

THE Pension Digest

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2001 Form 5498

The IRS has issued the 2001 version of Form 5498. The form and the IRS' instructions to the participant, and the IRS' instructions to the IRA custodian/trustee are set forth below.

Changes in the Form

A new box has been added — Box 4 was changed to represent recharacterization amounts, and all the boxes after it have been renumbered. This should make tracking recharacterization amounts much more simple. Box 7 (Box 6 on the 2000 form) now has only 5 choices rather than 6, since the "recharacterization" box has been deleted.

Completion of Form

Other than the addition of Box 4 for recharacterization amounts (used only for the traditional or Roth IRA) and the subsequent renumbering of the boxes, the completion of the form remains the same as for the 2000 form.

The type of IRA is indicated in box 7, and the information regarding the IRA is furnished in the other boxes.

For a traditional IRA, the boxes that need to be completed, if applicable, are 1, 2, 4, 5, and 7.

For a SEP-IRA, the boxes that need to be completed, if applicable, are 1, 2, 4, 5, 7, and 8. Keep in mind that a SEP participant may make his or her traditional IRA contribution to the same SEP-IRA that receives "employer" contributions.

For a SIMPLE-IRA, the boxes that need to be completed, if applicable, are 2, 5, 7, and 9.

For a Roth IRA, the boxes that need to be completed, if applicable, are 2, 3, 4, 5, 7, and 10.

For an Education IRA, the boxes that need to be completed, if applicable, are 2, 5, 7, and 11.

Deadlines

- January 31, 2002 — Furnish the fair market value to participants in all types of IRAs.
- January 31, 2002 — Furnish 5498 to beneficiaries and responsible parties of Education IRAs.
- April 15, 2002 — Contribution deadline for regular traditional and Roth IRA contributions.
- May 31, 2002 — Furnish 5498 to accountholders of all IRAs except the Education IRA.
- May 31, 2002 — IRS deadline for 5498s for all types of IRAs. ♦

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IMPORTANT CORRECTION

The February newsletter contained a comprehensive discussion of recharacterizing an IRA contribution for tax year 2000 in 2001. Because taxpayers have 6 months after the tax filing deadline (4/16/2001) to make such recharacterization for tax year 2000 or until 10/16/01, IRA custodians may well be asked to still help with such recharacterization. When we wrote this article the IRS had not yet issued their 2001 version of the Form 5498. The IRS has recently issued such form. As discussed in the accompanying article the IRS has finally made the "right" decision — have a box (i.e. box 4) solely devoted to recharacterizations rather than as in past years trying to get by using the rollover box. The February article is still worthwhile as long as you are aware of the revised Form 5498.

5498 for 2001
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☐ CORRECTED (if checked)

TRUSTEE'S or ISSUER'S name, street address, city, state, and ZIP code		1 IRA contributions (other than amounts in boxes 2, 3, 4, and 8-11) \$	2 Rollover contributions \$	OMB No. 1545-0747 2001 Form 5498	IRA Contribution Information
TRUSTEE'S or ISSUER'S federal identification no.	PARTICIPANT'S social security number	3 Roth conversion amount \$	4 Recaptured contributions \$	Copy B For Participant This information is being furnished to the Internal Revenue Service.	
PARTICIPANT'S name Street address (including apt. no.) City, state, and ZIP code		5 Fair market value of account \$	6 Life insurance cost included in box 1 \$		
Account number (optional)		7 IRA SEP SIMPLE Roth IRA Ed IRA <input type="checkbox"/> <input type="checkbox"/> <input type="checkbox"/> <input type="checkbox"/> <input type="checkbox"/>	8 SEP contributions \$		
		9 SIMPLE contributions \$	10 Roth IRA contributions \$		
		11 Ed IRA contributions \$			

Form **5498** (Keep for your records.) Department of the Treasury - Internal Revenue Service

Instructions to Participant

The information on Form 5498 is submitted to the Internal Revenue Service by the trustee or issuer of your individual retirement arrangement (IRA) to report contributions and the fair market value of the account. For information about IRAs, see Pub. 590, Individual Retirement Arrangements (IRAs), and Pub. 580, Retirement Plans for Small Business.

Reminder: If you converted from a traditional IRA, simplified employee pension (SEP) IRA, or savings incentive match plan for employees (SIMPLE) IRA to a Roth IRA in 1998 and you elected to spread the taxable income over 4 years, you must include one-fourth of the taxable amount converted in your income in 2001. See your Form 1040 instructions.

Box 1. Shows traditional IRA contributions for 2001 you made in 2001 and through April 15, 2002. These contributions may be deductible on your Form 1040 or 1040A. However, if you or your spouse was an active participant in an employer's pension plan, these contributions may not be deductible. This box does not include amounts in boxes 2-4 and 8-11.

Box 2. Shows any rollover, including a direct rollover to a traditional IRA, you made in 2001. It does not show any amounts you converted from your traditional IRA, SEP IRA, or SIMPLE IRA to a Roth IRA. They are shown in box 3. See the Form 1040 or 1040A instructions for information on how to report rollovers. If you have ever made any nondeductible contributions to your traditional IRA or SEP IRA and you did not roll over the total distribution, use Form 8606, Nondeductible IRAs, to figure the taxable amount. If property was rolled over, see Pub. 590.

Box 3. Shows the amount converted from a traditional IRA, SEP IRA, or SIMPLE IRA to a Roth IRA in 2001. Use Form 8606 to figure the taxable amount.

Box 4. Shows amounts recharacterized from transferring any part of the contribution (plus earnings) from one type of IRA to another. See Pub. 590.

Box 5. Shows the fair market value of your account at year end.

Box 6. For endowment contracts only, shows the amount allocable to the cost of life insurance. Subtract this amount from your allowable IRA contribution included in box 1 to compute your IRA deduction.

Box 7. May show the kind of IRA reported on this Form 5498.

Box 8. Shows SEP contributions made in 2001, including contributions made in 2001 for 2000, but not including contributions made in 2002 for 2001. If made by your employer, do not deduct on your income tax return. If you made the contributions as a self-employed person (or partner), they may be deductible. See Pub. 560.

Box 9. Shows SIMPLE contributions made in 2001. If made by your employer, do not deduct on your income tax return. If you made the contributions as a self-employed person (or partner), they may be deductible. See Pub. 560.

Box 10. Shows Roth IRA contributions you made in 2001 and through April 15, 2002. Do not deduct on your income tax return.

Box 11. Shows education IRA (Ed IRA) contributions made in 2001 on your behalf. Do not deduct on your income tax return. If the total of all contributions made to all your Ed IRAs this year exceeded \$500, you should withdraw the excess, plus earnings, generally by April 15, or you may owe a penalty. You must keep track of your Ed IRA basis (contributions and distributions). See Pub. 590.

SEP, PROFIT SHARING, MONEY PURCHASE OR SIMPLE — WHICH PLAN IS BEST?

There have been three important changes since we ran a similar article in April of 1999.

- The elective deferral limit for employees has been increased to \$6,500 for 2001. For 2000 and prior years, the limit had been \$6,000. This change makes the SIMPLE plan more attractive.

- The 415(c) limit has been raised from the lesser of 25% of compensation, or \$30,000, to the lesser of 25% of compensation, or \$35,000. This change makes the money purchase plan a more viable option for employees.

- The contribution limit was raised to \$170,000 for 2000. This amount also applies for 2001.

An employer will want to consider these changes and how they affect the various pension plans, when deciding which plan to establish. A SIMPLE plan is many times the better plan. In brief, a one-person business will generally be better off (i.e. allows a larger contribution) with a SIMPLE-IRA when his or her net profit is less than \$41,142.

For example, a person who is an employee for another business, but who has a small business of his or her own, with a net profit of \$18,000, would certainly benefit from a SIMPLE-IRA plan. In contrast, a person with net profits in excess of \$69,646, will normally be better off with a profit sharing or money purchase plan since it will allow for a larger contribution than with a SIMPLE-IRA plan. There are also situations in which the owner of a multiple-employee business may wish to establish a SIMPLE-IRA plan rather than any of the other types of pension plans.

The following charts and discussion include the revised contribution and income limits as now allowed by the Internal Revenue Code.

A person who is self-employed or owns a small business needs to know which type of retirement plan they should set up for themselves and/or their business. The self-employed individual, or the owner/employer of a corporation, generally wants to contribute as much as possible for themselves, but they also need to weigh that against the amount they will need to invest for their employees, if they have any.

CHART A-1 — We will start by looking at examples of self-employed individuals who have no employees. We will compare the

Best Plan Continued from page 2

maximum contribution the employer is eligible to make under each of the four types of plans.

The contribution for a self-employed person to a profit sharing plan, money purchase plan, or SEP plan is calculated as follows:

- The sole proprietor must have net profits from self-employment and must file Schedule C or Schedule F with his or her Federal income tax return to report self-employment profit and expenses. The owner must also file a Schedule SE as an attachment to the Form 1040 to report Social Security taxes owed.

- A special calculation is used to determine the "compensation" that a self-employed individual uses to determine his or her contributions. The self-employed person must reduce their profit by the amount of the contribution to be made for himself or herself, and by the deduction they are permitted for the self-employment tax they pay. It also can be argued that a self-employed person is able to reduce his or her compensation subject to the self-employment tax by the amount of his or her pension contribution. The IRS has never allowed for this adjustment. The IRS has been able to collect substantial tax revenues by not allowing self-employed individuals this adjustment. Not allowing self-employed individuals to make this

adjustment does seem to contradict the primary concept of the TEFRA (1984), which was to have the same rules apply to pension plans whether such plans were being established by a corporation, partnership or sole proprietor. However, we at CWF do not see the IRS conceding this issue unless forced to do so by a court decision. On line 4 of Schedule SE, the Schedule C or F income is multiplied by .9235. This is done because the self-employed individual should not be required to pay the self-employment FICA tax on an amount which includes his FICA tax. He should be allowed to reduce his "gross" income by an amount equivalent to

this FICA tax amount (100% - 7.65% = 92.35%). The 7.65% is the tax rate paid by both the employer and the employee in a corporate situation. A corporate employee pays the 7.65% FICA tax on his wage income and not on his wage income as increased by the amount of his FICA taxes. A reduction is necessary for the self-employed person because he pays his self-employment FICA tax out of his gross earnings (net income plus FICA tax on his net income). An example will illustrate how the calculation is made to a self-employed individual. Assume an individual had gross earnings of \$30,000. Determine the amount of self-employment tax he must

pay—\$30,000 x .9235 = \$27,705; \$27,705 x .153 (EE plus ER FICA) = \$4,238.87; 50% of \$4,238.87 is \$2,119.43. Thus, his adjusted income is \$27,880.57 (\$30,000 - \$2,119.43). From his adjusted amount he must subtract his own pension contribution; then this amount is multiplied by the contribution percentage of 15% for SEP and profit sharing plans, and 25% for a money purchase plan. A mathematical shortcut which takes into account his own pension contribution is to multiply the adjusted amount by 13.0435% for a SEP and profit sharing plan and 20% for a money purchase plan. Thus, the maximum contribution

CHART A-1

Net Income from Schedule C or F	Net Income less 1/2 of Self-Emp. Tax	Maximum SEP Contribution	Maximum Profit Sharing Contribution	Maximum Money Purchase Contribution	SIMPLE Total	SIMPLE Employee Deferral	SIMPLE Employer Match
1. 10,000.00	9,293.52	1,212.20	1,212.20	1,858.70	6,778.81	6,500.00*	278.81
2. 20,000.00	18,587.05	2,424.40	2,424.40	3,717.41	7,057.61	6,500.00*	557.61
3. 30,000.00	27,880.57	3,636.60	3,636.60	5,576.11	7,336.42	6,500.00*	836.42
4. 35,000.00	32,322.50	4,242.70	4,242.70	6,505.47	7,475.82	6,500.00*	975.82
5. 37,977.20	35,071.94	4,603.60	4,603.60	7,058.84	7,558.83	6,500.00*	1,058.83
6. 40,000.00	37,174.09	4,848.80	4,848.80	7,434.82	7,615.22	6,500.00*	1,115.22
7. 41,142.00	38,236.00	4,987.00	4,987.00	7,647.00	7,647.00	6,500.00*	1,147.00
8. 50,000.00	46,467.61	6,061.00	6,061.00	9,293.52	7,894.03	6,500.00*	1,394.03
9. 60,000.00	55,761.14	7,273.20	7,273.20	11,152.23	8,172.83	6,500.00*	1,672.83
10. 64,281.48	59,363.94	7,792.20	7,792.20	11,948.03	8,292.20	6,500.00*	1,792.20
11. 65,000.00	60,470.90	7,887.52	7,887.52	12,094.18	8,314.13	6,500.00*	1,814.13
12. 69,646.00	64,725.00	8,442.00	8,442.00	12,945.00	8,442.00	6,500.00*	1,942.00
13. 70,000.00	65,054.66	8,485.40	8,485.40	13,010.93	8,451.64	6,500.00*	1,951.64
14. 80,000.00	74,687.94	9,741.92	9,741.92	14,937.59	8,740.64	6,500.00*	2,240.64
15. 90,000.00	84,554.03	11,028.80	11,028.80	16,910.81	9,036.62	6,500.00*	2,536.62
16. 100,000.00	94,420.12	12,315.69	12,315.69	18,884.02	9,332.60	6,500.00*	2,832.60
17. 150,000.00	143,750.59	18,750.11	18,750.11	28,750.12	10,812.52	6,500.00*	4,312.52
18. 211,694.00	203,874.00	25,500.00*	25,500.00*	35,000.00*	12,616.00	6,500.00*	6,116.00
19. 224,660.00	216,667.00	25,500.00*	25,500.00*	35,000.00*	13,000.00	6,500.00*	6,500.00*
20. 250,000.00	241,667.00	25,500.00*	25,500.00*	35,000.00*	13,000.00	6,500.00*	6,500.00*

*Limited

Chart A-1 Shows the following:

1. As long as the self-employed individual's net profit is less than \$41,142, then the largest contribution is permitted by the SIMPLE plan. At \$41,142, a 25% contribution to a money purchase plan will be \$7,647—the same amount which arises from a \$6,500 elective deferral to a SIMPLE-IRA plus the 3% matching contribution of \$1,147 (3% X \$38,236).
2. If the self-employed individual's net income exceeds \$41,142, then the largest contribution will be permitted by a 25% money purchase plan. Because the section 415 limit is the lesser of 25% of compensation or \$35,000, and because the compensation limit is \$170,000, the maximum contribution to a money purchase plan is \$35,000. This occurs when the net profit amount is \$211,694.
3. Many employers do not want to sponsor a money purchase plan. Once the net profit of the self-employed individual is \$69,646 or greater, an equal or larger contribution will be possible under a SEP or profit sharing plan than the SIMPLE plan.

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Continued from page 3

under a SEP and profit sharing plan is \$27,880.57 x .130435 or \$3,636.60. The maximum contribution under a money purchase plan for this individual is \$27,880.57 x .20, or \$5,576.11.

• Contributions to a SIMPLE Plan are made as follows: A contribution of \$6,500 (formerly \$6,000) is made by the employee. The \$6,500 is not a percentage of income. The employer must match on a dollar-for-dollar basis what the

employee has chosen to defer, up to 3% of the employee's compensation. The employer is considered both an employer and an employee. He or she makes a \$6,500 contribution in his or her role as employee, and a 3% matching contribution in his or her role as employer.

Note that under the SIMPLE plan, the self-employed individual is NOT required to reduce his or her net profit by the amount of his or her pension contribution as must be done for SEP, profit sharing, and money purchase plans. The adjustment for the self-

employment tax deduction must still be made.

CHARTS A-2 AND A-3 — Now we will look at two corporations and compare the amount of contributions the employer can make for himself or herself under each of the four plan types to the cost of the employee contributions. The first corporation has 6 employees (Chart A-2), and the second has 28 employees (Chart A-3). Note that there are no special calculations for the owner of a corporation who is a corporate employee. For purposes of these charts, it is assumed the maximum contributions (15%, 25%, or

3%) are made by the employer.

AN INCREASED INTEREST IN SEP PLANS

We at CWF have been experiencing an increased number of consulting calls concerning Simplified Employee Pension (SEP) Plans. We believe there is good reason for this renewed interest in this type of pension plan.

Advantages of a SEP plan—

- The employer can limit participation. To be eligible to participate in the SEP plan, an employee must have worked for the employer three out of the immediately preceding five years.
- The employer contribution is totally discretionary. There is no required percentage of compensation which the employer must contribute. The employer is not required to make any contribution. If a contribution is made, the amount is determined by the employer, and may vary from year to year.
- The employer does not need to decide to make a contribution until 4/15 of the following year plus any valid extensions the employer has received for the business tax return, yet the employer may deduct his SEP contribution on his current year's tax return.

Continued on page 5

CHART A-2

Compensation	SEP	Profit Sharing	Money Purchase	SIMPLE Total	SIMPLE Employee Deferral +	SIMPLE Employer Match =
1. 170,000 (owner)	25,500	25,500	35,000	11,600	6,500	5,100
Subtotal	25,500	25,500	35,000	11,600	6,500	5,100
2. 40,000 (EE)	6,000	6,000	10,000	2,400	1,200	1,200
3. 25,000	3,750	3,750	6,250	1,500	750	750
4. 20,000	3,000	3,000	5,000	1,200	600	600
5. 18,000	2,700	2,700	4,500	1,080	540	540
6. 12,000	1,800	1,800	3,000	720	360	360
Subtotal	17,250	17,250	28,750	6,900	3,450	3,450
Totals	\$42,750	\$42,750	\$63,750	\$18,500	\$9,950	\$8,550

Chart A-2 Shows the following:

1. The cost for a full 15% SEP is \$42,750 per year. The owner receives a contribution of \$25,500 and the other employees receive a contribution of \$17,250.
2. The cost for a full 15% profit sharing plan is \$42,750 per year. The owner receives a contribution of \$25,500 and the other employees receive contribution of \$17,250.
3. The cost for a full 25% money purchase plan is \$63,750 per year. The owner receives a contribution of \$35,000 and the other employees receive contribution of \$28,750.
4. The total cost for a SIMPLE plan with a 3% match is \$18,500. The owner receives a contribution of \$11,600 and the other employees receive a contribution of \$6,900. For purposes of this calculation, it is assumed every employee will defer 3% of his or her compensation. In fact, some employees will defer less, which will mean the cost to the employer is less; some will defer more, but the cost for the employer will not increase, since the employer cannot match at rate higher than 3%.
5. Note the employer's cost of making the matching contribution to the SIMPLE for the other employees is \$3,450.
6. The owner must decide if he or she is willing to receive a contribution of only \$11,600 versus \$25,500 to lower the contribution amount for the other employees from \$17,250 to \$3,450.
7. Note that a contribution of 6.82% to a profit sharing or SEP plan would give the owner a contribution of \$11,600, which is the same amount he or she receives under the SIMPLE. However, 6.82% times the employees' compensation of \$115,000 means the contribution for these employees will be \$7,843. Thus, the owner can save \$4,393 (\$7,843 - \$3,450) by setting up SIMPLE plan rather than a profit sharing or money purchase plan.

Best Plan
Continued from page 4

**General discussion —
What is the difference
between a SEP-IRA and a
traditional IRA?**

One difference is that funds contributed to a SEP-IRA by an employer are identified as SEP-IRA funds.

Distinction, the contribution and distribution rules are the same for a SEP-IRA and a traditional IRA. A second difference is that governmental reporting is done a calendar-year basis, even though contributions are allowed to be made through 4/15 of the

following year, plus extensions.

When does a SEP-IRA cease to be a SEP-IRA?

There may be cases where an employee has established his SEP-IRA as required, and the employer does not contribute for 2 or 3 years. Is this still considered a SEP-

IRA? The IRS has never discussed this question. We at CWF believe it can still be a SEP-IRA, if the employee desires. If, at some time in the future, the employer is again expected to make a contribution, you would want to keep this as a SEP-IRA. Otherwise, we at CWF see no reason it could not be considered a traditional IRA.

**What is a Simplified
Employee Pension (SEP)
plan?**

A SEP, also known as a SEP-IRA, is a retirement plan established by an employer. A one-person business is considered an employer for these purposes and may establish a SEP. An employer can use this SEP plan to make contributions to the IRAs of eligible employees, including himself or herself.

**Who is eligible to establish a
SEP?**

Any employer, including a sole proprietor, partnership, or corporation, can establish a SEP. The corporation may either be a for-profit corporation or a nonprofit corporation. A governmental entity may also establish a SEP. When a self-employed individual sponsors a SEP, he or she is considered to be both the employer and an employee.

**Why would an employer,
including a one-person
business, want to have a
SEP?**

There are five excellent reasons for establishing a SEP:

—The SEP contribution is deductible by the employer,

CHART A-3

	Compensation	SEP	Profit Sharing	Money Purchase	SIMPLE Total	SIMPLE Employee Deferral +	SIMPLE Employer Match =
Subtotal	1. 200,000.00 (owner) 200,000.00	25,500.00 25,500.00	25,500.00 25,500.00	35,000.00 35,000.00	12,500.00 12,500.00	6,500.00 6,500.00	6,000.00 6,000.00
2.	75,000.00 (EE)	11,250.00	11,250.00	18,750.00	4,500.00	2,250.00	2,250.00
3.	50,000.00	7,500.00	7,500.00	12,500.00	3,000.00	1,500.00	1,500.00
4.	40,000.00	6,000.00	6,000.00	10,000.00	2,400.00	1,200.00	1,200.00
5.	30,000.00	4,500.00	4,500.00	7,500.00	1,800.00	900.00	900.00
6.	27,500.00	4,125.00	4,125.00	6,875.00	1,650.00	825.00	825.00
7.	25,000.00	3,750.00	3,750.00	6,250.00	1,500.00	750.00	750.00
8.	24,500.00	3,675.00	3,675.00	6,125.00	1,470.00	735.00	735.00
9.	24,000.00	3,600.00	3,600.00	6,000.00	1,440.00	720.00	720.00
10.	23,500.00	3,525.00	3,525.00	5,875.00	1,410.00	705.00	705.00
11.	23,000.00	3,450.00	3,450.00	5,750.00	1,380.00	690.00	690.00
12.	22,500.00	3,375.00	3,375.00	5,625.00	1,350.00	675.00	675.00
13.	22,000.00	3,300.00	3,300.00	5,500.00	1,320.00	660.00	660.00
14.	21,500.00	3,225.00	3,225.00	5,375.00	1,290.00	645.00	645.00
15.	21,000.00	3,150.00	3,150.00	5,250.00	1,260.00	630.00	630.00
16.	20,500.00	3,075.00	3,075.00	5,125.00	1,230.00	615.00	615.00
17.	20,000.00	3,000.00	3,000.00	5,000.00	1,200.00	600.00	600.00
18.	19,750.00	2,962.50	2,962.50	4,937.50	1,185.00	592.50	592.50
19.	19,500.00	2,925.00	2,925.00	4,875.00	1,170.00	585.00	585.00
20.	19,000.00	2,850.00	2,850.00	4,750.00	1,140.00	570.00	570.00
21.	18,750.00	2,812.50	2,812.50	4,687.50	1,125.00	562.50	562.50
22.	18,500.00	2,775.00	2,775.00	4,625.00	1,110.00	555.00	555.00
23.	18,250.00	2,737.50	2,737.50	4,562.50	1,095.00	547.50	547.50
24.	18,000.00	2,700.00	2,700.00	4,500.00	1,080.00	540.00	540.00
25.	16,000.00	2,400.00	2,400.00	4,000.00	960.00	480.00	480.00
26.	15,000.00	2,250.00	2,250.00	3,750.00	900.00	450.00	450.00
27.	12,000.00	1,800.00	1,800.00	3,000.00	720.00	360.00	360.00
28.	8,700.00	1,305.00	1,305.00	2,175.00	522.00	261.00	261.00
Subtotal	\$653,450.00	\$98,107.50	\$98,107.50	\$163,362.50	\$38,937.00	\$19,468.50	\$19,468.50
Totals	\$853,450.00	\$123,607.50	\$123,607.50	\$198,362.50	\$51,437.00	\$25,968.50	\$25,468.50

Chart A-3 shows the following:

1. The cost for a full 15% SEP is \$123,607.50 per year. The owner receives a contribution of \$25,500 and the other employees receive a contribution of \$98,107.50.
2. The cost for a full 15% profit sharing plan is \$123,607.50 per year. The owner receives a contribution of \$25,500 and the other employees receive a contribution of \$98,107.50.
3. The cost for a full 25% money purchase plan is \$198,362.50 per year. The owner receives a contribution of \$35,000 and the other employees receive a contribution of \$163,362.50.
4. The total cost for a SIMPLE plan with a 3% match is \$51,437. The owner receives a contribution of \$12,500 and the other employees receive a contribution of \$38,937. For purposes of this calculation, it is assumed every employee will defer 3% of his or her compensation. In fact, some employees will defer less, which will mean the cost to the employer is less; some will defer more, but the cost for the employer will not increase, since the employer cannot match at rate higher than 3%.
5. Note the employer's cost of making the matching contribution to the SIMPLE for the other employees is \$19,468.50.
6. The owner must decide if he or she is willing to receive a contribution of only \$12,500 versus \$25,500 to a SEP or profit sharing plan to lower the contribution amount for the other employees from \$98,107.50 to \$19,468.50. Many employers would go with the SIMPLE.
7. Note that a contribution of 6.25% to a profit sharing or SEP plan would give the owner a contribution of \$12,500, which is the same amount he or she receives under the SIMPLE. However, 6.25% times the employees' compensation of \$653,450 means the contribution for these employees will be \$40,840.63. Thus, the owner can save \$21,372.13 (\$40,840.63 - \$19,468.50) by setting up SIMPLE plan rather than a profit sharing or money purchase plan.

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SEP Plans Continued from page 5

and it is not included in the employee's income for the year. See discussion on page 3.

—The SEP contributions are not subject to Federal withholding, FICA or FUTA taxes.

—Interest earned on the SEP deposit is sheltered from federal and most state income taxes until withdrawals are made at retirement.

—Due to the effects of compounding, the SEP funds can grow into a sizable nest egg for retirement.

—Administrative and legal costs are generally substantially less than would be incurred under a qualified plan.

What technical requirements must a plan meet to be a SEP?

A SEP requires a written plan document that meets the requirements of Internal Revenue Code section 408(k). This plan document requirement is normally met by using IRS Form 5305-SEP or an approved SEP prototype document. A SEP requires each participant to establish an approved IRA. Employer contributions to a SEP must be made under a definite written formula specifying the method for allocating contributions to each participant (a percent of compensation).

What is the cost to the employer?

The cost depends on the degree to which the employer makes

contributions. SEPs have relatively few governmental reporting requirements, which also makes a SEP less costly to administer.

Must the employer make a contribution each year?

The employer has total discretion whether or not to make a contribution each year under a SEP. The employer need not make any contribution.

What compensation limits apply?

An employer cannot consider compensation in excess of \$170,000 (for prior years, this amount was \$160,000) when figuring contributions for an employee for 2000. Since most SEPs are not integrated with Social Security, the maximum contribution for an employee in 2000 will be \$170,000 times 15%, or \$25,500. An employer cannot consider compensation in excess of \$170,000 when figuring contributions for an employee for 2001. Since most SEPs are not integrated with Social Security, the maximum contribution for an employee in 2001 will be \$170,000 times 15%, or \$25,500.

Compensation, for this purpose, does not include employer contributions to the SEP.

What amount can the employer deduct each year?

The maximum amount is 15% of the eligible employees' compensation paid to them during the year. Compensation for common-law employees is

their income as shown on Form W-2. Compensation for a self-employed individual is defined to be his or her net earnings from self-employment as reduced by the deduction one is allowed for one-half of his or her self-employment tax and the deduction for contributions on his or her behalf to the plan. See IRS Publication 560 for a more detailed discussion.

What employees must an employer cover under the SEP?

The employer must cover an individual who is a qualifying employee. Such an employee is one who:

—Has attained the age of 21 years;

—Has worked for the employer in at least three of the immediately preceding five years, and

—Received at least \$500 in compensation for 2000.

An employer may establish less strict eligibility requirements.

If an employer fails to cover a person who is eligible, then there is no SEP plan, and the favorable tax benefits will be lost.

The following employees need not be covered by a SEP:

—Employees covered by a union agreement and whose retirement benefits were bargained for in good faith by their union and the employer, and

—Nonresident alien employees who have no U.S. source of earned income from the employer.

If an employer "leases" employees, it should consult

with its tax advisor, as special rules may apply.

What is meant by the term "Self-Employed Person's Rate Table"?

Because a self-employed person's deduction amount and his or her compensation are each dependent on the other, the adjustment to net profits can be made indirectly by using an adjusted contribution rate as determined from the chart below:

Self-Employed Person's Rate Table

Column A If the Employed Plan Contri- bution Rate is: (shown as a %)	Column B The Self- Person's Rate is: (shown as a decimal)
1	.009901
2	.019606
3	.029126
4	.038482
5	.047619
6	.056604
7	.065421
8	.074074
9	.082569
10	.090909
11	.099099
12	.107143
13	.115044
14	.122807
15	.130435

Note: The rates in the table above apply only if the contribution rate is a whole number and if the employer only has this one plan.

How much will an employer save on its federal income taxes by making a SEP contribution?

Savings depends upon the employer's marginal income tax bracket. A corporation would list its deduction for SEP contributions on its corporate tax return. A self-employed person deducts contributions for himself or herself on Form 1040, and for employees on Schedule C or F.

SEP Plans **Continued from page 6**

In addition to the tax deduction limits, are there any limits on the amount an employer can contribute to one or more retirement plans on behalf of any one participant?

Yes. In general, an employer cannot contribute on behalf of any participant, more than the lesser of 25% of compensation, or \$35,000.

Special tax rules will apply if the employer sponsors plans in addition to a SEP such as a profit sharing, money purchase, or defined benefit plan.

What is the contribution deadline?

The employer's contribution deadline is the due date of that year's tax return, including any extensions. For many corporations this is March 15. For most individuals this is April 15.

Can an employer prohibit distributions from an employee's SEP-IRA?

No. Also, an employer cannot condition its SEP contributions on the keeping of any part of them in the IRA.

When must a person start to withdraw the money from the SEP-IRA?

With certain exceptions, a person must begin distributions by the first day of April following the calendar year in which he or she attains age 70½, and December 31 of each year thereafter.

Can an employee make regular IRA contributions into a SEP-IRA?

The answer is generally

"yes." However, the extent to which a deduction will be allowed for the contribution may be limited by participation in the SEP or any other qualified pension plan. The employee should consult with their tax advisor to determine the amount of deductible and nondeductible contribution(s) available to them.

How will distributions be taxed?

Distributions will be taxed as ordinary income. If the participant is under age 59½, penalties may apply.

Is a SEP deposit insured by the FDIC?

If a SEP-IRA is invested in time deposits or savings instruments in an insured financial institution, it is insured by the appropriate government agency up to \$100,000, aggregated with any traditional IRA, Roth IRA and any self-directed Keogh plan, eligible deferred compensation plans, and any individual account as defined in section 3(34) of ERISA. This \$100,000 aggregate limit applies on a per-participant, per-institution basis.

If the SEP-IRA is not invested in time deposits or savings accounts of an insured institution, then such investments are not insured by the FDIC.

What happens to a SEP-IRA when the participant dies?

The funds in a SEP will be paid to a participant's beneficiaries. Depending on their relationship to the participant, they may have the potential to partially continue to shelter the funds from

current taxation. The standard IRA rules apply.

May a SEP be integrated with social security?

Yes. An integrated SEP will permit a somewhat higher contribution percentage to be given to the more highly compensated employees. Integration may be permissible with a SEP prototype, but it is not permissible under the IRS Model Form 5305-SEP.

Who is responsible to administer the SEP?

The sponsoring employer is responsible for the SEP's administration. The employer may well need to consult with its tax and legal advisor. A financial institution's general role is to serve as the depository and not as the plan administrator.

What is a Salary-Reduction SEP (SAR-SEP), and what advantages does it offer?

An employer is not permitted to establish a salary-reduction SEP after December 31, 1996. SAR-SEPs established before January 1, 1997, can continue to receive contributions under present rules, and new employees of the employer, hired after December 31, 1996, can participate in the SAR-SEP in accordance with the rules. You should review IRS Publications 560 and 590 for additional information.

Are the rules for transferring a SIMPLE-IRA and the rules for transferring a SEP-IRA similar?

The answer to this question is, "No, they are not." A transfer from a SIMPLE-IRA to another SIMPLE-IRA follows the

standard rollover and transfer rules. However, to transfer a SIMPLE-IRA to a traditional IRA, a two-year requirement must be met, and a person not yet age 59 1/2 would be penalized 25% of the distribution, not 10%. The rules are quite different for these two types of IRAs

Note: The IRS has issued a Supplement to Publication 590 (reproduced below) explaining the new RMD rules. This Supplement makes clear that the new RMD rules for beneficiaries do apply for 2001, regardless of when the IRA accountholder died.



Department of the Treasury
Internal Revenue Service

Notice 1270

(February 2001)

Supplement to Publication 590, *Individual Retirement Arrangements (IRAs)*

New Simplified Rules for Minimum Required Distributions

After Publication 590 was printed, the IRS issued new rules that simplify how minimum required distributions will be figured after 2001. For 2001, you can figure the minimum required distribution using either these new rules or the old rules explained in Publication 590, *Individual Retirement Arrangements (IRAs)*. For most people, the new simplified rules will result in lower minimum required distributions.

If you are age 70½ or older and own a traditional IRA or if you are the beneficiary of an IRA, you may be subject to an additional tax if you do not take annual distributions from the IRA of at least the minimum required distribution for the year. This is discussed in Publication 590 beginning on page 21, under *When Must I Withdraw IRA Assets? (Required Distributions)*.

If you attained age 70½ in 2000 and are taking your minimum required distribution for 2000 by April 1, 2001, do not use the new rules for figuring the distribution for 2000. Instead, use the old rules in Publication 590. Use the new rules for figuring the required distribution for 2001 that must be made by the end of 2001.

For detailed information about the new rules, see the proposed regulations published in the Federal Register on January 17, 2001, 66 FR 3928, and Announcement 2001-18, IRB 2001-10, dated March 5, 2001.

Distributions during the owner's lifetime. Under the new rules, minimum required distributions during your lifetime are based on a distribution period that can be determined using a single table and your age. The distribution period is not affected by your beneficiary's age unless your sole beneficiary is your spouse who is more than 10 years younger than you are. In that case, you can use a different table.

To figure the minimum required distribution for 2001, divide your account balance at the end of 2000 by the distribution period from the table. This is the "applicable divisor" listed next to your age (as of your birthday in 2001) in the *Table for Determining Applicable Divisor for MDIB (Minimum Distribution Incidental Benefit)* on page 80 of Publication 590, unless your sole beneficiary is your spouse who is more than 10 years younger than you are. In that case, use the number at the intersection of the ages of you and your spouse (as of your birthdays in 2001) in *Table II (Joint and Last Survivor Expectancy)* beginning on page 76 of Publication 590. These rules also apply for figuring the minimum required distribution for 2001 for an owner who dies in 2001 after his or her required beginning date.

Distributions after the owner's death. Under the new rules, if the designated beneficiary of the owner is an individual, such as the owner's spouse or child, minimum required distributions for years after the year of the owner's death generally are based on a distribution period that can be determined using the beneficiary's single life expectancy. This rule applies whether or not the death occurred before the owner's required beginning date. If the owner's beneficiary is not an individual (for example, if the beneficiary is the owner's estate), the rule for determining minimum required distributions for years after the owner's death depends on whether or not the death occurred before the owner's required beginning date.

If the owner's designated beneficiary is an individual. To figure the minimum required distribution for 2001, divide the account balance at the end of 2000 by the distribution period from *Table I (Single Life Expectancy)* on page 75 of Publication 590. Determine the distribution period as follows.

- **Spouse as sole designated beneficiary.** The distribution period is the divisor listed in the table next to the spouse's age (as of the spouse's birthday in 2001). If the owner died before the year in which he or she attained age 70½, distributions to the spouse need not begin until the year in which the owner would have attained age 70½.
- **Other designated beneficiary.** The distribution period is the divisor listed in the table next to the beneficiary's age (as of his or her birthday in the year following the year of the owner's death), reduced by one for each elapsed year since the year following the owner's death.

If the owner's beneficiary is not an individual. Determine the minimum required distribution for 2001 as follows.

- **Death on or after the required beginning date.** Divide the account balance at the end of 2000 by the distribution period from *Table I (Single Life Expectancy)* on page 75 of Publication 590. The distribution period is the divisor listed next to the owner's age (as of his or her birthday in the year of death), reduced by one for each elapsed year since the year of death.
- **Death before the required beginning date.** The 5-year rule continues to apply. Under this rule, the entire account must be distributed by the end of the fifth year following the year of the owner's death. No distribution is required for a year before that fifth year. This rule may also be elected by a beneficiary who is an individual.