Switching from a SEP to a 401(k)

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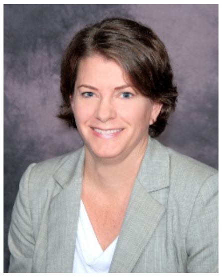

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Navigating the maze of retirement plan options can be confusing. 401(k), Simple, SEP, Money Purchase, Profit Sharing – how can an employer be sure it has chosen the right plan? When an employer implements a SEP (Simplified Employee Pension), oftentimes it is not aware of the limitations of that type of plan. While a SEP may be the perfect plan type for some situations, many employers who start with a SEP later realize that a 401(k) plan may actually help the owners better meet their objective of maximizing contributions to themselves at a lower contribution obligation for the employees.

A Simplified Employee Pension plan (SEP) provides business owners with a simplified method to contribute to their employee's retirement as well as to their own retirement. Although there are benefits to a SEP, there are also trade-offs associated with these plans that need to be understood and considered when an employer is deciding which type of plan to implement OR when an employer with a SEP is considering "upgrading" to a 401(k) plan.

Any employer, corporation, LLC or partnership can sponsor a SEP. There is no limit on the number of employees that the employer can have when sponsoring a SEP.

To understand the limitations of a SEP and the reasons that an employer may be better served by a 401(k) plan, below is a comparison of some of the key features of each type of plan.

Employee contributions: The biggest difference between a SEP and a 401(k) plan is that **employee deferrals are NOT allowed in a SEP**. The only contributions made to a SEP are those made by the employer. On the other hand, a 401(k) plan allows employee contributions of up to $18,000, or $24,000 if the employee is at least age 50. In addition, the 401(k) plan allows that employee deferrals may be made on a pre-tax basis or on an after-tax, Roth basis. The benefit of Roth deferrals is that, although the deferral is taxed before it is contributed to the plan, the Roth account (contributions PLUS any earnings) may be distributed completely tax-free after age 59 ½, as long as the first dollar to the Roth contribution account was contributed at least 5 years prior to the distribution. We find that many employers are interested in the 401(k) just for the purpose of having the Roth deferral option, which allows them to diversify their investments into an after-tax "bucket" that they can withdraw from in retirement as part of their tax-planning strategies.

Excluding certain groups of employees: Employees who work during 3 out of 5 years and who earn at least $600 in the current year must be covered under the SEP. The employer can also require that the employee be age 21 to be eligible for the plan. The only exception to the eligibility rules is that union employees and nonresident aliens can be permanently excluded from participation. By contrast, a **401(k) plan may be written to permanently exclude many other groups of employees**. So, if an employer would like to exclude a certain population from the plan (and therefore not be obligated to provide an employer contribution to them) the 401(k) plan provides much more flexibility to do so. 401(k) plans may indefinitely exclude employees who have never worked at least 1,000 hours in a year. 401(k) plans may also be written to exclude certain classes of employees, as long as that exclusion does not result in more than 30% of the employer's population being excluded from the plan. So, employers who want to exclude PRNs, for example, or employees of a certain location, etc. will have much more flexibility to do so in a 401(k) plan.

Employer contributions: Employers who sponsor a SEP may contribute an employer contribution that is a uniform dollar amount or percentage across all eligible employees (social security integration may be factored in, as well). **In a 401(k) plan, the employer contribution options are more flexible**. If the Employer has a profitable year and wants to contribute a large discretionary profit sharing amount, the plan document can be written in such a way that any profit sharing contributions are weighted more heavily toward certain owners or key employees. This is not permissible in a SEP. Even for sole proprietors who have no employees, if the owner is at least age 50, the 401(k) plan can make more sense, because the maximum annual contributions to the plan for the employee can be as much as $60,000, where the maximum annual contributions to a SEP can only be $54,000.

Employee access to account: Employees may take a distribution at any time from the SEP (subject to taxes and penalties). This means that each year when the employer makes a contribution to the plan, the employee may choose to withdraw the contribution immediately. The employer has no control over this. In a 401(k) plan, there are restrictions around when an employee may take a withdrawal from the account. The employer can require that the employee only take a withdrawal in the event of a financial emergency or upon attainment of a certain age, like 59 ½ or 65. Restricting employee access to the account helps ensure that the funds will be available for their intended use – in retirement.

Loans: A SEP cannot allow participant loans. 401(k) plans can be written to allow employees to borrow a portion of their account balance, up to the lesser of 50% or $50,000.

There are many benefits to a 401(k) plan over a SEP. The disadvantage to a 401(k) plan is that it is subject to more nondiscrimination testing, which could make the plan more complex and expensive to maintain. In addition, 401(k) plans must file a Form 5500 with the Department of Labor each year, so there is the expense of preparing that annual filing. But for many employers, the benefits of a 401(k) plan are significant enough to justify the additional administrative expense.

TERMINATING A SEP: A SEP may be terminated at any time and all funding can stop once the plan is terminated. The financial institution should be notified that the contributions will stop and that the contract or agreement should be terminated. It is a good idea to notify the employees that the plan has been discontinued. No notice has to be provided to the IRS about the SEP termination. Employees may take a distribution from the SEP or may roll their SEP account into the new 401(k) plan or into an IRA. Although an employer may sponsor both a SEP and a 401(k) in the same year, there is no benefit to doing so because employer contributions to both plans are combined when determining the annual limit of $54,000. The IRS also stipulates that an employer may not maintain a SEP and a 401(k) in the same year if the SEP was established using IRS Form 5305.

If we can help you or your client decide which type of plan best suits their business needs, please call us for a detailed analysis.

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