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What Is a SEP IRA?

A simplified employee pension plan (SEP) is a deferred-compensation arrangement that is similar to a profit-sharing plan. It can be set up by employers and self-employed individuals, as well as sole proprietorships and partnerships. Employers receive tax deductions for plan contributions made to employees' accounts, and employees do not pay taxes on SEP contributions until they begin taking distributions (generally, in retirement). Thus, SEPs can be attractive to both the employer and the employee.

Companies that institute SEPs agree to contribute on a nondiscriminatory basis to IRAs maintained by employees. Employers are required to provide benefits to all employees who are eligible. Employees are eligible if they are at least 21 years old, earn at least \$750 (in 2023) each year (indexed for inflation), and have been employed by the company for three out of the five years prior to the year for which the contribution is being made. Employers also have the option of selecting eligibility requirements that are less restrictive, but they must be applied to every employee.

Employer contributions are limited to the lesser of \$66,000 or 25% of an employee's compensation (in 2023). Contributions are made on a discretionary basis, which means that the employer can decide each year whether or not to contribute, as well as how much to contribute.

SEP contributions are made to separate IRAs for eligible employees. Employees are responsible for setting up their own traditional IRAs to receive employer contributions, which are immediately 100% vested, and employees direct their own account investments.

When participants start taking distributions from a SEP IRA, the rules are essentially the same as those for a traditional IRA. Distributions are taxed as ordinary income and cannot be taken before the age of 59½ without incurring a 10% federal tax penalty, except in the case of extenuating circumstances. SEP

IRA account owners must begin taking annual minimum distributions after reaching age 73 (for individuals who reach age 72 after December 31, 2022). If you attained age 72 in 2022 or earlier, you are already required to take annual RMDs. The RMD age will rise to 75 in 2033.

If you are a small-business owner or are self-employed, a SEP IRA may be a good option for you, because contributions may be tax deductible and this type of plan is easy to establish and administer. If you are an employee of a company that offers a SEP IRA, you can benefit from the potential to receive employer-paid contributions. If you are a business owner, always make sure to discuss your retirement plan options with a financial professional before deciding on a method.

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