April 28, 2011

Retirement Scheme for Tax Break

If you are a small business owner, you should take advantage of the tax law that allows you to draw up a retirement benefit scheme for your employees. This is because you can claim tax deductions from it if you have such a scheme.

The most commonly known retirement scheme is the 401(k) retirement scheme. But the cost of setting up and maintaining a 401(k) can be a deterrent to some small business owners. Here's where the tax code comes in. Certain provisions of the tax code allows you as a small business owner to establish a retirement scheme other than a 401(k), called a Simplified Employee Pension or SEP. Although the SEP is not maintenance free, it is a viable option to the 401(k).

Setting up a Simplified Employee Pension is a three-step process. Firstly, you need to fill up and execute Form 5305-SEP. Then you serve notice to your employees who are eligible for the SEP and set up an IRA account for each of them. This account is to receive each of their contributions. Annual contributions are not obligatory but in years when the contribution is made an employee must receive an amount proportional to his or her salary but not more than 25% of eligible compensation or $49,000 whichever is less. Employee contributions are not permitted for SEP IRAs but employees are immediately vested in their full account balance.

The final step is to maintain the SEP once you have established it. The most important thing to do in maintenance is to keep your plan current. The quickest way to do this would be to check your adopted Form 5305-SEP against the latest version available on the IRS website www.irs.gov. Plan rules may be changed and you need to ensure that your plan document is updated continuously.

As an employer, it is you responsibility to conduct an annual review to see that the plan is being implemented according to the rules and any issues are nipped in the bud. One common issue is inadvertent exclusion of eligible employees. This is especially common in the cases of part-time employees and employees of associated companies. You should review payroll records against plan eligibility for each employee before giving out annual contributions.

If a contribution was missed for an eligible employee, a replacement contribution must be made. On the other hand, if a contribution was made in excess of what should have been made, then contributions exceeding IRS limits, along with earnings on the excess, should be withdrawn from the plan and returned to the employer. The rules state that the distribution must be reported on a Form 1099-R for the employee concerned.