

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 Simplified Employee Pension (SEP) plan. Use this checklist to help you keep your plan in compliance with many of the important rules. See [www.irs.gov/retirement](http://www.irs.gov/retirement) for online versions of this checklist, Fix-It Guides and other resources for SEPs and other plan types. On the online version of this checklist, click on "(More)" in any of the questions for additional information (including examples) on how to find, fix and avoid each mistake.

**1. Has your SEP been amended for current law?** Yes No

Laws related to retirement plans change quite frequently. You will need to change plan language and operation to keep the plan within the law.

[\(More\)](#)

**2. Is the business that the SEP covers the only business you own?** 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 this SEP.

[\(More\)](#)

**3. Are all eligible employees participating in the SEP?** Yes No

Any employee who is at least 21 years of age, was employed by you for 3 of the immediately preceding 5 years, and received compensation from you of at least \$550 during the year (subject to cost-of-living adjustments after 2011) is eligible to participate in a SEP.

[\(More\)](#)

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

Compensation used to determine contributions generally includes all bonuses and commissions and is limited to \$245,000 for 2011, subject to cost-of-living adjustments in later years.

[\(More\)](#)

**5. Are contributions to each participant's SEP-IRA a uniform percentage of the participant's compensation?** Yes No

Employer contributions to a SEP must be the same percentage of compensation of each employee maintaining a SEP-IRA in the plan.

[\(More\)](#)

**6. Are SEP contributions to each participant's IRA limited as required by the Internal Revenue Code?** Yes No

All SEP contributions must go to traditional IRAs set up for the eligible employees and are limited to the lesser of 25% of compensation or \$49,000 for 2011, subject to cost-of-living adjustments in later years..

[\(More\)](#)

**If you answered "No" to any of the above questions, you may have a mistake in the operation of your SEP plan. 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/retirement](http://www.irs.gov/retirement)**      ■ **call the IRS at (877) 829-5500**

## SEP Plan Fix-It Guide

### Common Problems, Real Solutions

Potential Mistake	Find the Mistake	Fix the Mistake	Avoid the Mistake
1) You have not updated your SEP plan document for current law <a href="#">(More)</a> <a href="#">(Video)</a>	Determine if your Form 5305-SEP is the current revision (December 2004) <a href="#">(More)</a>	Adopt revised Form 5305-SEP <a href="#">(More)</a>	Maintain regular contact with the company that sold you the plan <a href="#">(More)</a>
2) The plan excluded employees of related businesses from participating <a href="#">(More)</a>	Identify any companies that you own or with which you have a financial relationship <a href="#">(More)</a>	Apply reasonable correction method that would place affected employees in the position they would have been in if there were no operational plan mistakes <a href="#">(More)</a>	Determine if you own any other businesses <a href="#">(More)</a>
3) The plan excluded an eligible employee from participating <a href="#">(More)</a> <a href="#">(Video)</a>	Review eligibility and participation plan document sections. Check when employees are entering the plan <a href="#">(More)</a>	Corrective contribution that would place affected employees in the position they would have been in if there were no operational plan mistakes <a href="#">(More)</a>	Review the participation status of all employees at least once a year <a href="#">(More)</a>
4) Contributions to participants' SEP-IRAs were miscalculated because the wrong definition of compensation was used <a href="#">(More)</a> <a href="#">(Video)</a>	Review the plan document to determine if you are using the proper compensation for allocations <a href="#">(More)</a>	Correction is based upon the terms of the plan at the time of the mistake <a href="#">(More)</a>	Review the plan terms to ensure that you are considering the correct amount of compensation when calculating contributions <a href="#">(More)</a>
5) Contributions to each participant's SEP-IRA were not a uniform percentage of the participant's compensation <a href="#">(More)</a>	Divide contributions by compensation for each employee <a href="#">(More)</a>	Corrective contribution that would place affected employees in the position they would have been in if there were no operational plan mistakes <a href="#">(More)</a>	After the initial calculation of allocations based on the plan terms, verify that all proposed contributions are based on a uniform percentage of participants' compensation <a href="#">(More)</a>
6) Contributions to the SEP-IRA exceeded the maximum legal limits <a href="#">(More)</a> <a href="#">(Video)</a>	Calculate 25% of each employee's compensation and compare total contribution made for the employee to the lesser of that amount or the dollar limitation for that year (\$49,000 in 2011) <a href="#">(More)</a>	Either distribute or retain the excess amount <a href="#">(More)</a>	After the initial calculation of allocations based on the terms of the plan, check to make sure none of the proposed allocations would violate the Code <a href="#">(More)</a>

## SEP Plan - Overview

A SEP is a **Simplified Employee Pension** plan. To establish a SEP, the employer:

- Can be a business of any size, even self-employed.
- Must adopt a SEP plan document.

Under a SEP, the employer makes contributions to traditional IRAs set up for eligible employees (including self-employed individuals), subject to certain limits. A SEP is funded solely by employer contributions. Each employee is always 100% vested in (or, has ownership of) all money in his or her SEP-IRA.

There are three basic steps in setting up a SEP.

- 1) Execute a formal written agreement to provide benefits to all eligible employees.
- 2) Give employees certain information about the SEP.
- 3) Set up a SEP-IRA for each eligible employee.

**Formal written agreement.** You must execute a formal written agreement to provide benefits to all eligible employees under a SEP. You can satisfy the written agreement requirement by adopting an IRS model SEP using [Form 5305-SEP](#).

If you use Form 5305-SEP, no prior IRS approval or determination letter is required. Keep the original form. Do not file it with the IRS. Also, using Form 5305-SEP will usually relieve you from filing annual retirement plan information returns with the IRS and Department of Labor. See the Form 5305-SEP instructions for details.

**When not to use Form 5305-SEP.** You cannot use Form 5305-SEP if you:

- 1) Currently maintain any other qualified retirement plan.
- 2) Have any eligible employees for whom you have not set up IRAs.
- 3) Use the services of leased employees.
- 4) Are a member of any of the following, unless eligible employees of all the members of these groups, trades or businesses participate under the SEP.
  - a. An affiliated service group described in §414(m) of the Code.
  - b. A controlled group of corporations described in §414(b) of the Code.
  - c. Trades or businesses under common control described in §414(c) of the Code.

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

**Information you must give to employees.** You must give each eligible employee a copy of Form 5305-SEP, its instructions and the other information listed in the Form 5305-SEP instructions. An IRS Model SEP is not considered adopted until you give each employee this information. If you adopt a prototype SEP, 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 SEP contributions to the financial institution where the SEP-IRA is maintained.

**Deadline for setting up a SEP.** A SEP can be set up for a year as late as the due date (including extensions) of the business's income tax return for that year.

### **Who is eligible to participate?**

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

- Have not worked for you during three out of the last five years.
- Have not reached age 21.
- 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."

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

By establishing a SEP, you have adopted a plan that requires a SEP-IRA to hold the contributions made for each of the eligible employees. A SEP is funded by employer contributions. The SEP plan document will indicate the amounts you have agreed to contribute. This amount can be discretionary, including zero. The SEP document must include a definite written allocation formula for determining how the contribution is allocated to the employees' SEP-IRAs.

SEP contributions must bear a uniform relationship to compensation. Generally, a uniform relationship means that each employee's contribution must represent the same percentage of compensation. Nonuniformity is possible with a permitted disparity formula (see §408(k)(3)(D) of the Code). The amount of compensation taken into account under the plan cannot exceed \$245,000 in 2011, and is subject to [cost-of-living adjustments](#) for later years.

Total contributions to each employee's SEP-IRA cannot exceed the lesser of \$49,000 for 2011, (subject to [cost-of-living adjustments](#) for later years) or 25% of compensation. Each employee is always 100% vested in (or, has ownership of) all contributions to his or her SEP-IRA.

After you send the SEP contributions to the financial institution, it will manage the funds. Depending on the financial institution, SEP contributions can be invested in individual stocks, mutual funds and other, similar types of investments.

Each participating employee must receive an annual statement stating the amount contributed to the SEP-IRA for the year.

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

Employees can withdraw SEP 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 SEP contributions and earnings tax-free to other IRAs and retirement plans.

SEP contributions and earnings must eventually be distributed. A [specific minimum amount](#) is required to be distributed by April 1 of the year following the year the employee reaches age 70½.

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

An employer generally has no filing requirements. The annual reporting required for qualified plans (Form 5500 series) is normally not required for SEPs. 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 SEP plan, you may utilize the IRS's Employee Plans Compliance Resolution System 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, 2008-35 I.R.B. 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, any time before audit, to 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:**

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

**Audit CAP:**

- The plan sponsor or plan is under examination.
- The plan sponsor:
  - 1) enters into a Closing Agreement with the IRS
  - 2) effects correction prior to entering into the Closing Agreement
  - 3) 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 for employees in the plan (Form 1040), including the tax on plan distributions that have been rolled over to other IRAs (and any interest and penalties applicable to the employees' tax return).
  - 2) Additional tax resulting from the 6% tax imposed under §4973 of the Code on excess contributions to IRAs.

[Return to Table](#)

Potential Mistake	Find the Mistake	Fix the Mistake	Avoid the Mistake
1) You have not updated your SEP plan document for current law <a href="#">(More)</a> <a href="#">(Video)</a>	Determine if your Form 5305-SEP is the current revision (December 2004) <a href="#">(More)</a>	Adopt revised Form 5305-SEP <a href="#">(More)</a>	Maintain regular contact with the company that sold you the plan <a href="#">(More)</a>

## 1) You have not updated your SEP plan document for current law.

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. Also, these law changes might mean you can simplify some areas of plan administration or improve benefits. You will need to change plan language and operation to keep the plan within the law and to take advantage of increased benefit limits.

[Return to Table](#)

### How to Find the Mistake:

At some point in the plan's existence, you may be asked to demonstrate your plan has been in compliance 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 be asked to demonstrate the plan has complied with all current and prior law, sometimes reaching back several years.

You may have a written plan document that is a model SEP ([Form 5305-SEP, Simplified Employee Pension - Individual Retirement Accounts Contribution Agreement](#)) or a [pre-approved plan](#). The IRS has already favorably reviewed both model SEPs and pre-approved plans.

If your plan is a [Form 5305-SEP](#) that is the current revision (December 2004), 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 even if you do not apply for a determination letter. Individually designed SEPs must be updated for law changes. If you have this situation, consult your tax advisor.

[Return to Table](#)

### How to Fix the Mistake:

#### Corrective Action:

If you have not amended your plan timely for law changes, you should adopt the latest revision of Form 5305-SEP (dated December 2004) or adopt the latest revised document (approved for EGTRRA) provided by your financial institution. You will need to confirm that the operation of the plan is consistent with the plan's terms.

#### Example:

Employer Y established a SEP in 1995 using a prototype plan and never subsequently amended for any law changes.

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. To benefit under these new provisions, employers must amend their SEP prototype and individually designed plans for



current law. For employers with model SEP plans to avail themselves of the latest law changes, they must adopt the latest model Form 5305-SEP (for EGTRRA it must have a revision date of March 2002 or later).

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

##### **SCP:**

Employer Y may not correct this mistake under SCP. SCP is limited to operational problems, and this mistake is the result of the failure to keep the plan language up to date. To retain plan qualification, Employer Y must correct this mistake using VCP.

##### **VCP:**

Employer Y would make 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 \(MPA\)](#).

[Return to Table](#)

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

There are a number of ways to avoid this mistake:

- Do an annual review of your plan document.
- Knowing your plan is up to date may or may not be a simple process. If you use a Form 5305-SEP, annually check [www.irs.gov/retirement](http://www.irs.gov/retirement) to determine the most recent version of the Form. Certain plans must be individually amended for each change, while others may have a prototype document that is amended. We recommend you maintain contact, on at least a yearly basis, with the company that sold you 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.

[Return to Table](#)



Potential Mistake	Find the Mistake	Fix the Mistake	Avoid the Mistake
2) The plan excluded employees of related businesses from participating <a href="#">(More)</a> <a href="#">(Video)</a>	Identify any companies that you own or with which you have a financial relationship <a href="#">(More)</a>	Apply reasonable correction method that would place affected employees in the position they would have been in if there were no operational plan mistakes <a href="#">(More)</a>	Determine if you own any other businesses <a href="#">(More)</a>

## 2) The plan excluded employees of related businesses from participating.

“Employees” for purposes of determining who is an eligible employee under a SEP 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 your SEP.

[Return to Table](#)

### How to Find the Mistake:

All owners or partners of your business should identify any companies they own or with which they have a financial relationship. If any of these companies or relationships exist, the requirements of §§414(b), (c) and (m) of the Code should be scrutinized to ensure that all required employees are included in the plan.

[Return to Table](#)

### How to Fix the Mistake:

#### Corrective Action:

Generally, if you did not provide an employee the opportunity to participate in your SEP plan, you must make a contribution to the plan for the employee that compensates for the missed contribution. You should treat the employees of the related business as improperly excluded employees, and you should make corrective contributions for each excluded employee of the related business. 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:

Edward owns Business A, a restaurant that has 40 employees. Edward also owns Business B, a copy shop that has 30 employees. Edward established a SEP plan in 2009 and only the eligible employees in Business A were included in the plan.

#### Reasonable Correction:

The 30 employees of Business B are eligible employees who Business B improperly excluded. 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 SEPs in most cases since IRAs hold the assets of the plan. The contribution method requires the employer to make a corrective contribution to the plan. The corrective contribution is determined taking into account the excluded employees’ compensation. 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, Edward would contribute an amount equal to the same percentage of compensation to each of the 30 excluded employees as was made to the 40 included employees for the 2009-year (adjusted for earnings) or an alternative correction method that satisfies Revenue Procedure 2008-50's general correction principles.

**Correction Program(s) Available:**

**SCP:**

The example illustrates a significant operational problem, because the employer failed to follow the terms of the plan by improperly excluding employees from Business B. Because this example is a significant operational failure, SCP is not available for the mistake and must be corrected using VCP.

**VCP:**

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

[Return to Table](#)

**How to Avoid the Mistake:**

You and all owners or partners of your business should review 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 and payroll records necessary to make eligibility decisions for all employees of all related employers.

[Return to Table](#)

Potential Mistake	Find the Mistake	Fix the Mistake	Avoid the Mistake
3) The plan excluded an eligible employee from participating <a href="#">(More)</a> <a href="#">(Video)</a>	Review eligibility and participation plan document sections. Check when employees are entering the plan <a href="#">(More)</a>	Corrective contribution that would place affected employees in the position they would have been in if there were no operational plan mistakes <a href="#">(More)</a>	Review the participation status of all employees at least once a year <a href="#">(More)</a>

### 3) The plan excluded eligible employees from participating in the SEP.

You must allow all eligible employees to participate, 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 three of the immediately preceding five years.

The term “employee” includes both a self-employed individual who has earned income and a working business owner.

You must treat certain leased employees as “employees.”

Your SEP 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 SEP may not impose an hours-of-service requirement.

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

- 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 2011.

You may not exclude employees simply because they are classified as “part-time” or “seasonal.” “Employees,” for determining who is an eligible employee under a SEP, 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 your SEP.

Example 1: Employer X maintains a calendar year SEP. The eligibility requirements under the SEP are: an employee must perform service in at least three of the immediately preceding five years, reach age 21 and earn the minimum amount of compensation during the current year. Andy 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, Andy turned 21. In August 2010, Andy began working for Employer X on a full-time basis, earning \$12,000 in 2010. Andy is an eligible employee in 2010 because he met the minimum age requirement, worked for Employer X in three of the five preceding years and met the 2010 minimum compensation requirement.

Example 2: Employer Y designs its SEP to provide for immediate participation regardless of age, service or compensation. Bill is age 18, and began working part-time for Employer Y in 2010. Bill is an eligible employee for 2010.

[Return to Table](#)

**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.

[Return to Table](#)

**How to Fix the Mistake:**

**Corrective Action:**

Generally, if you did not provide an employee the opportunity to participate in your SEP plan, you must make a contribution to the plan for the employee that compensates for the missed contribution. The corrective contribution is an employer contribution that is intended to place the employee in the same position had he/she participated in the plan timely. Open a SEP-IRA for the excluded employee and make contributions to the SEP-IRA equal to the same percentage of compensation received by other employees. Increase the amount contributed to reflect missed earnings through the date of correction. Do not reduce other employees' SEP-IRAs.

**Example:**

Employer D maintains a SEP plan for its 20 employees. The plan provides that the contributions are allocated to the SEP-IRAs in the ratio that each eligible employee's compensation for the year bears to the compensation of all eligible employees for the year. For 2009, Employer D made a contribution to the plan of a fixed dollar amount. However, Employer D inadvertently excluded one part-time employee who met the eligibility requirements for participating in the plan. The employee had terminated during the plan year and did not receive an allocation of the contribution. The contribution resulted in an allocation for each of the eligible employees, other than the excluded employee, equal to 10% of compensation. Most of the employees who received allocations under the plan for the year of the failure were nonhighly compensated employees. If the one excluded employee had shared in the original allocation, the allocation made for each employee would have equaled 9% of compensation.

**Reasonable Correction:**

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 SEPs in most cases since the assets of the plan are held in IRAs. The contribution method requires the employer to make a corrective contribution to the plan. The corrective contribution is determined taking into account the excluded employees' compensation. 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, Employer D would contribute an amount equal to 10% of the excluded employee's compensation for the 2009 year (adjusted for earnings), and does not adjust the 10% allocations that were made to the other employees.

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

### **SCP:**

The example illustrates an insignificant operational problem, because the employer failed to follow the terms of the plan by failing to give one employee an allocation of the employer contribution to the plan for the 2009 year. Therefore, if the other eligibility requirements of SCP are satisfied, Employer D 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 D 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." Employer D and the IRS enter into a Closing Agreement outlining the corrective action and negotiate a sanction based on the [Maximum Payment Amount \(MPA\)](#).

[Return to Table](#)

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

Review 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 and payroll records necessary to make eligibility decisions for all employees.

[Return to Table](#)

Potential Mistake	Find the Mistake	Fix the Mistake	Avoid the Mistake
4) Contributions to participants' SEP-IRAs were miscalculated because the wrong definition of compensation was used <a href="#">(More)</a> <a href="#">(Video)</a>	Review the plan document to determine if you are using the proper compensation for allocations <a href="#">(More)</a>	Correction is based upon the terms of the plan at the time of the mistake <a href="#">(More)</a>	Review the plan terms to ensure that you are considering the correct amount of compensation when calculating contributions <a href="#">(More)</a>

#### 4) Contributions to the participants' SEP-IRAs were miscalculated because the wrong definition of compensation was used.

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 2011 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 the 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.

[Return to Table](#)

#### How to Find the Mistake:

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

Spot-check allocations to see if you are using the correct compensation. If you are using the Form 5305-SEP, make sure you are basing allocations on total compensation. If you have a plan with a complicated definition of compensation, develop a worksheet to calculate the correct amounts. 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.

[Return to Table](#)

#### How to Fix the Mistake:

##### Corrective Action:

You would make a corrective contribution, including earnings, for the affected employees.

##### Example:

Employer G operates a restaurant with 15 employees. Under the terms of the SEP document, compensation for determining allocations of the employer contribution is total wages earned including bonuses, tips and other income reported on the Form W-2. Since the inception of the

plan, it was determined that Employer G considered bonuses and other income for the contribution allocation, but tips had not been included.

**Reasonable Correction:**

Recalculate the contribution amounts based on the correct definition of compensation. If compensation was understated, make corrective contributions to the SEP-IRAs of affected employees, adjusted for earnings through the date of correction.

**Correction Program(s) Available:**

**SCP:**

The example illustrates an operational problem, because Employer G failed to follow the plan terms by not including tips in compensation used to determine allocations under the plan. Therefore, if the other eligibility requirements of SCP are satisfied, Employer G 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." Employer G 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." Employer G and the IRS enter into a Closing Agreement outlining the corrective action and negotiate a sanction based on the [Maximum Payment Amount \(MPA\)](#).

[Return to Table](#)

**How to Avoid the Mistake:**

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

[Return to Table](#)



Potential Mistake	Find the Mistake	Fix the Mistake	Avoid the Mistake
5) Contributions to each participant's SEP-IRA were not a uniform percentage of the participant's compensation <a href="#">(More)</a>	Divide contributions by compensation for each employee <a href="#">(More)</a>	Corrective contribution that would place affected employees in the position they would have been in if there were no operational plan mistakes <a href="#">(More)</a>	After the initial calculation of allocations based on the plan terms, verify that all proposed contributions are based on a uniform percentage of participants' compensation <a href="#">(More)</a>

### 5) Contributions to each participant's SEP-IRA were not a uniform percentage of the participant's compensation.

Unless the SEP plan has an allocation formula that involves permitted disparity (and most SEP documents, including the model SEP, Form 5305-SEP, do not allow for permitted disparity), employer contributions to participants' SEP-IRAs must be equal to the same percentage of compensation (as limited - see Question 4) of each participant.

[Return to Table](#)

#### How to Find the Mistake:

Divide contributions made to each employee's SEP-IRA by their compensation for the year. The result should be the same for all participating employees.

[Return to Table](#)

#### How to Fix the Mistake:

##### Corrective Action:

Generally, if you did not provide an employee the correct contribution in your SEP plan, you must make a contribution to the plan for the employee that places the employee in the position he or she would have been in you had not made the mistake. Make a contribution to the SEP-IRA equal to the same percentage of compensation received by other employees. Increase the amount contributed to reflect missed earnings through the date of correction. Do not reduce other employees' SEP-IRAs.

##### Example:

Employer Q maintains a SEP plan for its 20 employees. The plan provides that the contributions are allocated to participants' SEP-IRAs in the ratio that each eligible employee's compensation for the year bears to the compensation of all eligible employees for the year. For 2009, Employer Q made a contribution to the plan of a fixed dollar amount. All of the employees except Jim received a contribution in the amount of 8% of compensation. Jim's contribution was in the amount of 5% of his compensation.

##### Reasonable Correction:

Employer Q should make an additional contribution to Jim's SEP-IRA in the amount of 3% (8% allocation to other employees less 5% already made to Jim's SEP-IRA) of his compensation plus earnings through the date of correction. No adjustments are made to the employees who shared in the prior allocation, even though their allocations would have been different had Employer Q not made the mistake.

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

### **SCP:**

The example illustrates an insignificant operational problem, because the employer failed to follow the terms of the plan by failing to give one employee the proper allocation of the employer contribution to the plan for the 2009 year. Therefore, if the other eligibility requirements of SCP are satisfied, Employer Q 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 Q 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." Employer Q and the IRS enter into a Closing Agreement outlining the corrective action and negotiate a sanction based on the [Maximum Payment Amount \(MPA\)](#).

[Return to Table](#)

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

After the initial calculation of allocations based on the terms of the plan, you should check to make sure all of the proposed allocations are in an equal percentage of compensation. If there is a problem, you can adjust it before you transfer the money into the SEP IRAs.

[Return to Table](#)

Potential Mistake	Find the Mistake	Fix the Mistake	Avoid the Mistake
6) Contributions to the SEP-IRA exceeded the maximum legal limits <a href="#">(More)</a> <a href="#">(Video)</a>	Calculate 25% of each employee's compensation and compare total contribution made for the employee to the lesser of that amount or the dollar limitation for that year (\$49,000 in 2011) <a href="#">(More)</a>	Either distribute or retain the excess amount <a href="#">(More)</a>	After the initial calculation of allocations based on the terms of the plan, check to make sure none of the proposed allocations would violate the Code <a href="#">(More)</a>

## 6) Contributions to each participant's SEP-IRA exceeded the maximum legal limits.

All contributions made to a SEP are employer contributions.

Section 415 of the Internal Revenue Code limits the amount of contributions made to an employee's SEP-IRA. Contributions made to each employee's SEP-IRA cannot exceed the lesser of \$49,000 for 2011 (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 2011 (subject to [cost-of-living adjustments](#) for later years). If your SEP 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.

[Return to Table](#)

### How to Find the Mistake:

Calculate 25% of each employee's compensation (limited to \$245,000 in 2011) 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 2011). Review the special calculations in Publication 560 for self-employed individuals.

[Return to Table](#)

### 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 amount in excess of the annual limit, adjusted for earnings through the date of correction, should be distributed from the SEP-IRA and returned to the employer. The distributed amount is not included in the income of the affected employee, but is reported on Form 1099-R with a taxable amount of zero. Alternatively, the excess amount may be retained in the SEP-IRA, but only if the plan sponsor pays an additional fee of 10% of the excess amount, excluding earnings.

**Example:**

Employer I maintains a SEP plan. For the 2009 year, the contributions made for 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.

**Correction Program(s) Available:**

**SCP:**

The example illustrates an operational problem, because 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.

- 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 corrects under the retention method described above under “Corrective Action” (#2), the Rev. Proc. imposes an additional fee equal to at least 10% of the excess amount excluding earnings 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 \(MPA\)](#).

[Return to Table](#)

**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 SEP-IRA. If there is a problem, you can adjust it before you transfer the money into the SEP-IRAs.

[Return to Table](#)