Not Just a Mere Technicality—SEP Disqualified
May 26, 2008

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SEP, S Corporations and Spouses

Simplified employee pensions, or SEPs, are a fairly popular retirement for small, closely held entities, especially where the owner (or owner and family) are the only employees. Part of the attraction for such plans is the fact that business owners see them as lower cost alternatives to full qualified plans, since there's no need to maintain a separate plan trust and, most often, no third party administrator is brought in to handle the plan. However, that also means that such plans often are run in a rather sloppy fashion.

This week we look at a case where an error that some might have characterized as a “no harm, no foul” rule should have resulted in no adjustment. However, the Tax Court was not inclined to accept that view, and disqualified the plan in its entirety—a result that should raise concerns for taxpayers who have such plans, and for advisers associated with clients with such plans that are not obtaining outside advice on the operation of the plan. The adviser may find that the client believes the adviser whom they are working with for other tax advice (be that a CPA, EA or attorney) is going to “take care” of advising them

on issues related to the SEP.

The case involved is the case of *Brown v. Commissioner*, TC Summary Opinion 2008-56 which involved Mr. and Mrs. Brown, their S corporation and a SEP. The problem occurred when, despite the fact that both Mr. and Mrs. Brown were employees of the S corporation, SEP contributions were made solely on behalf of Mr. Brown. The failure to comply with the terms of the plan that required contributions on behalf of all eligible employees doomed the deductions in the eyes of the Tax Court.

Simplified Employee Pensions

Simplified employee pensions (or SEPs) were created to give small businesses a "less complex" retirement plan that could be implemented without the complexity and cost of a full blown standard qualified plan under §401(a). The plan used IRA accounts created in the names of the participants in the plan to hold the plan's contributions, eliminating the need to maintain a tax exempt employee benefit trust. Since the accounts were fully in the control of the employee once the contribution was made, there was also no need to file the annual reports traditionally made on Form 5500s for qualified plans, nor does the plan account to the participants for the activity in their account—rather, the employee gets the regular reports from their IRA custodian.

As you might expect, not all is rosy for a SEP. A few notable disadvantages to SEPs incude:

- Contributions are fully vested in the employee once the contribution is made
- Coverage rules do not allow for an exclusion of employees based on hours of service
- Options for allocating employer contributions are very limited, with the only "fancy" allocation option available being permitted disparity

Participation rules are spelled out in §401(k)(2) which provides the following:

> (2) Participation requirements
>
> This paragraph is satisfied with respect to a simplified employee pension for a year only if for such year the employer contributes to the simplified employee pension of each employee who--
>
> (A) has attained age 21,
>
> (B) has performed service for the employer during at least 3 of the immediately preceding 5 years, and

> (C) received at least $450 in compensation (within the meaning of section 414(q)(4)) from the employer for the year.
>
> For purposes of this paragraph, there shall be excluded from consideration employees described in subparagraph (A) or (C) of section 410(b)(3). For purposes of any arrangement described in subsection (k)(6), any employee who is eligible to have employer contributions made on the employee's behalf under such arrangement shall be treated as if such a contribution was made.

Note that it's a relatively simple three part test to determine who is eligible to participate in the plan. Employees meeting that test are in the plan. It's also important to note that these are minimums-a SEP can be more generous in which employees are allowed in, but it needs to be consistent in its application.

Allocations are governed by §408(k)(3) which provides a similarly restricted set of requirements:

> (3) Contributions may not discriminate in favor of the highly compensated, etc.
>
> (A) In general
>
> The requirements of this paragraph are met with respect to a simplified employee pension for a year if for such year the contributions made by the employer to simplified employee pensions for his employees do not discriminate in favor of any highly compensated employee (within the meaning of section 414(q)).
>
> (B) Special rules
>
> For purposes of subparagraph (A), there shall be excluded from consideration employees described in subparagraph (A) or (C) of section 410(b)(3).
>
> (C) Contributions must bear uniform relationship to total compensation
>
> For purposes of subparagraph (A), and except as provided in subparagraph (D), employer contributions to simplified employee pensions (other than contributions under an arrangement described in paragraph (6)) shall be considered discriminatory unless contributions thereto bear a uniform relationship to the compensation (not in excess of the first $200,000) of each employee maintaining a simplified employee pension.
>
> (D) Permitted disparity

> For purposes of subparagraph (C), the rules of section 401(l)(2) shall apply to contributions to simplified employee pensions (other than contributions under an arrangement described in paragraph (6)).

Again, this presents us with only the permitted disparity option. The limited exclusion option noted for employees mentioned in §410(b)(3) involves certain employees covered by collective bargaining arrangements and certain nonresident aliens.

The Brown Case

As noted, Mr. Brown owned an S corporation (Aaron Brown Mortgage, Inc.) and both he and Mrs. Brown were employees of the corporation for the years in question. On October 1, 2001 the corporation established a SEP by executing a Form 5805-SEP with the Vanguard Group.

Note that a SEP plan doesn't need to be obtained from a financial institution—the IRS posts a SEP plan on its website (Form 5805-SEP) that employers can execute independently of any specific institution. However, that form offers only vanilla options (no permitted disparity provision is in that plan), though it also does not restrict funding to any particular IRA custodian. However, Mr. Brown elected to use the plan available directly from Vanguard which, in fact, is just the standard IRS form.

He did make the plan more generous than the default plan by requiring an employee be 18 years of age (as opposed to 21) and only have worked one-half year out of the previous five years (rather than 3). The opinion does not tell us why those options were chosen or what impact they had on how contributions should have been allocated or which employees were eligible. However, such modifications may need to be made in SEPs for entities just getting started—no one (including the owner) may meet the “3 of 5” test and it's possible that we want to benefit someone who is not yet age 21.

The Tax Court pointed out one little detail on the instructions on the form that Mr. Brown executed, noting:

> The instructions on the form caution the employer: "All eligible employees must be allowed to participate in the SEP."

Mere Technicality—Or Maybe Not

Operation of the plan proved to be a bit more difficult than Mr. Brown believed it was, and this would work to his disadvantage. In April of 2004 the Browns made a contribution under the SEP of $7,200. Both Mr. and Mrs. Brown worked for the corporation in that year, both were over age 18 and met the “1/2 year in prior 5 years” eligibility test. Mr. Brown had been paid $36,000 while Mrs. Brown had received $18,000.

However, when it came time to allocate the contribution, the entire $7,200 was deposited in an IRA for Mr. Brown, and the deduction for his SEP was claimed on page one of Form 1040 as an adjustment to income rather than on the Form 1120S of the corporation. Mrs. Brown made a regular $3,000 contribution to her own IRA for each of the two years.

The IRS noted an initial problem—the deduction was being claimed by the wrong entity. Since the corporation was the only eligible sponsor, and it had formed the plan, the deduction should have been claimed on the corporate return. The IRS cited §1366(a) which provides:

> (a) Determination of shareholder's tax liability
>
> (1) In general
>
> In determining the tax under this chapter of a shareholder for the shareholder's taxable year in which the taxable year of the S corporation ends (or for the final taxable year of a shareholder who dies, or of a trust or estate which terminates before the end of the corporation's taxable year), there shall be taken into account the shareholder's pro rata share of the corporation's--
>
> (A) items of income (including tax-exempt income), loss, deduction, or credit the separate treatment of which could affect the liability for tax of any shareholder, and
>
> (B) nonseparately computed income or loss.
>
> For purposes of the preceding sentence, the items referred to in subparagraph (A) shall include amounts described in paragraph (4) or (6) of section 702(a).
>
> (2) Nonseparately computed income or loss defined
>
> For purposes of this subchapter, the term "nonseparately computed income or loss" means gross income minus the deductions allowed to the corporation under this chapter, determined by excluding all items described in paragraph (1)(A).

But, as the Tax Court noted, this wasn't going to be the IRS's real complaint about this plan—rather coverage issues were the problem.

The IRS argued that the failure to make a contribution for Mrs. Brown caused the plan to violate §408(k)(2) and rendering the contribution nondeductible

The taxpayers argued that this was being unfair. First, they argued that this was merely a minor technicality, but the Court didn't buy that argument as was noted:

> Petitioners argued at trial that they have been caught by a mere "technicality". The Court disagrees with petitioners' contention that the failure of the corporation to contribute to an IRA in favor of an employee, Mrs. Brown, was a mere technicality. The requirement, aimed at fairness and equitable treatment for employees, is one of the few basic provisions of the SEP regime.

The Court also pointed out that the instructions contained on the Form the taxpayer executed pointed out this little "technicality" was an important requirement, so the taxpayer should have no reason to have been unaware of these requirements. It noted:

> Even if the provision could fairly be characterized as a "technicality", it is one that was brought to the attention of the president of the corporation, Mr. Brown, more than once in the agreement. Mr. Brown, as president, signed and agreed to the provisions contained in the agreement, including the requirement that each employee receive from the corporation a contribution to his or her IRA.

It's important to note that the Court does not seem to have a lot of sympathy for the "do it yourselfer" in this case. A taxpayer who had unrelated employees that were excluded from the plan (something we sometimes see when the owner doesn't meet the 3 of 5 test, but gets a contribution while other employees don't) would likely fare worse than this taxpayer did.

The taxpayer did suggest that maybe there should be some slack granted since, for other purposes, the spouse and employee are given a rough equivalence—the taxpayer looked to the attribution rules of §318. The taxpayer argued that since §318 creates a "my stock is your stock" rule of sorts, it should follow that Mr. Smith's IRA account is the equivalent of Mrs. Smith's IRS account.

The Tax Court, however, pointed out that the provision has no relevance here. As the Court notes:

> Petitioners' contention in their petition is that the section 318 rules of attribution treat the contribution to Mr. Brown's IRA as a contribution to Mrs. Brown's IRA. The problem with this position is that section 318, Constructive Ownership of Stock, as the title implies, addresses stock ownership, not IRA or SEP contributions. For example, an individual shall be considered as owning the stock owned, directly or indirectly, by or for his spouse. Sec. 318(a)(1)(A)(i). In addition, section 318 applies to "those provisions of this subchapter to which the rules contained in this section are expressly made applicable". Sec. 318(a). Section 318(b) lists the "provisions to which the rules contained in subsection (a) apply". Section 408 is not one of the provisions listed in section 318(b) and is not in the same subchapter of the Code as section 318.,

So, having rejected all of the taxpayer's defenses, the deduction for the SEP was disallowed as the IRS had argued.

Lessons for SEPs

SEPs present special problems, ones that the IRS has been made aware of in the past. One thing to consider immediately is the mere existence of this case indicates that the IRS likely has the issue in minds of agents conducting examinations of closely held businesses. SEPs have been difficult for the IRS to target in a special program because there is no filing requirements for a SEP, and even the deduction is reported on the same lines as regular qualified plans. Since agents did not appear to be specially instructed to look at SEP plans in the past, they often seemed to go unchallenged even when a small business with a SEP was examined.

Many taxpayers have little or no clue about how a SEP should be operated, and often arrive with misinformation they have gathered from various unofficial sources. For instance, in this case I doubt it was coincidental that the amount contributed to the plan was 20% of Mr. Smith's earnings—and amount Mr. Smith likely thought was the maximum contribution available for his wages based on information he saw about the limits for SEPs for the self-employed. In reality for an S corporation, the limit is 25% of the employee's wages—and that is true even for an owner of the S corporation.

As well, quite a few people (and even some practitioners I've run into) believe that having self-employment income allows an individual to set up a SEP plan covering just themselves, even when that self-employment income comes from a partnership. That also is a mistake, since the only valid sponsor is the business and the coverage rules apply to the business as a whole.

A real risk is that taxpayers in this position may assume that the person doing their tax return or their business's attorney would let them know about any issues of this sort—an assumption the attorney, CPA or EA may not share, especially if that person sees

themselves as not a qualified plan specialist. Such individuals whose clients have qualified plans often are used to relying on the plan's third party administrator to take care of all of the issues related to the plan. But since one of the selling points of the SEP is that a separate trust and related accounting is not necessary, no third party administrator will normally exist for the SEP. That may leave the CPA, EA or attorney as the only professional for a client to attempt to assign blame to if things go wrong.