Simplified Employee Pension (SEP)

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Simplified Employee Pension (SEP)

The Concept

- A simplified employee pension (SEP) is an arrangement sponsored and managed by an employer.
- The employer can make contributions to an employee's individual retirement account or individual retirement annuity (IRA) that has been established for that purpose.

The Appeal

- The employer can establish a SEP by completing an IRS model form or using a financial institution prototype document, or can establish a customized arrangement subject to IRS approval.
- A SEP is easier to administer than a 401(k) plan or other qualified retirement plan because ERISA reporting and disclosure requirements are greatly reduced.
- The employer is not required to contribute every year.

Who Can Participate

- Eligible employees must be allowed to participate in the SEP.
- To be eligible, an employee must have:
  - Reached age 21.
  - Worked for the employer for at least three of the past five years.
  - Received at least $800 (for 2026) in compensation from the employer.
- These requirements must be met in each year that the company makes a contribution for the employee.

The Process

- The employer contributes to an IRA established for each participating employee with a financial institution, bank, or annuity provider.
- In 2026, the IRS limits employer contributions to each employee's SEP-IRA to the lesser of $72,000 or 25% of the employee's pay up to a maximum annual income of $360,000.
- The SEP generally allocates employer contributions to each employee's IRA as a uniform percentage.
- An employee is always 100% vested in employer contributions to an IRA.
- Employees may also contribute up to the annual limits for traditional IRAs.

The Tax Picture

- SEPs offer the usual tax characteristics of qualified retirement plans.
- The employer may deduct contributions up to a specified maximum.
- Employees are not taxed on employer contributions made on their behalf.
- Earnings inside the SEP accumulate on a tax-deferred basis.

- Distributions from SEP-IRAs are taxed as ordinary income.
- Distributions prior to age 59½ can incur an additional 10% penalty tax on the taxable portion of a distribution, unless certain exceptions apply.
- Distributions must begin after the participant reaches age 73, with a 25% penalty tax (or 10% if corrected promptly) applied to any amount that should have been distributed but was not.

The Bottom Line

A SEP gives employers an opportunity to enhance employee morale and retention by establishing retirement benefits without taking on the complexities and administrative headaches of other qualified retirement plans.

Summary

What Are Simplified Employee Pensions?

Some employers hesitate to establish a qualified employee retirement arrangement because of the administrative hassles and expense. An attractive alternative is a simplified employee pension, or SEP. SEPs are an effective way to provide employee retirement benefits with minimal paperwork and reporting requirements.

SEPs may be suitable for employers who don't want to be locked in to making contributions every year. The employer can choose whether to contribute based on business performance and capital needs.

How Do They Work?

Under a SEP arrangement, the employer makes contributions to individual retirement accounts and/or individual retirement annuities (IRAs) that have been established for eligible employees. The employer has three options when setting up the SEP: adopt an IRS model agreement, use a financial institution's prototype, or create a custom-designed SEP (with IRS approval).

Eligible employees must be allowed to participate in the SEP. To be eligible, the employee must have:

- Reached age 21.
- Worked for the employer for at least three of the past five years.
- Received at least $800 (for 2026) in compensation from the employer.

These requirements must be met in each year that the company makes a contribution for the employee.

What Are the Contribution Limits?

An employer can make deductible contributions to an employee's SEP-IRA up to certain limits. In 2026, contributions must be the lesser of 25% of the employee's compensation (not exceeding $360,000) or a specified dollar limit ($72,000).

A SEP doesn't allow contributions that discriminate in favor of highly compensated employees.

All contributions are fully vested in the employee, who can withdraw the money at any time. Withdrawals are taxed as ordinary income when they are received, and an additional 10% penalty tax may apply to distributions taken before age 59½ unless certain exceptions apply.

Participants must begin receiving payments—at least a minimum required amount—by April 1 of the year following the calendar year in which they reach 73. A 25% penalty tax applies to any amount that should have been paid out but wasn't (10% if the distribution error is corrected quickly).

What's the Conclusion?

A SEP gives employers the opportunity to boost employee morale and improve retention by establishing a retirement benefit without taking on the administrative headaches of other types of retirement plans. A SEP requires minimal paperwork, reporting, and bookkeeping, with the flexibility to decide whether and how much to contribute each year. Employer contributions are also tax deductible. Employees benefit as a result of tax-deferred contributions and earnings.

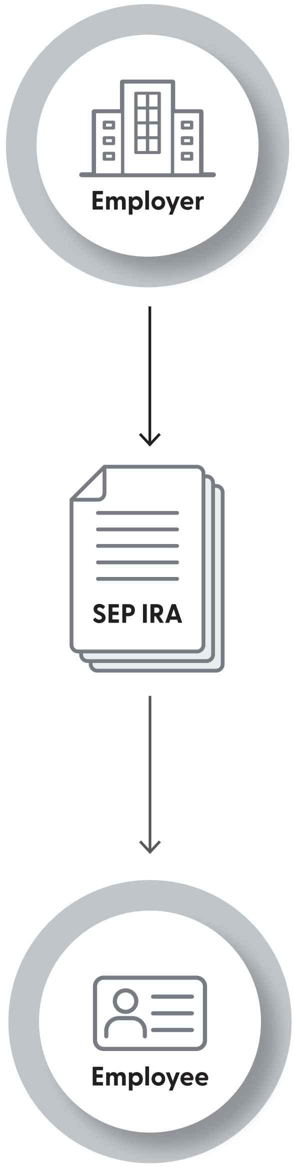
SIMPLIFIED EMPLOYEE PENSION (SEP)

1

An eligible employer who wants an easy-to-administer retirement plan creates a simplified employee pension plan.

2

The employee opens an IRA (or the employer opens one for the employee).



3

The employer makes contributions to the employee's SEP-IRA. Contributions are deductible by the employer (up to annual limits) and tax deferred to the employee. Earnings inside the plan grow tax deferred.

4

The employee may begin taking distributions from the plan at age 59½ and must begin taking distributions by age 73 or actual retirement, if later. Early distributions face a 10% penalty (with some exceptions). A 25% penalty applies to any amount that should have been taken but was not (10% if corrected promptly). Distributions are taxed as ordinary income.

This information is not intended to be a substitute for specific individualized tax advice. We suggest that you discuss your specific tax issues with a qualified tax advisor.

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