

Business Planning with SEPs

Today, the **Simplified Employee Pension (SEP)** plan is a popular retirement savings option for self-employed sole proprietors and partners. However, before these individuals start a SEP, it's important they recognize the distinctions between contributions made under a SEP for employees and contributions that benefit the self-employed sole proprietor or partner.

Digging through the Details

When making SEP contributions for employees, the employer must base contributions on an employee's compensation (as reported on Form W-2). However, if the employer is a self-employed sole proprietor or partner, the SEP contribution is based on *his or her* earned income. Earned income is generally defined as net earnings from self-employment in "a trade or business in which the personal services of the taxpayer are a material income-producing factor."

For tax purposes, net earnings for a self-employed sole proprietor are gross Schedule C income less business deductions. On the other hand, net earnings for a partner include the partner's distributive share of partnership income or loss (other than separately treated items such as capital gains or losses). In addition, if net earnings include payment for services to a partnership, then net earnings can also include guaranteed payments to a limited partner, but not distributions of income or losses to a limited partner.

Making Contributions

For 2010, the Internal Revenue Code (IRC) limits SEP employer contributions to the lesser of (1) 25% of compensation; or (2) \$49,000 (subject to inflation indexing). The maximum amount of compensation eligible for consideration for qualified plans is \$245,000 (subject to inflation indexing). Contributions have the opportunity to grow on a tax-deferred basis. As with other qualified retirement plans, distributions taken before the age of 59½ may be subject to a 10% federal income tax penalty.

There are some additional rules that apply to a self-employed sole proprietor or partner when calculating the maximum allowable contribution to a SEP. Because a self-employed person's compensation is his or her net earnings from self-employment, net earnings from self-employment must be adjusted by reducing the contribution rate in the plan for the self-employed person. For self-employed individuals who are not considered employees of their own corporations, the limits result in an allowance of only 20% of self-employment compensation.

In addition to the limitations on contribution amounts, the IRC places a limitation on the deductibility of employer contributions. Employers can deduct contributions to a SEP of up to 25% of participants' compensation in a particular calendar year. In the case where the taxpayer is a self-employed sole proprietor or partner, the taxpayer reports the deduction directly on his or her return for the appropriate tax year (the deduction for common law employees is taken on a sole proprietor's Schedule C and tax deductions for the sole proprietor's contribution are taken on IRS Form 1040).

Parting Thought

Self-employed sole proprietors and partners are in a unique situation under a SEP—they are both employer *and* employee. Thus, they can reap the tax benefits of making a potentially substantial contribution to a retirement plan on their own behalf. However, a self-employed taxpayer needs to be fully aware of the contribution limitations set forth under the IRC.

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