The annual contribution for an employee in this type of plan may not exceed 25% of the employee's compensation or a dollar limit, $58,000 for 2021. The dollar limit is subject to future inflation adjustments. Unlike the SIMPLE IRA, there are no additional "catch-up" SEP contributions permitted for those who are 50 and older.

Simplified example. An owner of a small business pays himself $300,000 in salary and bonus and has an employee earning $100,000. Only $290,000 of the owner's compensation may be taken into account for SEP-IRA contribution calculations. Should the owner declare a 20% contribution, to permit a maximum personal deferral of $58,000 in 2021, a contribution of $20,000 must be made for the employee. Alternatively, if the owner decides on a 10% contribution rate, the deferral for the employee drops to $10,000 and for the owner to $28,500.

Investment considerations

The investment rules for the SIMPLE IRA and SEP-IRA are the same as for traditional IRAs. In general, the deferrals will be invested in stocks, bonds or mutual funds. Asset allocation planning should be used to balance risk and reward, in accordance with the account owner's financial goals and other assets.

Build your retirement capital

If you own a small business, adopting a retirement plan offers several benefits on a tax-favored basis:

- Helps attract and retain skilled employees.
- Boosts employee morale and financial security.
- Builds a strong financial base for your own retirement.

We are here to support your efforts in this regard.

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What is a SIMPLE IRA? What is an SEP?

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What is a SIMPLE IRA?
What is an SEP?

Small businesses often point to regulatory complexity and administrative costs as reasons that they can't afford to adopt qualified retirement plans for their employees. To remedy those problems, Congress has provided standardized plans built on the foundation of IRAs, savings vehicles with which most people are familiar.

SIMPLE IRA plans

The Savings Incentive Match PLan for Employees Individual Retirement Account, generally known as a SIMPLE IRA, provides a method for employees and employers together to set aside funds for retirement on a tax-preferred basis. These plans do not include the nondiscrimination testing and other administrative costs that may apply to 401(k) plans. They are available only to employers who have 100 or fewer employees.

Employee's part. All employees who receive at least $5,000 in compensation from the employer during any two preceding calendar years must be eligible to participate in the plan. Employee contributions are made on a salary-reduction basis, before taxes. Employees are not required to contribute, but they may defer up to $13,500 in 2021. Those who are age 50 or over may defer an additional $3,000 in 2021. These limits are subject to future inflation adjustments.

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Employer's part. The employer has choice in making annual contributions. In the usual case, the employer provides a dollar-for-dollar match of each employee's deferral, up to 3% of covered compensation ($290,000 per employee in 2021). Alternatively, the employer may make a nonelective contribution of 2% of covered compensation for each employee, whether the employee makes a deferral or not. In limited cases, the matching contribution may be reduced temporarily to 1% of covered compensation, but some employer contribution will be required every year.

Additional penalty for early withdrawal. The 10% tax penalty for early withdrawal that applies to all IRAs when the owner is under age 59½ applies as well to SIMPLE IRAs. The penalty may be boosted to 25% if it occurs within two years after an individual first participated in the SIMPLE IRA.

SEPs

The Simplified Employee Pension Individual Retirement Arrangement, commonly referred to as the SEP-IRA, allows employers to set aside larger amounts of money for their employees' retirement.

Employee's part. All employees who are 21 or older, who have worked for the employer for at least three of the last five years, and who have at least $600 in annual compensation from the employer must be covered by the plan. Employees do not contribute to the SEP.

Partners in an LLC or partnership may not set up their own SEPs. Rather, the SEP must be created and funded at the partnership level.

Employer's part. Annual SEP contributions are not required from the employer, so, in a sense, the SEP-IRA operates like a profit-sharing plan. When an annual contribution is made, all eligible employees must receive the same contribution as a percentage of their compensation. "Compensation" in this context includes bonuses and overtime and is limited to $290,000. Self-employed individuals also may establish and contribute to SEP-IRAs for themselves and their employees.

Which plan is right for your business?

	SIMPLE IRA	SEP-IRA
Who contributes?	Employee and employer	Employer
Required annual contributions?	Yes	No
Investment rules	Same as for IRAs	Same as for IRAs
Annual contribution limit (2021)	$13,500	Lesser of 25% of compensation or $58,000
Catch-up contribution?	$3,000	None
Covered compensation limit (2021)	$290,000	$290,000

Sources: Internal Revenue Code; IRS; M.A. Co.