

SARSEP Plan Fix-It Guide

Mistake	Find the Mistake	Fix the Mistake	Avoid the Mistake
1) You haven't updated your SARSEP plan document for current law. (More)	Determine if your Form 5305A-SEP or prototype is the current revision .	Adopt a current IRS Model Form 5305A-SEP or IRS-approved SARSEP prototype.	Maintain regular contact with the company that sold you the plan.
2) You have more than 25 eligible employees. (More)	Review payroll and plan document eligibility requirements for the prior year. If more than 25 employees were eligible to participate in the plan, no employee elective deferrals may be accepted in the current year.	Stop employee elective deferral contributions to the SEP-IRAs.	If more than 25 employees become eligible during any year, stop withholding employee elective deferrals in the first pay period of the subsequent year and notify all employees.
3) Eligible employees were excluded from participating in the plan. (More)	Review eligibility and participation plan document sections. Check when employees are entering the plan.	Make a corrective contribution that would place affected employees in the position they would have been in if they were correctly included in the plan.	Review the participation status of all employees at least once a year.
4) Contributions to participants' SEP-IRAs were miscalculated because you used the wrong definition of compensation. (More)	Review the plan document to determine if you're using the correct compensation amount for allocations.	Correction of the failure is based on the terms of the plan at the time of the mistake.	Review the SARSEP plan terms to ensure that you're considering the correct amount of compensation when calculating contributions.
5) Employee elective deferrals exceed the IRC Section 402(g) limit for the calendar year (\$17,500 in 2014) and excess deferrals haven't been distributed. (More)	Inspect deferral amounts for plan participants to ensure that they haven't exceeded the limits.	Two possible correction methods: a. Distribution method b. Retention method	Have sufficient payroll information to verify that the deferral limitations of IRC Section 402(g) were satisfied.
6) Less than 50% of eligible employees made employee elective deferrals. (More)	Review payroll records and ensure that 50% of eligible employees are actually making employee elective deferrals annually.	Stop employee elective deferral contributions to the SEP-IRAs.	Annually review plan document for eligibility requirements and payroll records. If less than 50% of eligible employees made elective deferrals during any year, stop withholding employee elective deferrals and notify all employees.

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<p>7) Total contributions (employee elective deferrals and nonelective employer contributions) exceeded the maximum legal limits. (More)</p>	<p>Calculate 25% of each employee's compensation and compare the total contribution made for the employee to the lesser of that amount or the dollar limitation for that year (\$52,000 in 2014).</p>	<p>Two possible correction methods: a. Distribution method b. Retention method</p>	<p>Calculate the allocations based on the plan terms and then check to make sure none of the proposed allocations would violate the Internal Revenue Code.</p>
<p>8) Employee elective deferrals weren't deposited by the required date. (More)</p>	<p>Review employee data and payroll remittances to ensure that elective deferrals were properly withheld and deposited by the due date.</p>	<p>Make a contribution for each participant.</p>	<p>Review the SARSEP plan rules on the timing of employer contributions and adopt administrative procedures to ensure that you contribute them on time.</p>
<p>9) You didn't pass the annual deferral percentage test. (More)</p>	<p>Perform and review the test for each year in which deferrals were made.</p>	<p>Two possible correction methods: a. Distribution method b. Retention method</p>	<p>Communicate with plan administrator to ensure proper employee classification. Ensure that both you and the plan administrator are familiar with the terms of the plan. Consider converting to a SIMPLE IRA plan.</p>
<p>10) You didn't make required top-heavy minimum contributions to the SARSEP. (More)</p>	<p>Review the rules and definitions for top-heavy found in your plan document. Determine whether your plan is top-heavy for each plan year.</p>	<p>Contribute and allocate the required top-heavy minimum, adjusted for earnings, to affected non-key employees.</p>	<p>Perform a top-heavy test each year. If your plan is top-heavy or deemed top-heavy, ensure that you've made all top-heavy minimum contributions.</p>

SARSEP Plan - Overview

A SARSEP is a **Salary Reduction Simplified Employee Pension** plan. It's a Simplified Employee Pension (SEP) plan set up before 1997 that permits employees to contribute through employee salary reductions, also called "employee elective deferrals."

Under a SARSEP, employees and employers make contributions to traditional IRAs set up for eligible employees, subject to certain limits. Each employee is always 100% vested in (or, has ownership of) all money in his or her SEP-IRA.

To have a SARSEP, you:

- Must have established the SARSEP before 1997.
- Need to keep the plan amended for current law changes (see [Question 1](#)).
- Must meet the following participation requirements annually based on all eligible employees (even those hired after 1996).
 - At least 50% of your employees eligible to participate must choose to make employee elective deferrals for the year.
 - You must have no more than 25 employees who were eligible to participate in the SARSEP at any time during the preceding year.

Employers who established a SARSEP prior to January 1, 1997, can continue to maintain it and new employees hired after December 31, 1996, can participate in the existing SARSEP.

Formal written agreement. You must maintain a formal written agreement to provide benefits to all eligible employees under a SARSEP. You can satisfy the written agreement requirement with the IRS model SARSEP using [Form 5305A-SEP, Salary Reduction Simplified Employee Pension—Individual Retirement Accounts Contribution Agreement](#).

Prototype SARSEPs. Financial institutions and other approved sponsoring organizations can sponsor a prototype SARSEP document. The IRS issues opinion letters approving prototypes. Plan sponsors can use individually designed documents, but the IRS doesn't have an approval process for these.

Information you must give to employees. You must give each eligible employee a copy of Form 5305A-SEP, its instructions and the other information listed in the Form 5305A-SEP instructions. If you adopted a prototype SARSEP, you must give each eligible employee similar information.

Setting up the employee's SEP-IRA. A SEP-IRA must be set up by or for each eligible employee. SEP-IRAs can be set up with banks, insurance companies or other qualified financial institutions. You send SARSEP contributions to the financial institution where you maintain the SEP-IRA.

Who is eligible to participate?

Generally, any employee who performs services for your business must be included in your SARSEP. However, there are some exceptions to this general rule. Among the employees that you may exclude from a SARSEP are those who:

- Haven't worked for the company during three out of the last five years.
- Haven't reached age 21 during the year for which you make contributions.
- Are employees who are covered by a union agreement and whose retirement benefits were bargained for in good faith by you and the employees' union.

- Are nonresident alien employees who have received no U.S. source wages, salaries or other personal services compensation from you.
- Received less than \$550 in compensation (subject to [cost-of-living adjustments](#)) during the year. Generally, W-2 compensation will satisfy the definition of “compensation.”

Only employers with 25 or fewer eligible employees in the prior year can permit employee elective deferrals in the current year. If you have more than 25 eligible employees this year, but had less than 25 employees in the preceding year, employees can make elective deferrals this year. For example, if you had 23 eligible employees in 2013, but 27 eligible employees in 2014, those 27 employees may make elective deferrals to their SEP-IRAs in 2014. However, in 2015, no employee elective deferrals may be made by you or your employees.

What are the participation rules?

At least 50% of all eligible employees must make employee elective deferrals each year. If less than 50% of your eligible employees choose to make employee elective deferrals to the SARSEP for a year, all employee elective deferrals made by other eligible employees for that year are disallowed and must be withdrawn from the employees' SEP-IRAs.

What are the contribution requirements?

By establishing a SARSEP, you've adopted a plan that requires a SEP-IRA to hold the contributions made for each of the eligible employees. A SARSEP is funded by money that employees elect to defer from their salaries. Employer contributions are also allowed, but only in the form of “nonelective” contributions - employer contributions made to each eligible employee's SEP-IRA - regardless of whether, or how much, the employee deferred into the SEP-IRA. Your SARSEP plan document will specify the nonelective contributions, if any, required under the plan. The law does not permit matching contributions in a SARSEP.

Total contributions to each employee's SEP-IRA cannot exceed the lesser of \$52,000 for 2014 (subject to [cost-of-living adjustments](#) for later years) or 25% of pay. (Employee elective deferrals are subject to lower limits imposed by IRC Section 402(g) (see [Question 5](#)). Contributions made under the SARSEP - both employee elective deferrals and employer nonelective contributions - are 100% vested (or owned by) the employees. [Publication 560, Retirement Plans for Small Business \(SEP, SIMPLE, and Qualified Plans\)](#), has a worksheet to help self-employed individuals determine the amount of their maximum contribution.

Contributions must be in the form of money (cash, check or money order). You can't contribute property, except in a rollover. See [Publication 590, Individual Retirement Arrangements \(IRAs\)](#), for more information about rollovers.

After you send the SARSEP contributions to the financial institution, it will manage the funds. Depending on the financial institution, participants can invest SARSEP contributions in stocks, mutual funds and other, similar types of investments.

The financial institution/trustee handling the SEP-IRAs provides the IRS and participants with an annual statement containing contribution and fair market value information on [Form 5498](#).

Do SARSEPs have anti-discrimination tests?

SARSEP DP test. The employee elective deferrals of your [highly compensated employees \(HCEs\)](#) must meet the SARSEP DP (deferral percentage) test. Under the SARSEP DP test, the

amount deferred each year by each eligible HCE, as a percentage of pay (the deferral percentage), can't be more than 125% of the deferral percentage of all eligible non-highly compensated employees (NHCEs).

Deferral percentage. Each employee's deferral percentage is the ratio of the employee's elective deferrals for a year divided by the employee's compensation for the same year.

You must compute the deferral percentage limitation each year. The instructions for [Form 5305A-SEP](#) have a worksheet you can use to determine whether the elective deferrals of your HCEs meet the SARSEP DP test.

Top-heavy contributions. A SARSEP is top-heavy when more than 60% of all contributions go to [key employees](#). Many SARSEPs are written to operate as if they were always top-heavy, thereby eliminating the need to make the annual 60% determination. When a SARSEP is top-heavy, non-key employees must receive a minimum employer contribution of up to 3% of pay.

What are the basic distribution rules?

Employees can withdraw their SARSEP contributions and earnings at any time. A withdrawal is taxable in the year you receive it. If an employee makes a withdrawal before the employee is age 59½, a [10% additional tax](#) will generally apply. Employees may roll over SARSEP contributions and earnings tax-free to other IRAs and retirement plans.

SARSEP contributions and earnings must eventually be distributed. The law requires a [specific minimum amount](#) be distributed by April 1 of the year following the year the employee reaches age 70½.

What are the filing requirements?

A SARSEP plan sponsor generally has no filing requirements. The annual reporting required for qualified plans (Form 5500 series) is normally not required for SARSEPs. The financial institution that holds the plan SEP-IRAs handles most of the other paperwork.

Employee Plans Compliance Resolution System (EPCRS) – Overview

If you make mistakes with respect to your SARSEP plan, you may use the IRS [Employee Plans Compliance Resolution System](#) to remedy your mistakes. A correction for a mistake should be reasonable and appropriate. The correction method should resemble one already provided for in the Internal Revenue Code and you should consider all facts and circumstances. [Revenue Procedure 2013-12](#), 2013-04 I.R.B. 313 is the official guidance governing the EPCRS program.

There are three ways to correct mistakes under EPCRS:

- 1) **[Self-Correction Program \(SCP\)](#)** - permits a plan sponsor to correct certain plan failures without contacting the IRS or paying a fee.
- 2) **[Voluntary Correction Program \(VCP\)](#)** - permits a plan sponsor to, any time before audit, pay a fee and receive IRS approval for correction of plan failures.
- 3) **[Audit Closing Agreement Program \(Audit CAP\)](#)** - permits a plan sponsor to pay a sanction and correct a plan failure while the plan is under audit.

A general description of each component of EPCRS is provided below:

Self-Correction Program:

- To be eligible for SCP, the plan sponsor or administrator must have established practices and procedures (formal or informal) reasonably designed to promote and facilitate overall compliance with the law. A plan document alone does not constitute evidence of established procedures.
- SCP is only available for correcting an insignificant failure to follow the terms of your SARSEP plan document. SCP is not available for problems with the plan document, such as the failure to keep your plan document current to reflect changes in the law.
- The plan sponsor should follow the general correction principles in Revenue Procedure 2013-12, section 6.
- A plan sponsor that corrects a mistake listed in Appendix A or Appendix B of Revenue Procedure 2013-12 according to the correction methods listed may be certain that their correction is reasonable and appropriate for the failure.
- If needed, the plan sponsor should make changes to its administrative procedures to ensure that the mistakes don't recur.
- When using SCP, the plan sponsor should maintain adequate records to demonstrate correction in the event of an audit of the plan.
- There is no fee for self-correction.

Voluntary Correction Program:

- The plan sponsor makes a submission to the IRS that:
 - includes completed Forms [8950](#) and [8951](#).
 - identifies the mistakes.
 - proposes correction using the general correction principles in Revenue Procedure 2013-12, section 6.
 - proposes changes to its administrative procedures to ensure that the mistakes do not recur.
 - pays a compliance fee of \$250.
 - a higher compliance fee will be owed if excess amounts are allowed to be retained in affected participants' IRAs.
- The IRS issues a Compliance Statement detailing the mistakes identified by the plan sponsor and the correction methods approved by the IRS.

- The plan sponsor corrects the identified mistakes within 150 days of the issuance of the Compliance Statement.
- While the IRS is processing the submission, IRS won't audit the plan, except under unusual circumstances.

Audit Closing Agreement Program:

- The plan sponsor or plan is under audit.
- The plan sponsor:
 - 1) enters into a Closing Agreement with the IRS.
 - 2) makes correction prior to entering into the Closing Agreement.
 - 3) pays a sanction negotiated with the IRS.
 - The sanction paid under Audit CAP should be greater than the fee paid under VCP.
- The sanction under Audit CAP is a negotiated percentage of the **Maximum Payment Amount** based on the sum for all open taxable years of the:
 - 1) Additional income tax resulting from income inclusion of disallowed elective deferrals and any employer contributions for employees in the plan (Form 1040), including the tax on plan distributions that have been rolled over to other IRAs (and any interest and penalties applicable to the employees' tax returns).
 - 2) Additional tax resulting from the 6% tax imposed under Internal Revenue Code Section 4973 on excess contributions to IRAs.

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You haven't updated your SARSEP plan document for current law.	Determine if your Form 5305A-SEP or prototype is the current revision .	Adopt a current IRS Model Form 5305A-SEP or IRS-approved SARSEP prototype.	Maintain regular contact with the company that sold you the plan.

1) You haven't updated your SARSEP plan document for current law.

Employers can't establish new SARSEPs after December 31, 1996 (the Small Business Jobs Protection Act of 1996 prospectively repealed SARSEPs). However, employers that had already established a SARSEP prior to January 1, 1997, can continue to maintain it and new employees hired after December 31, 1996, can participate in the existing SARSEP. The introduction of [SIMPLE IRA plans](#) is intended to fill the need for retirement plans like SARSEPs.

Retirement plans law changes frequently. There are statutory deadlines for which many provisions must become effective. The IRS generally establishes a firm deadline for adopting these changes. These law changes might mean employers can simplify some areas of plan administration or improve benefits. You'll need to change plan language and operation to keep the plan within the law and to take advantage of increased benefit limits.

How to find the mistake:

A financial institution, third-party administrator, plan service provider, or the IRS during an audit may ask you to demonstrate your plan has complied with current and prior law.

You may have a written plan document that is a model SARSEP ([Form 5305A-SEP](#), *Salary Reduction Simplified Employee Pension - Individual Retirement Accounts Contribution Agreement*) or a pre-approved plan. The IRS has already favorably reviewed both model SARSEPs and pre-approved plans.

If your plan document is the current version (June 2006) of Form 5305A-SEP, you can be assured that it complies with the law. If your plan is a pre-approved plan, you have a level of assurance that the plan is written in compliance with the law even if you don't apply to the IRS for a determination letter. You must update individually designed SARSEPs for law changes. If you have this situation, consult your tax advisor.

How to fix the mistake:

Corrective action:

If you find your plan document hasn't been amended on time for law changes, you should adopt the latest revision of Form 5305A-SEP (June 2006) or adopt the latest revised document (approved for EGTRRA) given to you by your financial institution. You'll need to confirm that you've operated your plan consistently with the plan terms.

Example:

Employer Y established a SARSEP in 1995 using a prototype plan and never amended for any law changes.

The Economic Growth and Tax Relief Reconciliation Act of 2001 changed many of the Internal Revenue Code requirements and limits for qualified plans and IRAs. To benefit under these new

provisions, employers must amend their SARSEP prototype and individually designed plans for current law. For employers with model SARSEP plans to avail themselves of the latest law changes, they must adopt the latest model Form 5305A-SEP (for EGTRRA it must have a revision date of March 2002 or later. The instructions for the Form 5305A-SEP (with a June 2006 revision date) provide that if you used the March 2002 version of the form to establish a model SARSEP plan, you aren't required to use the June 2006 form).

Employers had to notify employees who participate in these plans of the increased EGTRRA contribution limits no later than October 1, 2002. See [Revenue Procedure 2002-10](#) (as modified by [Announcement 2002-49](#)) for details. Individually designed SARSEPs that have received a ruling from the IRS should use the procedures listed in Revenue Procedure 2002-10, section 4.07. Any other SARSEP outside of the correction periods discussed above should have amended their plan and given proper notice to participants before the new limits were used.

Correction programs available:

Self-Correction Program:

Employer Y cannot correct this mistake under SCP, which is limited to insignificant operational problems. This mistake is the result of failing to keep the plan language up to date. To retain plan qualification, the employer must correct this mistake under VCP.

Voluntary Correction Program:

Employer Y would make a VCP submission to the IRS under Revenue Procedure 2013-12, using the model document in [Appendix C – Part 1](#), including Forms [8950](#) and [8951](#). The fee for this mistake is \$250.

Audit Closing Agreement Program:

If this mistake is discovered on audit, it may be corrected under Audit CAP. Correction of the mistake under Audit CAP should be very similar to correction under VCP. The sanction under Audit CAP is a percentage of the [maximum payment amount](#).

How to avoid the mistake:

Knowing your plan is up to date may not be a simple process. If you use a Form 5305A-SEP, annually check the IRS website to see if you're using the most recent version of the form. Certain plans must be individually amended for each change, while others may have a prototype document that is amended. We recommend you maintain contact, on at least a yearly basis, with the company that sold you the plan. If the company sends you a set of amendments to formally adopt, make certain you timely execute the amendments per their instructions. Keep signed and dated copies of your plan document and any amendments for your records.

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You have more than 25 eligible employees.	Review payroll and plan document eligibility requirements for the prior year. If more than 25 employees were eligible to participate in the plan, no employee elective deferrals may be accepted in the current year.	Stop employee elective deferral contributions to the SEP-IRAs.	If more than 25 employees become eligible during any year, stop withholding employee elective deferrals in the first pay period of the subsequent year and notify all employees.

2) You have more than 25 eligible employees.

Employees can't make elective deferrals to a SARSEP for a year if the sponsoring employer had more than 25 employees who were eligible to participate (see [Question 3](#)) at any time during the preceding year.

The 25-employee rule is a look-back rule and it's a year-by-year rule. For example, if you had 23 eligible employees in 2013, but 27 eligible employees in 2014, the 27 employees may make elective deferrals to their SEP-IRAs for 2014. However, in year 2015, employees can't make elective deferrals.

How to find the mistake:

Review payroll records and the plan eligibility and participation requirements for the prior year. If more than 25 employees were eligible to participate, you may not accept any employee elective deferrals in the current year.

- Make a list of all employees who are eligible to participate in the plan.
- If you had 26 or more eligible employees in any prior year, then you must suspend all elective deferrals until the year after the number of eligible employees drops below 26.
- Review payroll records to ensure that no participant made salary deferrals in any of the pay periods of the suspended years.

How to fix the mistake:

Corrective action:

Stop making employee elective contributions to the plan. If the plan is not under audit by the IRS, you can file a VCP submission requesting that contributions made for previous years in which you had more than 25 employees remain in the employees' SEP-IRAs.

Correction programs available:

Self-Correction Program:

This mistake cannot be corrected under SCP.

Voluntary Correction Program:

File a VCP submission to the IRS under [Revenue Procedure 2013-12](#) identifying the failure, using the [model documents](#), including Schedule 3 and Forms 8950 and 8951. The fee for the VCP submission is \$250.

Audit CAP:

Under Audit CAP, correction of the mistake should be very similar to correction under VCP. The sanction under Audit CAP is a percentage of the [maximum payment amount](#).

How to avoid the mistake:

Review the participation status of all employees at the end of each year to determine whether you had more than 25 eligible employees during the year. If more than 25 employees were eligible, you should cease withholding employee elective deferrals in the first pay period of the subsequent year and notify all employees of the situation.

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Eligible employees were excluded from participating in the plan.	Review eligibility and participation plan document sections. Check when employees are entering the plan.	Make a corrective contribution that would place affected employees in the position they would have been in if they were correctly included in the plan.	Review the participation status of all employees at least once a year.

3) Eligible employees were excluded from participating in the plan.

You must allow all eligible employees to participate in the SARSEP, including part-time and seasonal employees and employees who die or terminate employment during the year. An eligible employee is an employee who:

- is at least 21 years of age.
- has performed service for you in at least three of the immediately preceding five years.

Your SARSEP document can allow less restrictive eligibility requirements (but not more restrictive ones). “Service” means any work performed for you for any period of time, however short. A SARSEP may not impose an hours-of-service requirement.

The term “employee” includes self-employed individuals who have earned income and working business owners.

You must treat certain leased employees as “employees.”

“Employee,” for purposes of determining who is an eligible employee under a SARSEP, includes all employees of all related employers. Related employers include:

- controlled groups of corporations that include your business,
- trades or businesses under common control with your business, and
- affiliated service groups that include your business.

This means, for example, that if you or your family members own a controlling interest in another business, employees of that other business are “employees” for purposes of determining who is eligible to participate in your SARSEP.

Excludable employees: You don’t need to cover:

- employees covered by a union agreement whose retirement benefits were bargained for in good faith by you and their union.
- nonresident alien employees who did not earn U.S. source income from you.
- employees who received less than \$550 in compensation (subject to [cost-of-living adjustments](#)) during the year.

Example 1: Employer X maintains a calendar year SARSEP, which requires that all employees who perform service in at least three of the immediately preceding five years, reach age 21 and earn the minimum amount of compensation during the current year are eligible to participate in the SARSEP. Joe worked for Employer X during his summer breaks from school in 2010, 2011 and 2012, but never more than 34 days in any year. In July 2013, Joe turned 21. In August 2013, Joe began working for Employer X on a full-time basis, earning \$12,000 in 2013. Joe is an eligible employee in 2013 because he met the minimum age requirement, worked for Employer X in three of the five preceding years and met the 2013 minimum compensation requirement.

Example 2: Employer Y designs its SARSEP to provide for immediate participation regardless of age, service or compensation. Sue is age 18 and begins working part-time for Employer Y in 2013. Sue is an eligible employee for 2013.

Example 3: Alex owns Business A, a computer rental agency that has four eligible employees. Alex also owns Business B, which repairs computers, and has three eligible employees. Alex is the sole owner of both businesses. The SARSEP rules treat all eight employees (including Alex) as employed by a single employer.

How to find the mistake:

Review the section of your plan document on eligibility and participation. Check when employees are entering the plan.

- Make a list of all employees who received a W-2.
- Compare their dates of hire and annual compensation to the plan eligibility and participation requirements.
- Determine when each employee is entitled to participate in the plan according to the plan document.
- Inspect plan records to make certain the employees timely entered the plan.

How to fix the mistake:

Corrective action:

Generally, if you didn't give an employee the opportunity to participate in your SARSEP plan, you must make a contribution to the plan for the employee to compensate for the missed employer contribution and "missed deferral opportunity." The corrective contribution is an employer contribution intended to place the employee in the same position had the employee participated in the plan timely. Open a SEP-IRA for the excluded employee and make a contribution to the SEP-IRA equal to the same percentage of compensation that other employees received. Increase the amount contributed to reflect missed earnings through the date of correction. Don't reduce other employees' SEP-IRAs. If it isn't feasible to determine what the actual investment results would have been, you may use a reasonable rate of interest.

Example:

In 2012, Company X failed to include Jan in its SARSEP plan. Jan had met the SARSEP age, service and earnings requirements. Jan is a non-highly compensated employee and earned \$10,000. Company X had two other NHCEs who had deferral percentages of 3% and 5%. In addition, Company X's SARSEP plan provides for discretionary employer contributions. The plan provides that the employer contributions should be allocated to account balances in the ratio that each eligible employee's compensation for the year bears to the compensation of all eligible employees for the year. For 2012, Company X contributed a fixed dollar amount to the plan. Jan didn't receive an allocation of the contribution. The contribution resulted in an allocation for each of the eligible employees, other than Jan, equal to 10% of compensation. Most of the employees who received plan allocations for the year of the mistake were NHCEs. If Jan had shared in the original allocation, the allocation made for each employee would have equaled 9% of the employee's compensation.

Reasonable correction:

Revenue Procedure 2013-12 provides different safe harbor methods for correcting eligible employees who have been excluded from participating. For SARSEPs, the plan sponsor must generally make corrective contributions because the plan assets are held in IRAs. This

contribution method requires the employer to make a corrective contribution to the excluded employees' SEP-IRAs. The corrective contribution is calculated using each excluded employee's compensation. Adjust this amount for earnings through the date of correction. Don't reduce the other employees' contributions, even though their allocations would have been different had the excluded employee not been excluded. For the above example, Company X would contribute 10% of Jan's 2012 compensation, and would not adjust the 10% allocations previously made to the other employees. If it isn't feasible to determine what the actual investment results would have been, you may use a reasonable rate of interest. You may use the Department of Labor's [Voluntary Fiduciary Correction Program Online Calculator](#) for this purpose.

Correction programs available:

Self-Correction Program:

The example illustrates an operational problem because the employer failed to follow the SARSEP plan document terms by excluding eligible employees from participating in the plan. If the other eligibility requirements of SCP are satisfied, Company X might be able to use SCP to correct the mistake. Company X would have to determine whether:

- Appropriate practices and procedures were originally in place to facilitate compliance with requirements for employee eligibility
- The failure is [insignificant](#).

Voluntary Correction Program:

Under VCP, correction is the same as described above under "Reasonable correction." Company X files a VCP submission according to Revenue Procedure 2013-12, using the [model documents](#), including Schedule 3 and Forms 8950 and 8951. The fee for the VCP submission is \$250.

Audit Closing Agreement Program:

Under Audit CAP, correction is the same as described above under "Reasonable correction." Company X and the IRS enter into a Closing Agreement outlining the corrective action and negotiate a sanction based on the [maximum payment amount](#).

How to avoid the mistake:

Monitor census information and the participation status of all employees at least once a year. The person assigned this task should have a good understanding of the plan eligibility requirements and have access to the employment records necessary to determine if all eligible employees are participating in the SARSEP.

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Contributions to participants' SEP-IRAs were miscalculated because you used the wrong definition of compensation.	Review the plan document to determine if you're using the correct compensation amount for allocations.	Correction of the failure is based on the terms of the plan at the time of the mistake.	Review the SARSEP plan terms to ensure that you're considering the correct amount of compensation when calculating contributions.

4) Contributions to participants' SEP-IRAs were miscalculated because you used the wrong definition of compensation.

A SARSEP plan definition of "compensation" must satisfy rules for determining the amount a participant receives in contributions. The [amount of compensation](#) you may consider for each participant is limited.

You must follow your plan definition of compensation when operating your plan. Compensation generally includes the pay an employee received from you for personal services for a year including:

- Wages and salaries
- Fees for professional services
- Other amounts received (cash or non-cash) for personal services actually rendered, including, but not limited to:
 - Commissions and tips
 - Overtime
 - Fringe benefits
 - Bonuses

Compensation generally doesn't include any employer contributions, including elective deferrals that either you or your employees made to the SARSEP.

Compensation, for purposes of the \$550 rule (see [Question #3](#)), is the same, except it includes deferrals the participant made to the SARSEP and any amount that the employee doesn't include in gross income under Internal Revenue Code Section 125 (cafeteria plans) or 132(f)(4) (certain qualified fringe benefits).

You may use an alternative definition of compensation, permitted under Internal Revenue Code Section 414(s) that excludes some of the above listed items but these compensation exclusions must be specified in your plan document.

If you are a self-employed person sponsoring a SARSEP, the compensation on which you calculate your maximum contribution is your net earnings from self-employment. Publication 560, *Retirement Plans for Small Business (SEP, SIMPLE, and Qualified Plans)*, has a [worksheet](#) for this calculation.

How to find the mistake:

To determine if you're using the correct compensation for allocations, you'll need to review your SARSEP plan document.

You may not be aware your plan contains different definitions of compensation when calculating the [deferral percentage test](#). In some cases, you or the plan administrator may:

- use the incorrect definition of compensation when determining the compensation eligible

- for the employee to defer, or
- fail to limit compensation to the annual amount (\$260,000 in 2014).

Review the plan section on allocations and deferrals, which will have language that says, for example, “Employees may defer up to 15% of their Compensation.” You then have to go to the plan section containing definitions and find the “Compensation” definition.

Spot-check allocations to see if you’re using the correct compensation as defined in your plan document. If you’re using the Form 5305A-SEP, make sure you are basing allocations on total compensation. If you have a plan with a complicated definition of compensation, develop a worksheet to calculate the correct amounts.

How to fix the mistake:

Corrective action:

If you’ve improperly determined elective deferrals by basing them on compensation that your plan doesn’t allow, you have excess amounts that you should correct by using either the:

1. *Distribution Method* - effects distribution for the excess amount, as adjusted for earnings (Revenue Procedure 2013-12, section 6.11(5)(a)).
 - a. When the excess amount is caused by contributing excess elective deferrals, the amount may be distributed and reported ([Form 1099-R](#)) as taxable for the year the distribution is made.
 - b. When the excess amount is caused by contributing excess employer contributions, the excess amount may be distributed to the plan sponsor rather than to the participants. If an excess amount caused by excess employer contributions is distributed to the plan sponsor, it is still reported on a Form 1099-R issued to the participant, but the taxable amount is zero.
2. *Retention Method* – retains excess amounts in the SEP-IRA. If the retention method is used, the plan sponsor is subject to a special fee of at least 10% of the excess amount (Revenue Procedure 2013-12, section 12.05(2)). The 10% special fee is in addition to the Voluntary Corrections Program submission fee.

Small excess amounts. If the total excess amount is \$100 or less, you aren’t required to distribute the excess and aren’t subject to the special additional VCP fee if the excess amount is retained.

If you improperly determined elective deferrals and employer contributions because you excluded part of a participant’s compensation, you would contribute:

- 50% of the employee’s salary deferral percentage times the employee’s excluded compensation (Note: unlike mistake #3, in this case, the participant’s salary deferral election is known), and
- the employer’s original contribution rate under the plan times the excluded compensation. Adjust the amounts contributed for earnings to the date you correct.

Example:

Susan elected to make an elective deferral equal to 5% of her compensation to her employer’s SARSEP plan. The plan terms require that the employer contribute 2% of compensation for each employee. However, when determining Susan’s elective deferral and required employer contributions, her employer didn’t include \$1,000 of her overtime income. Thus, Susan wasn’t able to make elective deferral contributions (based on her election of 5% of compensation) on overtime income, and her employer ignored overtime income for determining the employer contribution that Susan was entitled to under the plan terms.

Reasonable correction:

The required corrective employer contribution must replace Susan's missed opportunity to make elective deferral contributions on her overtime income and any employer contribution that Susan would be entitled to under the plan terms.

- **Missed deferral opportunity.** Susan's missed deferral, based on her election is 5% of \$1,000, or \$50. The required corrective employer contribution to replace her missed deferral opportunity, before adjusting for earnings, is 50% of \$50, or \$25.
- **Employer contributions.** Under the plan terms, Susan was entitled to an employer contribution equal to 2% of the excluded overtime income of \$1,000. To correct the missed employer contribution for Susan's overtime income, her employer must make a corrective employer contribution of \$20 (2% of \$1,000). The corrective contribution must be adjusted for earnings.

The total corrective employer contribution for Susan is a corrective contribution to replace Susan's missed deferral opportunity for her overtime compensation (\$25 adjusted for earnings) and to replace the employer contributions that Susan would have been entitled to under the plan (\$20 adjusted for earnings). If it isn't feasible to determine what the actual investment results would have been, you may use a reasonable rate of interest.

Correction programs available:**Self-Correction Program:**

The example illustrates an operational problem, because the employer failed to follow the SARSEP plan document terms by failing to include overtime income in compensation used to determine plan allocations. If the other eligibility requirements of SCP are satisfied, the employer may be able to use SCP to correct this mistake if no excess monies are allowed to remain in the affected participants' IRAs. The employer would have to determine whether:

- Appropriate practices and procedures were originally in place to facilitate compliance with requirements for compensation and allocations under the plan.
- The failure is [insignificant](#).

Voluntary Correction Program:

Under VCP, correction is the same as described above under "Corrective action." The employer files a VCP submission according to Revenue Procedure 2013-12, using the [model documents](#), including Schedule 3 and Forms 8950 and 8951. The fee for the VCP submission is \$250.

If the mistake includes excess amounts contributed to the employees' SEP-IRAs, the employer must use VCP if the employer wishes to allow the excess amounts to remain in the affected participants' IRAs. In this case, the employer must pay an additional compliance fee of 10% of the excess amounts.

Audit Closing Agreement Program:

Under Audit CAP, correction is the same as described above under "Corrective action." The employer and the IRS enter into a Closing Agreement outlining the corrective action and negotiate a sanction based on the [maximum payment amount](#).

How to avoid the mistake:

When calculating allocations, it's important to review the plan terms to ensure that you're using the correct amount of compensation. Consider including in your payroll program an account that lists all of a participant's compensation as defined in the plan.

[Return to Table](#)

Mistake	Find the Mistake	Fix the Mistake	Avoid the Mistake
Employee elective deferrals exceed the IRC Section 402(g) limit for the calendar year (\$17,500 in 2014) and excess deferrals haven't been distributed.	Inspect deferral amounts for plan participants to ensure that they haven't exceeded the limits.	Two possible correction methods: a. Distribution method b. Retention method	Have sufficient payroll information to verify that the deferral limitations of IRC Section 402(g) were satisfied.

5) Employee elective deferrals exceed the IRC Section 402(g) limit for the calendar year (\$17,500 in 2014) and excess deferrals haven't been distributed.

Limit on employee elective deferrals: The most a participant can choose to defer for the 2014-calendar year is the lesser of:

- 1) 25% of the participant's compensation, or
- 2) \$17,500

The dollar limitation (subject to [cost-of-living adjustments](#)) applies to the total elective deferrals the employee makes for the year to the SARSEP and any:

- Cash or deferred arrangement (401(k) plan),
- Salary reduction arrangement under a tax-sheltered annuity plan (403(b) plan), or
- SIMPLE IRA plan.

Catch-up contributions: A plan may permit participants who are age 50 or over at the end of the calendar year to make additional elective deferrals. These additional catch-up contributions aren't subject to the above general limits. If your plan provides for catch-up contributions, then **all** eligible participants must have the opportunity to make the same election for catch-up contributions.

The limit on catch-up elective deferral contributions for 2014 is the lesser of \$5,500 (subject to cost-of-living adjustments) or the excess of the employee's compensation over elective deferrals that are not catch-up contributions.

Excess deferrals: The law considers amounts deferred for a year in excess of the above limits "excess elective deferrals." An employee may have excess elective deferrals even if the amount the employee deferred under this SARSEP alone doesn't exceed the limit. This could happen if an employee who elects to defer compensation under a SARSEP also participates in another plan with elective deferrals that is sponsored by the same or a different employer.

When an employee exceeds that annual limit, the employee must withdraw those excess deferrals and associated income by April 15 following the calendar year to which the deferrals relate. Income earned on excess elective deferrals for the year contributed is includible in the employee's income in the year it is withdrawn from the IRA.

Deferrals not withdrawn by April 15 - the SARSEP contributions will be subject to the [IRA contribution limits](#) (\$5,500 in 2014; \$6,500 if age 50 or over) and may be considered excess contributions to the employee's IRA. For the employee, these excess elective deferrals are subject to a 6% tax on excess contributions under Internal Revenue Code Section 4973. If the participant withdraws the excess elective deferral and related income after April 15 and isn't age 59½, it may be subject to the [10% tax on early distributions](#).

How to find the mistake:

Inspect payroll records and participants' year-end deferrals to ensure that they haven't exceeded the limits.

How to fix the mistake:

Corrective action:

When there is a deferral in excess of the Internal Revenue Code Section 402(g) or 408(k)(6)(A)(iii) limit, you have until April 15 of the calendar year after the year in which the excess occurred to correct it. After that, you must use VCP. To correct, the plan sponsor may effect distribution of the excess amount, adjusted for earnings through the date of correction, to the affected participant. The affected participant must include the amount distributed in his or her gross income in the year of distribution. Each distribution must be reported on Form 1099-R for the year of distribution. In addition, you must inform affected participants that this distribution of an excess amount is not eligible for tax-free rollover.

As an alternative, you may use the Retention of Excess Amounts method (see [Mistake #4](#)). If you retain an excess amount in the SARSEP plan, you are subject to a special fee in addition to the VCP submission fee. You aren't entitled to a deduction for an excess amount retained in the SARSEP plan.

If the total excess amount in your SARSEP plan, whether attributable to elective deferrals or employer contributions, is \$100 or less, you aren't required to distribute the excess amount and the special fee doesn't apply.

Example:

Employer X maintains a SARSEP. For calendar year 2012, Bill defers \$19,000 to the plan. Bill is under age 50, so he is not eligible to make catch-up contributions. Bill has excess deferrals of \$2,000 because \$17,000 is the maximum amount permitted for 2012 (\$19,000 - \$17,000 = \$2,000). Employer X didn't discover this mistake until after April 15, 2013. On November 1, 2013, X effected distribution of the excess deferral (plus applicable earnings of \$100, totaling \$2,100) to Bill.

Reasonable correction:

For 2012 (year of deferral), Bill must include the \$2,000 in gross income. For 2013 (year of distribution), Bill must include the \$2,100 distribution in gross income. This amount would be shown on a Form 1099-R for each year and Bill, because he is under age 59 ½, must pay the [10% early distribution tax](#).

Correction programs available:

Self-Correction Program:

When correction of this type of mistake occurs timely, SCP may be used provided the other eligibility requirements of SCP were satisfied and practices and procedures were in place.

The example illustrates a situation in which Employer X can't use SCP because correction didn't occur within the period required by the Revenue Procedure. VCP must be used to correct the mistake.

Voluntary Correction Program:

Under VCP, correction is the same as described under "Reasonable correction." Employer X files a VCP submission according to Revenue Procedure 2013-12, using the [model documents](#),

including Schedule 3 and Forms 8950 and 8951. The fee for the VCP submission is \$250. If Employer X chooses to retain the excess amounts in participants' SEP-IRAs, an additional compliance fee equal to 10% of the excess amounts will apply.

Audit Closing Agreement Program:

Under Audit CAP, correction is the same as described above under "Reasonable correction." Employer X and the IRS enter into a closing agreement outlining the corrective action and negotiate a sanction based on the [maximum payment amount](#).

How to avoid the mistake:

Determine the 402(g) limits for each year and monitor deferrals participants' deferrals throughout the year to ensure that no excess amount is placed into a participant's SEP-IRA.

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Mistake	Find the Mistake	Fix the Mistake	Avoid the Mistake
Less than 50% of eligible employees made employee elective deferrals.	Review payroll records and ensure that 50% of eligible employees are actually making employee elective deferrals annually.	Stop employee elective deferral contributions to the SEP-IRAs.	Annually review plan document for eligibility requirements and payroll records. If less than 50% of eligible employees made elective deferrals during any year, cease withholding employee elective deferrals and notify all employees.

6) Less than 50% of eligible employees made employee elective deferrals.

Each year at least 50% of your eligible employees must choose to make employee elective deferrals into the SARSEP. If fewer than 50% of the eligible employees do so, the law disallows all employee elective deferrals made for that year and the deferrals must be withdrawn from the employees' SEP-IRAs. In that case, by 2 ½ months (March 15 for calendar-year plans) of the following year, you must provide each affected employee:

- The amount of the disallowed deferrals to the employee's SEP-IRA for the preceding year,
- The year the disallowed deferrals and earnings are includible in the employee's gross income,
- Information stating that the employee must withdraw the excess contributions (and earnings), and
- An explanation of the tax consequences if the employee doesn't withdraw the excess.

See the Instructions for [Form 5305A-SEP](#) for information on how to treat disallowed deferrals.

This is a year-by-year rule. Each year the SARSEP doesn't meet the 50% rule, employee elective deferrals for that year cannot remain in the employees' SEP-IRAs.

How to find the mistake:

Review the plan document and determine how many employees are eligible to participate in the plan. Review payroll records to ensure that at least 50% of the eligible employees are making elective deferrals each year.

How to fix the mistake:

Corrective action:

Stop making employee elective contributions to the plan. If the plan isn't under IRS audit, you can file a VCP submission requesting that contributions made for previous years in which fewer than 50% of eligible employees made elective deferral be allowed to remain in the employees' SEP-IRAs.

Example:

In 2011 and prior years, three of the four eligible employees made employee elective deferrals to the ABC SARSEP calendar-year plan. In 2012, one of the contributing employees separated from service from ABC and two other employees became eligible to make employee elective deferrals, but opted not to contribute to the plan. Thus, in 2012, only two of the five eligible employees made employee elective deferrals.

Correction programs available:

Self-Correction Program:

ABC cannot correct this mistake under SCP, which is limited to insignificant operational problems. This mistake is an employer eligibility failure. To retain plan qualification, ABC must correct this mistake under VCP or Audit CAP.

Voluntary Correction Program:

ABC should file a VCP submission to the IRS under Revenue Procedure 2013-12 identifying the failure, using the [model documents](#), including Schedule 3 and Forms 8950 and 8951. The fee for the VCP submission is \$250.

Audit Closing Agreement Program:

Under Audit CAP, correction is the same as described above under “Corrective action.” ABC and the IRS enter into a Closing Agreement outlining the corrective action and negotiate a sanction based on the [maximum payment amount](#).

How to avoid the mistake:

Annually review your plan document eligibility requirements and compare them with your payroll records to determine which employees are eligible to participate. Compare the number of participating employees to the number of eligible employees. If you do not meet the 50% rule, stop transmitting elective contributions to participants’ SEP-IRAs and send a notice within 2 ½ months of the following year (March 15 for calendar-year plans) to each affected employee.

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Mistake	Find the Mistake	Fix the Mistake	Avoid the Mistake
Total contributions (employee elective deferrals and nonelective employer contributions) exceeded the maximum legal limits.	Calculate 25% of each employee's compensation and compare the total contribution made for the employee to the lesser of that amount or the dollar limitation for that year (\$52,000 in 2014).	Two possible correction methods: a. Distribution method b. Retention method	Calculate the allocations based on the plan terms and then check to make sure none of the proposed allocations the Internal Revenue Code.

7) Total contributions (employee elective deferrals and nonelective employer contributions) exceeded the maximum legal limits.

Internal Revenue Code Sections 402(h) and 415 limit the amount of contributions (including employee elective deferrals) made to an employee's SEP-IRA to the lesser of:

- The [dollar limit](#) for that year (\$52,000 in 2014), or
- 25% of the eligible employee's compensation.

The amount of compensation you may consider for each participant is [limited](#) (\$260,000 in 2014). If your SARSEP plan document specifies lower contribution limits, then the lower limits control.

There are special rules if you're self-employed. When calculating the deduction for contributions made to your own SEP-IRA, compensation is your net earnings from self-employment, which takes into account both the deduction for one-half of your self-employment tax and the deduction for contributions to your own SEP-IRA. For this reason, you determine the deduction for contributions to your own SEP-IRA indirectly by reducing the contribution rate called for in your plan. For more information on the deduction limitations for self-employed individuals, see [Publication 560](#), *Retirement Plans for Small Business (SEP, SIMPLE, and Qualified Plans)*.

Employer contributions to a SEP-IRA won't affect the amount you can contribute to a Roth or traditional IRA. However, this may preclude you from receiving a tax deduction for contributions to a traditional IRA. See [IRA Deduction Limits](#) and [Publication 590](#), *Individual Retirement Arrangements (IRAs)*.

How to find the mistake:

Calculate 25% of each employee's compensation (limited to \$260,000 in 2014) and compare the total contributions made for the employee to the lesser of that amount or the dollar limitation for that year (\$52,000 in 2014). Review the special calculations in Publication 560 if you're a [partner](#) or for self-employed.

How to fix the mistake:

Corrective action:

There are two methods to correct a failure to limit employer contributions to employees.

- The amount in excess of the annual limit, adjusted for earnings through the date it's corrected, should be distributed from the affected employee's SEP-IRA and returned to the employer if it exceeds \$100. If it isn't feasible to determine what the actual investment earnings would have been, you may use a reasonable rate of interest.

The affected employee doesn't include the distributed amount in income, but the plan sponsor must report it on Form 1099-R with a taxable amount of zero.

- Alternatively, if the plan sponsor makes a VCP submission, the excess amount may be retained in the SEP-IRA, but only if the plan sponsor pays an additional fee of 10% of the excess amount, excluding earnings. The additional compliance fee only applies if the excess amount is above \$100.

Under both correction methods, the plan sponsor is not entitled to a deduction for the excess contributions.

Example:

Employer I maintains a SARSEP plan. For the 2011 year, the contributions made for two employees, Tom and Ursula, exceeded the annual limit in IRC Section 415. Tom had an excess of \$3,000 and Ursula had an excess of \$300.

Generally, Employer I would have to get Tom and Ursula to take the excess monies as adjusted for earnings out of their SEP-IRAs by taking distributions and returning it to Employer I.

Correction programs available:

Self-Correction Program:

The example shows an operational problem because the employer failed to follow the terms of the plan by exceeding the 402(h) and 415 limits stated in the plan document and the Internal Revenue Code. Therefore, if Employer I meets the eligibility requirements of SCP, they may be able to use SCP to correct the failure by using the distribution of excess amounts correction method. Employer I would have to determine whether:

- Appropriate practices and procedures were originally in place to facilitate compliance with requirements for maximum contribution limits.
- The failure is [insignificant](#).

Voluntary Correction Program:

Under VCP, correction is the same as described under "Corrective action." Employer I files a VCP submission in accordance with Revenue Procedure 2013-12, using the [model documents](#), including Schedule 3 and Forms 8950 and 8951. The fee for the VCP submission is \$250. If Employer I corrects under the alternative retention method described under "Corrective action," they must pay an additional fee of 10% of the excess amount excluding earnings.

Audit Closing Agreement Program:

Under Audit CAP, correction is the same as described under "Corrective action." Employer I and the IRS enter into a Closing Agreement outlining the corrective action and negotiate a sanction based on the [maximum payment amount](#).

How to avoid the mistake:

After initially calculating participant contribution allocations based on your SARSEP plan document terms, make sure none of the proposed allocations violate Internal Revenue Code Sections 402(h) and 415. If the allocation exceeds the limit, adjust it before you transfer the money into the SEP-IRAs.

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Mistake	Find the Mistake	Fix the Mistake	Avoid the Mistake
Employee elective deferrals weren't deposited by the required date.	Review employee data and payroll remittances to ensure that elective deferrals were properly withheld and deposited by the due date.	Make a contribution for each participant.	Review the SARSEP plan rules on the timing of employer contributions and adopt administrative procedures to ensure that you contribute them on time.

8) Employee elective deferrals weren't deposited timely.

You're responsible for contributing the elective deferrals that plan participants make to their SEP-IRAs. If your plan document contains language specifying when you must deposit elective deferrals, you can correct the failure to follow the terms of the SARSEP plan document under EPCRS.

[Department of Labor rules](#) require you to transfer your employees' elective deferrals to their SEP-IRAs on the earliest date on which you can reasonably segregate the amount from your general assets; however, in no event later than the 15th business day of the following month. Keep in mind that these rules don't give a safe harbor for depositing deferrals; rather, they set the maximum deadline for deposit. Department of Labor has a [7-business day safe harbor rule](#) for employee contributions to plans with fewer than 100 participants.

This type of mistake can also lead to another problem – it may give rise to a [prohibited transaction](#) - a transaction that the law prohibits between an IRA and a [disqualified person](#). The law considers an employer a disqualified person with respect to any plan maintained by that employer.

A disqualified person who takes part in a prohibited transaction must correct the transaction and pay an [excise tax](#) based on the amount involved in the transaction. The initial tax on a prohibited transaction is 15% of the amount involved for each year (or part of a year) in the taxable period. If the disqualified person doesn't correct the transaction within the taxable period, the law imposes an additional tax of 100% of the amount involved.

If you didn't deposit elective deferrals by the required date, the failure may constitute both an operational mistake giving rise to plan disqualification (if your plan specifies a date by which elective deferrals must be deposited) and a prohibited transaction. Although you can correct the operational mistake under EPCRS, you can't correct a prohibited transaction using EPCRS. However, DOL maintains a [Voluntary Fiduciary Correction Program \(VFCP\)](#), which you may be able to use to resolve the prohibited transaction.

How to find the mistake:

For each pay period, review the date you withheld the elective deferral contributions from the employees' salaries, (typically the same date that you paid the net salaries to the employees) and compare it with the date you deposited the deferral contributions to the employees' SEP-IRAs. If there is a significant gap between the dates, check whether the gap is avoidable.

How to fix the mistake:

Corrective action:

Correction through EPCRS may be required if you didn't follow your plan terms for when you should've deposited employee salary deferrals. Correction for late deposits may require you to:

- Determine which deposits were late and calculate their lost earnings.
- Deposit any missed elective deferrals into the SEP-IRA, along with lost earnings.
- Review procedures and correct deficiencies that led to the late deposits.

Example:

Employer B sponsors a SARSEP plan for its 12 employees, all of whom are participants in the plan. B pays its employees on the first day of the month. The plan **expressly states** that deferrals are to be deposited within five days after each payday. B conducts a yearly compliance audit of its plan. During this review, B discovered that elective deferrals were deposited 30 days after each payday for the 2012 plan year.

Correction programs available:

Self-Correction Program:

The example shows an operational problem because the employer failed to follow the plan terms for the timing for depositing elective deferrals. Therefore, if the employer satisfies the other eligibility requirements of SCP, they may be able to use SCP to correct the failure. Employer B would have to determine whether:

- Appropriate practices and procedures were originally in place to facilitate compliance with requirements for depositing employee elective deferrals.
- The failure is [insignificant](#).

Voluntary Correction Program:

Under VCP, correction is the same as described above under “Corrective action.” Employer B files a VCP submission in accordance with Revenue Procedure 2013-12, using the [model document](#) and Forms 8950 and 8951. The fee for the VCP submission is \$250.

Audit Closing Agreement Program:

Under Audit CAP, correction is the same as described above under VCP. Employer B and the IRS enter into a closing agreement outlining the corrective action and negotiate a sanction based on the [maximum payment amount](#).

How to avoid the mistake:

Coordinate with your payroll provider to determine the earliest date the deferrals can reasonably be segregated from your general assets and then set up procedures to ensure that you make deposits by that date. Establish procedures so you deposit elective deferrals coincident with or after each payroll according to the plan document. If you have instances where your deferral deposits are a week or two later than the normal timely deposit (for example, because of vacations or other disruptions), keep a record of why those deposits were late. If you’ve changed the person responsible for depositing elective deferrals, make certain the new person understands when these deposits must be made.

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Mistake	Find the Mistake	Fix the Mistake	Avoid the Mistake
You didn't pass the annual deferral percentage test.	Perform and review the test for each year in which deferrals were made.	Two possible correction methods: a. Distribution method b. Retention method	Communicate with plan administrator to ensure proper employee classification. Ensure that both you and the plan administrator are familiar with the terms of the plan. Consider converting to a SIMPLE IRA plan.

9) You didn't pass the annual deferral percentage test.

SARSEPs must pass a nondiscrimination test similar to the annual test that 401(k) plans must pass. This test limits the amount [highly compensated employees](#) can defer based on what non-highly compensated employees defer into the SARSEP. Compute the deferral percentage (DP) limit for highly compensated employees by averaging the deferral percentages for the non-highly compensated employees for the year and then multiplying this result by 1.25. You must compute the DP limit each year. See the Instructions for [Form 5305A-SEP](#) for this computation.

The DP test for SARSEPs compares the deferral percentage of **each** highly compensated employee (not the average deferral percentage of all HCEs) with the average of the deferral percentages of all non-highly compensated employees. Unlike 401(k) plans, nonelective contributions from the employer can't be used to help the SARSEP satisfy the annual test.

If a highly compensated employee exceeded the deferral percentage limit for a year, you must notify each affected employee within 2 ½ months after the plan year (March 15 for calendar-year plans) of the:

- 1) amount of the employee's excess contributions,
- 2) calendar year the excess contributions and earnings are includible in gross income,
- 3) requirement that the employee must withdraw the excess contributions (and earnings), and
- 4) the tax consequences if the employee doesn't withdraw the amounts.

See the Instructions for [Form 5305A-SEP](#) for a detailed description of the notice procedures.

If you don't notify the affected employees within this time period, you must pay a 10% tax on the excess.

The employee must withdraw those excess contributions by April 15 following the year in which the employee is notified. Excess contributions not withdrawn by April 15 will be subject to the IRA contribution limits (\$5,500 in 2014; \$6,500 if age 50 or over) and may be considered excess contributions to the employee's IRA. For the employee, these excess contributions are subject to a 6% tax on excess contributions under Internal Revenue Code Section 4973. Income earned on excess elective deferrals for the year contributed is includible in the employee's income in the year it is withdrawn from the IRA. The income must also be withdrawn by April 15 following the year of notification. If the excess elective deferral and related income is withdrawn after that date and the recipient is not 59½ years old, it may be subject to the [10% tax on early distributions](#).

If you don't notify your employees within 12 months following the end of the plan year in which the excess SARSEP contributions arose (December 31st for calendar-year plans), the SARSEP will no longer be treated as meeting the rules of Internal Revenue Code Section 408(k)(6). In

this case, any contribution to an employee's SEP-IRA will be subject to the IRA contribution limits and may be considered an excess contribution.

Excess SARSEP contributions of an HCE who is age 50 or older before the end of the calendar year don't have to be removed from the employee's SEP-IRA to the extent the amount of the excess contribution is less than the catch-up elective deferral contribution limit (see [402\(g\) limit](#)) reduced by any catch-up elective deferral contributions already made for the year.

Highly compensated employee: An HCE is an employee who:

- Owned more than 5% of the capital or profits in your business at any time during the year or the preceding year, or
- In preceding year received more than \$115,000 (subject to [cost-of-living adjustments](#)) in compensation from you and, if your SARSEP document provides, was in the top 20% of employees when ranked by compensation.

How to find the mistake:

Complete an independent review to determine if you properly classified highly compensated and non-highly compensated employees for the deferral percentage test. Third party administrators should pay special attention to:

- Prior year compensation.
- The ownership attribution rules when identifying 5% owners.
 - TPAs need access to ownership documents to identify 5% owners.
 - Take care to identify family members of the owners, because some may have different last names and may need to be included under the attribution rules.

Also, review the rules and definitions in your plan document for:

- Highly compensated employees
- Compensation
- Deferral percentage testing

Highly or non-highly compensated employees include all employees eligible to make an elective deferral, even if they choose not to make one for the plan year.

How to fix the mistake:

Corrective action:

If a SARSEP plan fails to satisfy the deferral percentage test and you don't timely notify the affected highly compensated employees, it will result in plan disqualification. If you used incorrect data for testing, you may need to rerun the deferral percentage test. If the original or corrected test fails, then you're required to correct the highly compensated employees' excess contributions.

- By regulations, you must correct this error according to your plan document within 12 months following the end of the plan year in which highly compensated employees made excess contributions.
- If you haven't corrected this error within 12 months after the end of the plan year of the excess contributions, you may have to use EPCRS to correct this failure.

There are two methods to correct deferral percentage testing mistakes. You may choose whichever method you prefer. Both require you to make a contribution to the plan for non-highly compensated employees.

- **Method 1** - Under EPCRS, Appendix A, section .03 of Revenue Procedure 2013-12, the permitted correction method is to:
 - Determine the amount needed to raise the non-highly compensated employees' average deferral percentage to the percentage needed to pass the test.
 - Contribute (to the extent permitted by Internal Revenue Code Section [415](#)) to all eligible non-highly compensated employees an amount necessary to raise the deferral percentage to pass the test. Calculate this amount to provide the same percentage rate for all non-highly compensated employees regardless of the SARSEP terms.
- **Method 2** - Under EPCRS, Appendix B, section 2.01, another correction method is the one-to-one method.
 - Effect distribution of excess contributions, adjusted for earnings through the date of correction, to highly compensated employees. Report on Form 1099-R as taxable for the year the distribution is made.
 - Contribute an amount equal to the total amount distributed to the SEP-IRAs of:
 - current employees who were non-highly compensated employees in the year of the failure,
 - current non-highly compensated employees who were non-highly compensated employees in the year of the failure, or
 - current and former employees who were non-highly compensated employees in the year of the failure.

Example:

Employer A has one highly compensated employee, Andrea, who is a participant in the SARSEP. Andrea's compensation for 2012 was \$100,000. Andrea deferred \$6,000 into the SARSEP. Andrea's deferral percentage is 6% (6,000/100,000). Employer A also has three non-highly compensated employees who contributed deferral percentages of 3%, 4% and 5%. The average deferral percentage for the non-highly compensated employees is 4% (3%+4%+5% = 12% divided by 3). The maximum deferral percentage Andrea could have made is 5% (4% times 1.25). Andrea's excess contribution is \$1,000 (6% - 5% times \$100,000).

Correction programs available:

Self-Correction Program:

The example illustrates an operational problem because Employer A failed to follow the plan terms for nondiscrimination testing. Therefore, if the other eligibility requirements of SCP are satisfied, Employer A may be able to use this program to correct the failure. Employer A would have to determine whether:

- Appropriate practices and procedures were originally in place to facilitate compliance with requirements for the deferral percentage test.
- The failure is [insignificant](#).

Voluntary Correction Program:

Under VCP, correction is the same as described above. Employer A files a VCP submission according to Revenue Procedure 2013-12, using the [model documents](#), including Schedule 3 and Forms 8950 and 8951. The fee for the VCP submission is \$250.

Audit Closing Agreement Program:

Under Audit CAP, correction is the same as described above under VCP. Employer A and the IRS enter into a closing agreement outlining the corrective action and negotiate a sanction based on the [maximum payment amount](#).

How to avoid the mistake:

Ensure that both you and your plan administrator are familiar with your SARSEP plan document terms. Perform an annual deferral percentage test according to the instructions in your plan document. Compare the figures in the test with your payroll records, verify proper classification of employees as either highly or non-highly compensated and ensure that the results meet the required limits.

Consider terminating the SARSEP and establish, in a subsequent year, a SIMPLE IRA plan, which isn't subject to the discrimination testing

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Mistake	Find the Mistake	Fix the Mistake	Avoid the Mistake
You didn't make required top-heavy minimum contributions to the SARSEP.	Review the rules and definitions for top-heavy in your plan document. Determine whether your plan is top-heavy for each plan year.	Contribute and allocate the required top-heavy minimum contribution, adjusted for earnings, to affected non-key employees.	Perform a top-heavy test each year. If your plan is top-heavy or deemed top-heavy, ensure that you've made all top-heavy minimum contributions.

10) You didn't make required top-heavy minimum contributions to the SARSEP.

You're required to make a minimum contribution for non-key employees whenever your SARSEP is top-heavy - when more than 60% of all employer contributions go to key employees. SARSEPs are often drafted to operate as if they're always top-heavy, eliminating the need to calculate the annual 60% determination.

When determining if your plan is top-heavy, employee elective deferrals are considered employer contributions. You may not use employee elective deferrals, however, to satisfy the minimum contribution requirements for top-heavy plans. To determine if your SARSEP has met the top-heavy minimum 3% contribution requirement:

- Count employee elective deferrals made by key employees.
- Don't count employee elective deferrals made by non-key employees.

You'll satisfy the top-heavy requirements by making a minimum contribution each year to the SEP-IRA of each non-key employee eligible to participate in the SARSEP. This minimum contribution isn't required for key employees. This contribution, in combination with other nonelective contributions, must be the lesser of:

- 3% of each eligible non-key employee's compensation, or
- the highest percentage of compensation made for any key employee of elective (not including catch-up contributions) and nonelective contributions for the year.

A key employee is any employee who, at any time during the preceding year was a(n):

- officer of your company with compensation greater than \$165,000 in 2013 (subject to [cost-of-living adjustments](#)),
- 5% owner of your company, as defined in Internal Revenue Code Section 416(i)(1)(B)(i), or
- 1% owner of your company with compensation greater than \$150,000.

How to find the mistake:

Review the top-heavy rules and definitions found in your plan document. Determine whether your plan is top-heavy for each plan year. Be careful to identify the owners and their family members employed by your business and apply the family aggregation rules.

How to fix the mistake:

Corrective action:

Under EPCRS, Revenue Procedure 2013-12, Appendix A, section .02, if you didn't contribute the minimum 3% top-heavy contribution, follow these steps to correct this error:

- Identify the affected employees,

- Contribute the required top-heavy minimum, adjusted for earnings, to the affected non-key employees. In a SARSEP plan, the top-heavy minimum contribution is 3% of compensation.

However, if the highest percentage of contribution for a key employee is less than 3%, the top-heavy minimum is that percentage.

Example:

Employer J, a husband and wife business, have sponsored a SARSEP plan for themselves since 1992. As business expanded, they hired two other employees on July 31, 2009. According to the SARSEP plan document terms, both these new employees became eligible for the SARSEP plan on January 1, 2011. Both new employees made elective deferrals to the plan and it passed the deferral percentage test for 2011, 2012 and 2013. During a review of the plan, Employer J determined the plan was top-heavy for the 2011, 2012 and 2013 plan years; however, it did not make minimum top-heavy contributions.

Correction programs available:

Self-Correction Program:

The example illustrates an operational problem because the employer failed to follow the plan document top-heavy provisions. Therefore, if Employer J satisfies the other eligibility requirements of SCP, Employer J may be able to use SCP to correct the failure. Employer J would have to determine whether:

- Appropriate practices and procedures were originally in place to facilitate compliance with requirements for the top-heavy rules.
- The failure is [insignificant](#).

Voluntary Correction Program:

Under VCP, correction is the same as described above under “Corrective action.” Employer J files a VCP submission according to Revenue Procedure 2013-12, using the [model document](#) and including Forms 8950 and 8951. The fee for the VCP submission is \$250.

Audit Closing Agreement Program:

Under Audit CAP, correction is the same as described above under “Corrective action.” Employer J and the IRS enter into a closing agreement outlining the corrective action and negotiate a sanction based on the [maximum payment amount](#).

How to avoid the mistake:

Perform a top-heavy test each year. Properly identify ownership interests under the family aggregation rules so the test is accurate. Be especially careful if you have a smaller plan or one that only covered owners for a period and now has other participants. Verify that each non-key employee received the required top-heavy minimum contribution.

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