication 560](#), *Retirement Plans for Small Business (SEP, SIMPLE, and Qualified Plans)*.

Employer contributions to a SEP-IRA will not affect the amount an individual can contribute to a Roth IRA or a traditional IRA. However, it may preclude an individual from receiving a tax deduction for contributions to a traditional IRA. See [Publication 590](#), *Individual Retirement Arrangements (IRAs)*, for details.

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#### **How to Find the Mistake:**

After an employer makes the initial calculation of allocations based on the terms of the plan, your client should check to make sure none of the proposed allocations would violate §415 of the Code or the 25% limit contained in all SARSEP plans. Make the calculation based on the plan language. Check this against the §415 rules and the 25% limit before the actual allocation is made to the SARSEP. If there is a problem, your client can adjust it before it transfers the money into the SARSEP accounts.

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## **How to Fix the Mistake:**

### **Corrective Action:**

There are two alternative methods to correct a failure to limit employer contributions to employees as required under the Code.

The two methods of correction are:

- 1) You may effect a distribution of the amount in excess of the §415 limit, adjusted for earnings, through the date of correction. The earnings adjustment is based on the actual rate of return of the SEP-IRA from the date the excess employer contribution was made through the date of correction. The amount of employer contributions returned to you is not includible in the gross income of the affected employee. You are not entitled to a deduction for the excess contribution. Report the amount returned on Form 1099-R as a distribution issued to the affected employee, indicating the taxable amount as zero. Elective deferrals returned to the employee are includible in the income of the affected employee and is reported to them on a Form 1099-R indicating the taxable amount as the amount of elective deferrals returned.
- 2) The amount in excess of the §415 limit may be retained in the SEP-IRA. This correction method is available under VCP and requires an additional fee. The fee is equal to at least 10% of the excess amount excluding earnings. The excess amount, adjusted for earnings through the date of correction, must reduce affected employees' §415 limit for the year of correction and subsequent years, until the excess is eliminated.

### **Example:**

Employer I maintains a SARSEP plan. For the 2008 year, the contributions made on behalf of two employees, T and U, exceeded the limit in §415 of the Code. Employee T had an excess of \$3,000 and U had an excess of \$300. On January 1, 2009, Employee U terminated his employment.

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## **Correction Program(s) Available:**

### **SCP:**

The example illustrates an operational problem, in that the employer failed to follow the terms of the plan by improperly exceeding the 415 limitations provided for in the plan document and the Code. Therefore, if the other eligibility requirements of SCP are satisfied, Employer I may use SCP to correct the failure by using the distribution of excess amounts correction method described above.

- No fees for self-correction.
- Practices and procedures must be in place.

### **VCP:**

Under VCP, correction is the same as described above under "[Corrective Action](#)." Employer I makes a VCP submission in accordance with Rev. Proc. 2008-50. The fee for the VCP submission is \$250. If Employer I makes correction under the retention method described above under "Corrective Action" (#2), an additional fee equal to at least 10% of the excess amount excluding earnings will be imposed in addition to the \$250 submission fee.

### **Audit CAP:**

Under Audit CAP, correction is the same as described above under "[Corrective Action](#)." Employer I and the IRS enter into a Closing Agreement outlining the corrective action and negotiate a sanction based on the [Maximum Payment Amount \(MPA\)](#).

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**How to Avoid the Mistake:**

After the initial calculation of allocations based on the terms of the plan, you should check to make sure none of the proposed allocations would violate §415 of the Code. Make the calculation based on the plan language. Check this against the §415 rules before the actual allocation is made to the SARSEP. If there is a problem, you can adjust it before you transfer the money to the SEP-IRA accounts.

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-----Trends-----	-----Tips-----			
Potential Mistake	How to Find the Mistake	How to Fix the Mistake		How to Avoid the Mistake
		Corrective Action	Correction Program(s) Available	
8) Did you deposit employee elective deferrals timely? <a href="#">(More)</a>	Review employee data and payroll remittances to ensure amounts were properly withheld and timely deposited. <a href="#">(More)</a>	EPCRS You must make a contribution on behalf of each participant. <a href="#">(More)</a>	SCP* VCP Audit CAP <a href="#">(More)</a>	Review the SARSEP plan rules concerning the timing of employer contributions and adopt administrative procedures to implement proper timing. <a href="#">(More)</a>

## 8) Did you deposit employee elective deferrals timely?

You are responsible for making contributions to the SEP-IRAs for the amounts of the elective deferrals made by plan participants. To the extent your plan document contains language regarding the timing of deposits of elective deferrals, you can correct the failure to follow the terms of the plan document under EPCRS. However, this type of mistake can also lead to another problem – it may give rise to what is referred to as a “prohibited transaction.” A prohibited transaction is a transaction between an IRA and a disqualified person that the law prohibits. The law considers an employer a disqualified person with respect to any plan maintained by that employer.

A prohibited transaction gives rise to an excise tax. A disqualified person who takes part in a prohibited transaction must correct the transaction and pay an excise tax based on the amount involved in the transaction. The initial tax on a prohibited transaction is 15% of the amount involved for each year (or part of a year) in the taxable period. If the disqualified person does not correct the transaction within the taxable period, the law imposes an additional tax of 100% of the amount involved.

DOL rules require that elective deferrals be made to the SEP-IRA on the earliest date that the amount can reasonably be segregated from your general assets; however, in no event can the amount be deposited later than the 15<sup>th</sup> business day of the following month. Keep in mind that the rules regarding the 15<sup>th</sup> business day of the following month do not provide a safe harbor for depositing deferrals; rather, it sets the maximum deadline for deposit. DOL recently proposed a 7-business day safe harbor rule for employee contributions to plans with fewer than 100 participants ([73 FR 11072, February 29, 2008](#)).

If you did not make the deposits timely, the failure may constitute both an operational mistake giving rise to plan disqualification (if the plan specifies a date by which elective deferrals must be deposited) and a prohibited transaction. Although you can correct the operational mistake under EPCRS, correction of a prohibited transaction is not one of the correctable mistakes under EPCRS. However, the Department of Labor’s Employee Benefits Security Administration (EBSA) maintains a [Voluntary Fiduciary Correction Program \(VFCP\)](#), which may be able to resolve the prohibited transaction.

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### How to Find the Mistake:

For each pay period, review the date on which you withheld the elective deferral contributions from the employees’ salary, (typically the same date that you paid the net salaries to the employees) and compare with the date on which you contributed the salary deferral

contributions to the employees' SEP-IRA accounts. If there is a significant gap between the dates, check whether the gap is unavoidable or avoidable.

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### **How to Fix the Mistake:**

#### **Corrective Action:**

Correction through EPCRS may be required if the terms of the plan were not followed.

Correction for late deposits may require you to:

- Determine which deposits were late and calculate the lost earnings necessary to correct.
- Deposit any missed elective deferrals into the IRA, along with lost earnings.
- Review procedures and correct deficiencies that led to the late deposits.

#### **Example:**

Employer B sponsors a SARSEP plan for its 12 employees, all of whom are participants in the plan. B pays its employees on the first day of the month. The plan **expressly** provides that deferrals are to be deposited within five days after each payday. B conducts a yearly compliance audit of its plan. During this review, B discovered that elective deferrals were deposited 30 days after each payday for the 2009 plan year.

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### **Correction Program(s) Available:**

#### **SCP:**

The example illustrates an operational problem, in that the employer failed to follow the terms of the plan relating to the timing for depositing elective deferrals. Therefore, if the other eligibility requirements of SCP are satisfied, Employer B may use SCP to correct the failure.

- No fees for self-correction.
- Practices and procedures must be in place.

#### **VCP:**

Under VCP, correction is the same as described above under "[Corrective Action](#)." Employer B makes a VCP submission in accordance with Rev. Proc. 2008-50. The fee for the VCP submission is \$250.

#### **Audit CAP:**

Under Audit CAP, correction is the same as described above under VCP. Employer B and the IRS enter into a closing agreement outlining the corrective action and negotiate a sanction based on the [Maximum Payment Amount \(MPA\)](#).

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### **How to Avoid the Mistake:**

Coordinate with your payroll provider to determine the earliest date the deferrals can reasonably be segregated from general assets and then set up procedures to ensure you make deposits by that date. Establish procedures whereby you deposit elective deferrals coincident with or after each payroll in accordance with the plan document. If you have instances where your deferral deposits are a week or two later than the normal timely deposit (due to vacations or other disruptions, for example), keep a record of why those deposits were late. Coordinate with your payroll provider and others who provide service to your plan, if any, to determine the earliest date you can reasonably make deferral deposits. The date and related deposit procedures should match your plan document provisions, if any, dealing with this issue. If you have a change in the persons in charge of making these deposits, make certain the new person has a full understanding of when these deposits must be made.

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-----Trends-----	-----Tips-----			
Potential Mistake	How to Find the Mistake	How to Fix the Mistake		How to Avoid the Mistake
		Corrective Action	Correction Program(s) Available	
9. Did you pass the annual deferral percentage test? <a href="#">(More)</a>	Perform and review the test for each year in which deferrals were made. <a href="#">(More)</a>	EPCRS Two correction methods for excess contribution amounts under SEPs are allowed. <a href="#">(More)</a>	SCP* VCP Audit CAP <a href="#">(More)</a>	Communicate with plan administrator to ensure proper employee classification. Ensure both you and the plan administrator are familiar with the terms of the plan. Consider converting to a SIMPLE IRA plan. <a href="#">(More)</a>

## 9) Did you pass the annual deferral percentage test?

SARSEPs are subject to a nondiscrimination test similar to the annual test imposed on 401(k) plans. This test limits the amount your [highly compensated employees \(HCEs\)](#) can defer based on what your nonhighly compensated employees (NHCEs) defer into the SARSEP. Compute the deferral percentage (DP) limit for your HCE employees by first averaging the DPs for the NHCEs for the year and then multiplying this result by 1.25. You must compute the DP limitation each year. See the Instructions for [Form 5305A-SEP](#) for this computation.

The DP test for SARSEPs compares the DP of each HCE with the average of the DPs of all other employees – not the average of the DPs of all HCEs with the average of all other employees (as in a 401(k) plan). Further, unlike 401(k) plans, nonelective contributions from the employer cannot be used to help the SARSEP satisfy the annual test.

If an HCE has exceeded the DP limit for a year, you must notify each affected employee by 2 ½ months from the end of the plan year (March 15 for calendar-year plans) of the following:

- 1) The amount of the excess contributions to his or her SEP-IRA for the preceding year,
- 2) The calendar year the excess contributions and earnings are includible in gross income,
- 3) Information stating that the employee must withdraw the excess contributions (and earnings), and
- 4) An explanation of the tax consequences if the employee does not withdraw such amounts.

See the Instructions for [Form 5305A-SEP](#) for a detailed description of the notification procedures. If you, as the plan sponsor, do not notify them within this time period, you must pay a 10% tax on the excess. If you adopted a SARSEP using Form 5305A-SEP, the notification requirements are explained in the instruction for that form.

If you do not notify your employees within 12 months following the end of the plan year in which the excess SARSEP contributions arose (December 31<sup>st</sup> for calendar-year plans), the SARSEP no longer will be treated as meeting the rules of section 408(k)(6). In this case, any contribution to an employee's IRA will be subject to the IRA contribution limits of sections 219 and 408 and thus may be considered an excess contribution to the employee's IRA.

The employee must withdraw those excess contributions by April 15 following the year in which the employee is notified. Excess contributions not withdrawn by April 15 will be subject to the IRA contribution limits of Code (\$5,000 in 2010; \$6,000 if age 50 or over) and may be considered excess contributions to the employee's IRA. For the employee, these excess

contributions are subject to a 6% tax on excess contributions under Code §4973. Income earned on excess elective deferrals for the year contributed is includible in the employee's income in the year it is withdrawn from the IRA. The income must also be withdrawn by April 15 following the year of notification. If the excess elective deferral and related income is withdrawn after that date and the recipient is not 59½ years of age, it may be subject to the 10% tax on early distributions under §72(t).

Excess SARSEP contributions of an HCE who is 50 or older before the end of the calendar year do not have to be removed from the employee's SEP-IRA to the extent the amount of the excess contribution is less than the catch-up elective deferral contribution limit (see [402\(g\) limit above](#)) reduced by any catch-up elective deferral contributions already made for the year.

**Highly compensated employee:** An HCE is an employee who:

- Owned more than 5% of the capital or profits in your business at any time during the year or the preceding year, or
- For the preceding year (2009) received compensation from you of more than \$110,000 (subject to [cost-of-living adjustments](#) for later years), and, if your SARSEP document so provides, was in the top 20% of employees when ranked by compensation.

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### **How to Find the Mistake:**

You should complete an independent review to determine if you properly classified HCEs and NHCEs for purposes of the DP nondiscrimination test. Plan administrators (TPAs) should pay special attention to:

- Prior year compensation.
- The attribution rules related to ownership when identifying 5% owners.
  - TPAs need access to ownership documents to identify 5% owners.
  - Take care to identify family members of the owners, as many will have different last names, which may warrant further review for proper attribution.

Also, review the rules and definitions in your plan document for:

- Properly determining HCEs
- Compensation
- DP testing

An HCE or NHCE includes all employees eligible to make an elective deferral, even if they choose not to make one for the plan year.

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### **How to Fix the Mistake:**

#### **Corrective Action:**

If a plan fails to satisfy the DP test and you do not timely notify the affected HCEs, it will result in plan disqualification. If the data used for the original testing is incorrect, then the DP test may have to be rerun. If the original or corrected test fails, then corrective action is required in order to rectify the excess contributions that were made to the HCEs.

- By regulations, corrective action described in the plan document must be taken within 12 months following the end of the plan year to which the excess contributions (DP) relate. If this is done, EPCRS is not needed.
- If 12 months have elapsed since the close of the plan year, you may pursue corrective action through EPCRS.

There are two different methods of correcting DP testing mistakes. You may choose whichever method you prefer. Both require a contribution to the plan on behalf of NHCEs.

- Method 1 - Under EPCRS, Appendix A, section .03 of Rev. Proc. 2008-50, the permitted correction method is to:
  - Determine the amount necessary to raise the average of the DPs of the NHCEs to the percentage needed to pass the test.
  - You may make fully vested contributions (to the extent permitted by §415) for all eligible NHCEs as necessary to raise the DP to pass the test. This amount must be calculated to provide the same percentage rate for all NHCEs regardless of the terms of the SARSEP.
- Method 2 - Under EPCRS, Appendix B, section 2.01, an alternative permitted correction method is referred to as the one-to-one method.
  - You may effect distribution of excess contributions, adjusted for earnings through the date of correction, to HCEs to correct the failure. You must also contribute to the SEP-IRA an amount equal to the total amount distributed. This amount must be allocated to:
    - (i) current employees who were NHCEs in the year of the failure,
    - (ii) current NHCEs who were NHCEs in the year of the failure, or
    - (iii) employees (both current and former) who were NHCEs in the year of the failure.

**Example:**

Employer A has only one HCE who is a participant in the SARSEP. His compensation for 2008 is \$100,000. He defers \$6,000 into the SARSEP. The HCE's deferral percentage is 6% (6,000/100,000). Employer A also has three NHCEs who contributed deferral percentages of 3%, 4% and 5%. The average deferral percentage for the NHCEs is 4% (3%+4%+5%/3). The maximum deferral percentage the HCE could have made is 5% (4% times 1.25). The amount of the excess made by the HCE is \$1,000 or 1% of his salary (6% - 5% times \$100,000.)

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**Correction Program(s) Available:**

**SCP:**

The example illustrates an operational problem, in that the employer failed to follow the terms of the plan relating to nondiscrimination testing. Therefore, if the other eligibility requirements of SCP are satisfied, Employer A may use SCP to correct the failure.

- No fees for self-correction.
- Practices and procedures must be in place.

**VCP:**

Under VCP, correction is the same as described above. Employer A makes a VCP submission in accordance with Rev. Proc. 2008-50. The fee for the VCP submission is \$250.

**Audit CAP:**

Under Audit CAP, correction is the same as described above under VCP. Employer B and the IRS enter into a closing agreement outlining the corrective action and negotiate a sanction based on the [Maximum Payment Amount \(MPA\)](#).

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**How to Avoid the Mistake:**

Consider terminating the SARSEP and establish in a subsequent year a SIMPLE IRA plan, which is not subject to the discrimination testing. Communicate with the plan administrator to ensure proper employee classification. Ensure both you and the plan administrator are familiar with the terms of the plan. Perform a deferral percentage test annually in accordance with the

instructions provided in the plan document. Review the figures in the test against the payroll records, verify proper classification of employees as either HCE or NHCE, and ensure that the results meet the required limits.

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-----Trends-----		-----Tips-----		
Potential Mistake	How to Find the Mistake	How to Fix the Mistake		How to Avoid the Mistake
		Corrective Action	Correction Program(s) Available	
10. Have you made required top-heavy minimum contributions to the SARSEP? <a href="#">(More)</a>	Review the rules and definitions for top-heavy found in your plan document. Make a determination whether your plan is top-heavy or not for each plan year. <a href="#">(More)</a>	EPCRS Appendix A (section .02) Properly contribute and allocate the required top-heavy minimum, adjusted for earnings, to the affected non-key employees. <a href="#">(More)</a>	SCP* VCP Audit CAP <a href="#">(More)</a>	Perform a top-heavy test each year. If your plan is top-heavy or deemed top-heavy, ensure that you have made all top-heavy minimum contributions. <a href="#">(More)</a>

### 10) Have you made required top-heavy minimum contributions to the SARSEP?

You are required to make a minimum contribution for non-key employees whenever the SARSEP is top-heavy. A SARSEP is top-heavy when more than 60% of all employer contributions go to key employees. SARSEPs are often drafted to operate as if they were always top-heavy, thereby eliminating the need to make the annual 60% determination.

For purposes of determining if a plan is top-heavy, employee elective deferrals are considered employer contributions. Employee elective deferrals may not be used, however, to satisfy the minimum contribution requirements for top-heavy plans. For purposes of determining the top-heavy minimum contribution, employee elective deferrals made by key employees must be counted.

You 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% of each eligible non-key employee's compensation or
- The percentage of compensation at which elective (not including catch-up contributions) and nonelective contributions are made under this SARSEP (and any other SEP you maintain) for the year for the key employee with the highest percentage for the year.

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

- An officer of your company with compensation greater than \$160,000 in 2010 (subject to [cost-of-living adjustments](#) thereafter),
- A 5% owner of your company, as defined in §416(i)(1)(B)(i) of the Code, or
- A 1% owner of your company with compensation greater than \$150,000.

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#### **How to Find the Mistake:**

Review the top-heavy rules and definitions found in your plan document. Make the determination as to whether or not your plan is top-heavy for each plan year. Be careful to properly identify the owners and their family members that are employed by your business and apply the family aggregation rules.

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**How to Fix the Mistake:**

**Corrective Action:**

Under EPCRS, Appendix A, section .02, the permitted correction method for failure to provide the minimum top-heavy contribution is to:

- Identify the affected employees, and
- Properly contribute the required top-heavy minimum, adjusted for earnings, to the affected non-key employees.
- Top-heavy minimums in a SARSEP plan are equal to 3% of compensation.
  - However, if the highest percentage of contribution for a key employee is less than 3%, the top-heavy minimum is equal to that percentage.

**Example:**

Employer J, a husband and wife business, have sponsored a SARSEP plan for themselves since 1992. As business expanded, they hired two other employees on July 31, 2004. According to the terms of the plan document, both these new employees became eligible for the SARSEP plan on January 1, 2006. Both new employees made elective deferrals to the plan and it passed the DP test for 2006, 2007 and 2008. During a review of the plan, Employer J determined the plan was top-heavy for the 2007 and 2008 plan years; however, it did not make minimum top-heavy contributions.

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**Correction Program(s) Available:**

**SCP:**

The example illustrates an operational problem, in that the employer failed to follow the top-heavy provisions of the plan. Therefore, if the other eligibility requirements of SCP are satisfied, Employer J may use SCP to correct the failure.

- No fees for self-correction.
- Practices and procedures must be in place.

**VCP:**

Under VCP, correction is the same as described above under SCP. Employer J makes a VCP submission in accordance with Rev. Proc. 2008-50. The fee for the VCP submission is \$250.

**Audit CAP:**

Under Audit CAP, correction is the same as described above under SCP. Employer J and the IRS enter into a closing agreement outlining the corrective action and negotiate a sanction based on the [Maximum Payment Amount \(MPA.\)](#).

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**How to Avoid the Mistake:**

You should perform a top-heavy test each year. You should properly identify ownership interests under the family aggregation rules so that the test is accurate. Be especially careful if you have a smaller plan or one that only covered owners for a period and now has other participants.

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