StatonWalsh

Financial Clarity Through Transparency

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Table of Contents

Simplified Employee Pension (SEP)

The basics: A SEP provides an employer with a simplified way to make contributions to an employee's individual retirement account or individual retirement annuity.

- Employer contributions are made directly to SEP-IRAs set up for each employee with a bank, insurance company or other qualified financial institution.
- Employer contributions are generally tax deductible.
- Contributions are not taxed currently to the employee.
- Earnings accumulate income tax-deferred.

How Much Will There Be at Retirement?

This will depend upon three factors:

- The frequency and amount of contributions,
- The number of years until retirement, and
- The investment return.

The risk of poor investment returns rests upon the *employee*. However, if the investment results are favorable, the participant will have a larger fund at retirement age. The following table illustrates the amount to which annual deposits of $10,000 will accumulate at various growth rates for various periods.

An Example of What $10,000 Per Year Will Grow to Over Several Years at Various Rates of Growth Without Tax[1]				
Years	2.00%	4.00%	6.00%	8.00%
5	$52,040	$54,163	$56,371	$58,666
10	$109,497	$120,061	$131,808	$144,866
15	$172,934	$200,236	$232,760	$271,521
20	$242,974	$297,781	$367,856	$457,620
25	$320,303	$416,459	$548,645	$731,059
30	$405,681	$560,849	$790,582	$1,132,832
35	$499,945	$736,522	$1,114,348	$1,723,168

Top-Heavy Plans

If more than 60% of the aggregate contributions have been allocated to key employees[2], then the employer must contribute at least as much as a percentage of compensation for non-key participants as it does for key employees. This requirement applies only to a contribution of up to the first 3% of includable compensation (higher in some instances).

Additional Considerations

- **Annual contribution:** No annual contribution is required. If a contribution is made, and IRS Form 5305-SEP is used as the plan document, the allocation must be the same percentage of compensation for each eligible employee. In calculating the contribution percentage, the compensation must be limited to the maximum amount discussed below. Allocation formulas that favor older employees may not be used. If integration with Social Security is desired, a custom plan or prototype document must be used.

[1] The rates of return used in this illustration are not representative of any actual investment. Typically, an investment will not provide a consistent, unchanging rate of return year after year. Years with a rate of return higher or lower (even negative) than the hypothetical returns shown here can substantially affect the final results.

[2] A "key" employee is someone who, at any time during the plan year was: (1) an officer of the employer whose compensation from the employer exceeded $215,000; or (2) a more than 5% owner; or (3) a 1% owner whose compensation from the employer exceeded $150,000.

- **Individual limits:** For 2023, the allocation of excludable employer contributions to a participant's account may not exceed the lesser of 25% of compensation or $66,000. For the self-employed, these maximum values are effectively 20% and $66,000. The maximum amount of compensation that may be considered is $330,000.

- **Time of contribution:** Contributions can be made until the due date (plus extensions) of the employer's return.

- **Vesting:** Vesting must always be 100%.

- **Who may participate:** Any employee who is at least 21 years old and has performed service in at least three of the last five calendar years must be permitted to participate under the SEP unless his or her total compensation is less than $750[1] for the year for which the contribution will be made.

- **Investment of contributions:** Each participant directs the investment of the funds contributed on his or her behalf. The funds may be invested in most equity or debt products, but may not be invested in life insurance, "hard" assets, or collectibles, except for U.S. gold and silver coins and certain other coins and precious metals.

- **Withdrawals:** Participants may withdraw or cash out at any time. However, withdrawals are included in taxable income in the year received.

- **Premature withdrawals:** Withdrawals prior to age 59½ are subject to an additional 10% penalty tax, unless one or more of the following exceptions apply.
  - A distribution is made because of the death or disability of the account owner.
  - A withdrawal is part of a scheduled series of substantially equal periodic payments.
  - A distribution is transferred into another qualified plan or IRA.
  - A withdrawal is used to pay deductible medical expenses.
  - The distribution is used to pay for certain qualified higher-education expenses.
  - Funds are withdrawn to pay for first-time homebuyer expenses up to $10,000.

[1] This amount applies to 2023. This *de minimis* threshold is subject to change as indexed for inflation.

- In certain situations, to pay health insurance premiums for unemployed individuals.
- Distributions by certain military reservists called to active duty after 09/11/2001.
- A distribution is transferred to a Health Savings Account (HSA)
- In case of an IRS levy on the account.
- To pay expenses (up to $5,000 per parent) related to the birth or adoption of a child.
- A distribution was a coronavirus-related distribution.

- **Required Minimum Distributions (RMDs):** These distributions must begin by April 1 of the year following the year in which the participant reaches age 72.[1] If the distribution is received in the year following attainment of age 72, two distributions are required in that specific year. Thereafter, the minimum distribution must be made by the end of each calendar year.
- **Coronavirus-related distribution (CRD):** One section of the Coronavirus Aid, Relief, and Economic Security (CARES) Act provided for a "Coronavirus-related distribution," or CRD. A CRD – optional (not mandatory) for a qualified retirement plan sponsor – was a distribution made from January 1, 2020, through December 30, 2020, from an IRA or qualified retirement plan. A CRD could not exceed $100,000 in aggregate per individual, was exempt from the usual 20% mandatory federal income tax withholding, and must have been made to an individual (or spouse or dependent) who was diagnosed with SARS-CoV-2 or COVID-19, or who experienced an adverse financial consequence as a result of the COVID-19 pandemic. A CRD was exempt from any 10% early withdrawal penalty that may have applied and, unless the individual chose otherwise, the CRD could be included in taxable income ratably over a three-year period. A CRD may be re-paid, without regard to the normal contribution limits, over a three-year period.

[1] The age 72 "trigger" date applies to distributions required to be made after December 31, 2019, to individuals who reach age 70½ after that date. Under prior law, age 70½ was the mandated age for beginning RMDs.

Advantages to Employer

- Contributions are generally tax deductible.
- Contributions and costs are very flexible.
- Reporting is very minimal—no IRS or Dept. of Labor forms.
- The plan is easily understood by the employees.
- The plan is easy to set up by merely completing IRS Model Form 5305-SEP,[1] or the funding institution's plan.
- There is little or no administrative expense.
- There is no ongoing fiduciary liability to the employer for plan asset management.
- Plan may be established up until the tax return deadline, including extensions.

Advantages to Employees

- Annual contributions are not taxed currently to the participant.
- Earnings on the account are not currently taxed.
- Participants have the right to direct investments.
- Federal law allows a qualified plan to establish an "eligible investment advice arrangement" under which individually tailored investment advice is provided to plan participants. Any fees or commissions charged must not vary with the investment options chosen, or else a computer model meeting certain requirements must be used.
- Participants may also have a traditional, deductible IRA (subject to certain income limitations based on filing status), a traditional, nondeductible IRA, or a Roth IRA.
- Funds can be withdrawn at any time, e.g., in the event of an emergency such as death or disability. Distributions are includable in taxable income in the year received. A

[1] This model form may not be used if the employer currently maintains any other qualified pension or profit sharing plan.

10% penalty tax may also apply if the participant is under age 59½ when a distribution is received.[1]

- ERISA and federal bankruptcy law provide significant protection from creditors to participant accounts or accrued benefits in tax-exempt retirement plans. In traditional and Roth IRAs, generally, up to $1,512,350[2] is protected. However, funds in a SEP IRA are protected without any dollar limitation.

Disadvantages to Employer

- Contributions must be made for part-time and seasonal employees.
- Employees can withdraw the funds as fast as they are put into the account.
- Employees are always 100% vested—there are no forfeitures to reduce employer contributions.
- Employees control investments.
- Allocation methods that reduce employer costs may not be used; employee costs can be high compared to other types of plans. However, some plan documents used by investment vendors permit integration with social security, which will reduce employer contributions to some extent.

Disadvantages to Employees

- There is no guarantee as to future benefits.
- Investment risks rest on the *employee*.
- There is no assurance as to the frequency and amount of employer contributions.
- Special lump-sum tax treatment of distributions is not available.
- There are no forfeitures to be reallocated.
- Life insurance funding is not available.

[1] See "Withdrawals" under "Additional Considerations," above.

[2] Effective April 1, 2022. This limit is indexed for inflation every three years.

SEP vs. Profit Sharing Plan

Item	SEP	Profit Sharing
Maximum employer deduction for all plan participants	25% of covered compensation	25% of covered compensation
Maximum amount excludable from current taxation for employee	Lesser of 25% of compensation (limited to $330,000 in 2023) or $66,000	Lesser of 100% of compensation (limited to $330,000 in 2023) or $66,000
Included in employee gross income?	No	No
Eligibility	All categories of employees except union	Some flexibility
Eligibility waiting period	Age 21/any amount of service during 3 of last 5 calendar years	Age 21/1 year service (or 2 years if 100% vested)
Part-time employees	Must be included if they earn more than $750 in the year for which a contribution is made.	Excluded if less than 1,000 hours in plan year[1]
Eligibility for contribution	If eligibility for plan is met, the employee is entitled to contribution whether or not employed on date of contribution	Determined by the plan document
Must annual contributions be made?	No – Discretionary	No – Discretionary
Deadline for making contributions	Tax filing date, including extensions	Tax filing date, including extensions
Reporting and disclosure (employer)	Minimal	Full ERISA requirements
Top-heavy regulations	Apply	Apply
Investments	Decided by employee; no hard assets or collectibles (except certain government coins)	Decided by trustee Plan may allow participants to direct investments

[1] Effective January 1, 2024, part-time employees working at least 500 hours per year for three years must be allowed to make 401(k) deferrals, but need not be included in employer contributions.

Simplified Employee Pension (SEP)

Item	SEP	Profit Sharing
Allocation of contributions	Pro rata by compensation, but may be integrated with Social Security	Various Most favorable to highly paid and/or older participants
Protects from claims of bankruptcy creditors	Federal bankruptcy law provides significant protection from creditors.	Federal bankruptcy law provides significant protection from creditors.
Who controls withdrawals?	Employee	Terms of the plan trustee/administrator
Vesting requirements	Always 100% vested	May be graded up to six years
Favorable taxation of lump-sum distribution	Not available	Maybe[1]
Employee withdrawals	Anytime, with 10% tax penalty prior to age 59½	Generally, only on death, termination or retirement as provided by plan
Employee loans	No	Yes, provided legal guidelines are observed
Life insurance	Not permitted	Permitted within legal guidelines
Deadline to Establish the Plan	Tax filing date, including extensions	Tax Filing date, including extensions.

[1] Those born before 1936 may be able to elect 10-year averaging or capital gain treatment; these strategies are not available to those born after 1935.

How a SEP-IRA Works

EMPLOYER

- Contributes for all qualified employees.[1]
- Contributions are generally tax deductible.
- Plan is flexible (contributions are not required each year).
- Generally little or no administrative expense.

SEP-IRA

- A separate IRA exists for each participant.
- Employer contributions are not currently taxable.
- Earnings accumulate tax-deferred.
- Plan is self-directed (employee controls investments).
- Investment risk remains on employee.

EMPLOYEE

- Maximum 2023 allocation to a SEP for an employee is $66,000.[2] For a self-employed individual, the limit is also $66,000.[3]

EARLY WITHDRAWALS

- A 10% penalty generally applies if withdrawals are made before age 59½.
- Some exceptions to 10% penalty are available.
- Earnings and contributions taxed as ordinary income in year received.

RETIREMENT

- Distributions must begin by April 1 of year following the year the owner reaches age 72.[4]
- Required minimum distribution rules apply.
- Earnings and contributions taxed as ordinary income in year received.

DEATH

- Value of IRA is included in owner's gross estate.
- Proceeds can pass to beneficiaries with payments over varying time periods.
- Income and estate taxes can severely reduce funds left to nonspousal beneficiaries.

[1] Any employee at least 21 years of age who has performed "service" in three of the last five years, and whose total compensation exceeds $750 for the year.

[2] For an employee, contributions may not exceed the lesser of 25% of compensation (maximum of $330,000) or $66,000.

[3] For a self-employed individual, contributions may not exceed the lesser of 20% of compensation (maximum of $330,000) or $66,000.

[4] Applies to distributions required to be made after December 31, 2019, to individuals who reach age 70½ after that date.

SIMPLE Retirement Plan

The Small Business Job Protection Act of 1996 created an entirely new type of retirement plan called "SIMPLE," an acronym that stands for Savings Incentive Match Plan for Employees. A SIMPLE plan is essentially a written arrangement providing an employer and its employees, with a simplified way to save for retirement. It is most often set up as a SIMPLE IRA plan using IRAs, but may also be set up as a SIMPLE 401(k) plan. Unlike their traditional 401(k) and 403(b) counterparts, SIMPLE plans are relatively easy to establish and maintain. Furthermore, they have lower administrative costs and lower contribution limits, which currently stand at $15,500[1] per year. A SIMPLE plan is available for any business which:

- Has 100 or fewer employees (including employees of related entities);
- Does not maintain another tax-qualified retirement plan to which contributions are made; and
- Is either an incorporated or unincorporated entity.

How It Works

- An employer considering offering a SIMPLE plan for a given year, must establish it no later than October 1st of the year. Employees must then be given advance notice, before the plan takes effect. A SIMPLE plan can be set up through financial service providers such as banks, online brokers, and mutual fund purveyors. To launch the plan, the employer plan must execute the paperwork generated by the plan provider, and participants then open SIMPLE accounts at the same place the plan was established. Most employers choose to have all participant accounts at the same financial institution. However, a SIMPLE plan may allow participants to select their own financial institution.
- Employee has the option of taking cash or having it contributed to the SIMPLE account for retirement. This is equivalent to the employee making a pre-tax contribution.

[1] This is the 2023 limit. In 2022, the limit was $14,000.

- Mandatory employer contributions are tax-deductible to the business.
- Employer contributions are not taxed currently to the participants.
- Earnings accumulate income tax deferred.
- The employer must deposit participant contributions within 30 days after the end of the month for which the contribution was made.
- There are two different types of SIMPLE plans that, although similar, do have distinct differences. There is an IRA version and a 401(k) version.

Item	IRA Version	401(k) Version
Plan type	Individual IRA for each participant.	Cash or deferred profit sharing plan.
Participation	Any employee who received $5,000 or more of income during any 2 prior years and is expected to earn $5,000 during the current year must be eligible.	Regular qualified plan rules apply, such as: Minimum age of 21 1 year of service 1000 hours[1]
Do cash or deferred nondiscrimination rules apply? [(401(k), 401(m)]	No	No, unless employer fails to contribute.
Top-heavy rules	They do not apply.	Do not apply unless employer fails to contribute.
ERISA reporting and disclosure rules	Simplified rules apply.	Regular rules apply.
Vesting	Always 100%	Always 100%
Employee contributions	Voluntary up to $15,500. May not exceed 100% of compensation. May stop at any time. For those age 50 and older, additional "catch-up" contributions of $3,500 may be made.	Voluntary up to $15,500. May not exceed 100% of compensation. May stop at any time. For those age 50 and older, additional "catch-up" contributions of $3,500 may be made.
Minimum participation requirements	There is no minimum number or percentage of eligible employees who must participate.	There is no minimum number or percentage of eligible employees who must participate.

[1] Effective January 1, 2024, part-time employees working at least 500 hours per year for three years must be allowed to make 401(k) deferrals, but need not be included in employer contributions.

Item	IRA Version	401(k) Version
Employer contributions	Employer must satisfy one of two alternatives. Election must be made at least 60 days before the start of the plan year.	Employer must satisfy one of two alternatives. Election must be made at least 60 days before the start of the plan year.
Alternative #1 - Matching contributions	Employer matches employee's elective deferral, dollar for dollar, up to 3.0% of compensation.	Employer matches employee's elective deferral, dollar for dollar, up to 3.0% of compensation.
	For any two years out of five, employer may have a lower match, but not less than 1.0%.	Not available.
	The $330,000 compensation limit does not apply.	The $330,000 compensation limit does apply.
	No conditions may be imposed on the right to the employer match such as minimum hours or end of year employment.	No conditions may be imposed on the right to the employer match such as minimum hours or end of year employment.
Alternative #2 - Nonelective contribution	Employer contribution is 2% of compensation to all eligible employees, whether they defer or not.	Employer contribution is 2% of compensation to all eligible employees, whether they defer or not.
	The $330,000 compensation limit does apply.	The $330,000 compensation limit does apply.
Employer contributions are due by:	Due date of employer's income tax return, plus filing extensions.	Due date of employer's income tax return, plus filing extensions.
Employee in-service withdrawals	Allowed for any reason. Taxed as ordinary income and may be subject to IRS penalties if taken before age 59½.	Rules are the same as for 401(k) plans. If plan provides for loans or hardship withdrawals, they are allowed.
Taxation of distributions	Generally, treated in the same fashion as withdrawals from a traditional IRA. Ordinary income. Penalty taxes may apply.	Same as 401(k) plans. Distribution is ordinary income. 10-Year averaging[1] may be available.
Additional employer contributions	Are not permitted.	Are not permitted.

[1] Those born before 1936 may be able to elect 10-year income averaging or capital gain treatment; these strategies are not available to those born after 1935.

Item	IRA Version	401(k) Version
May employer have another plan to which contributions are made or in which benefits accrue?	No	No
Rollovers	Allowed if to another SIMPLE IRA or, after 2 years of SIMPLE participation, to a traditional IRA or qualified plan.	These are allowed when made to a traditional IRA or qualified plan.
Taxation of premature (before age 59½) distributions within first two years of participation	Taxed as ordinary income, plus a 25% penalty, unless an exception applies.	Taxed as ordinary income, plus a 10% penalty, unless an exception applies.
Taxation of premature (before age 59½) distributions after first two years of participation	Taxed as ordinary income, plus a 10% penalty, unless an exception applies.	Taxed as ordinary income, plus a 10% penalty, unless an exception applies.
Reporting requirements	Plan trustee must provide employer with information on basic plan details.	Regular reporting and disclosure requirements apply. 5500 filing, Summary Plan Description and Summary Annual Report.
	Employer must notify employee of right to defer and provide above information.	
	By January 30, employer must give each participant a statement setting forth account balances as of December 31, and all activity during the calendar year.	401(k)-type of participant reports is required. Time limit is 9 months after the close of the plan year with Summary Annual Report.

Advantages to Employer

- Unlike 401(k) plans, the employer knows in advance approximately what the financial commitment will be.
- Employer contribution is tax deductible.
- The plan is easily understood by employees.
- The 401(k) version of the plan can provide employees with permanent life insurance benefits that need not expire nor require costly conversion at retirement age.

- In the 401(k) version, plan trustee can direct plan investments.
- If former participants do not provide the plan with distribution instructions, the plan may automatically distribute accounts less than $5,000. In the case of a plan that provides for such mandatory distributions, the plan must automatically roll an eligible distribution amount that exceeds $1,000 to a Rollover IRA in the former participant's name. A plan may allow direct rollovers of less than $1,000.

Advantages to Employees

- Participant deferrals are made with pre-tax dollars.
- Employer contributions are not currently taxable to participant.
- In the 401(k) version, distributions may be eligible for 10-year income averaging[1] or, at retirement from the current employer, rolled over to a traditional or a Roth IRA, or to another employer plan if that plan will accept such a rollover.
- Distributions from the IRA version are taxed in the same manner as a traditional IRA, except for a 25% penalty for premature distributions in the first two years.
- In the IRA version, participants have the right to direct investments. In the 401(k) version, participants may have the right to direct investments, depending on plan provisions.
- Federal law allows a qualified plan to establish an "eligible investment advice arrangement" under which individually tailored investment advice is provided to plan participants. Any fees or commissions charged must not vary with the investment options chosen, or else a computer model meeting certain requirements must be used.
- Participants may also have a traditional, deductible IRA, or Roth IRA, subject to certain income limitations based on filing status.
- In the 401(k) version there is the ability to purchase significant permanent life insurance which is not contingent upon the company group insurance program. Purchase of life insurance will generate taxable income to the employee.

[1] Those born before 1936 may be able to elect 10-year averaging or capital gains treatment

- Younger employees can accumulate a larger fund than with a defined benefit plan.
- If the 401(k) plan permits, participants can borrow from the plan, within the requirements of the plan and the law.
- In the 401(k) version, if the plan permits, participants can make hardship withdrawals within the requirements of the plan.
- ERISA and federal bankruptcy law provide significant protection from creditors to participant accounts or accrued benefits in tax-exempt retirement plans. In traditional and Roth IRAs, generally, up to $1,512,350[1] is protected. However, funds in either a SIMPLE IRA or SIMPLE 401(k) are protected without any dollar limitation.

Disadvantages to Employer

- The employer is required to contribute.
- The more highly paid participants may not be able to contribute sufficient funds to build an adequate retirement. This may bring pressure on the employer to provide additional retirement benefits.
- In any given calendar years, a SIMPLE plan can be the only employer-sponsored retirement plan in which the employees benefit. This can make it difficult for an employer to change to a 401(k), profit sharing, or defined benefit plan during the year.
- While called a “SIMPLE” plan, in operation it is not nearly as simple as often thought.

Disadvantages to Employees

- There is no guarantee as to future benefits.
- Investment risk rests on the *employee*.
- There are no forfeitures to reallocate as under other types of defined contribution plans.
- For older employees, there may not be sufficient time to accumulate a decent retirement fund. Other types of defined contribution plans can provide a better retirement benefit for older workers.

[1] Effective April 1, 2022. This limit is indexed for inflation every three years.

Coronavirus Aid, Relief, and Economic Security (CARES) Act

- **Coronavirus-related distribution (CRD):** One section of the Coronavirus Aid, Relief, and Economic Security (CARES) Act provided for a "Coronavirus-related distribution," or CRD. A CRD – optional (not mandatory) for a qualified retirement plan sponsor – was a distribution made from January 1, 2020, through December 30, 2020, from an IRA or qualified retirement plan. A CRD could not exceed $100,000 in aggregate per individual, was exempt from the usual 20% mandatory federal income tax withholding, and must have been made to an individual (or spouse or dependent) who was diagnosed with SARS-CoV-2 or COVID-19, or who experienced an adverse financial consequence as a result of the COVID-19 pandemic. A CRD was exempt from any 10% early withdrawal penalty that may have applied and, unless the individual chose otherwise, the CRD could be included in taxable income ratably over a three-year period. A CRD may be re-paid, without regard to the normal contribution limits, over a three-year period.

How a SIMPLE IRA Works

EMPLOYER

- SIMPLE plans are only available to firms with 100 or fewer employees and which do not maintain another qualified retirement plan.
- Employer generally must match employee contributions dollar for dollar up to 3%.[1]
- Mandatory contributions are tax deductible to the business.

SIMPLE-IRA

- A separate IRA exists for each participant.
- Employer contributions are not currently taxable to employee and earnings accumulate tax deferred.
- Most plans are self-directed (employee controls investment).
- Investment risk remains on employee.

EMPLOYEE

- Employee may elect to defer a percentage of salary.
- Contributions are pre-tax, thus lowering total taxable income.
- For 2023, elective contributions cannot exceed the lesser of $15,500 or 100% of compensation.[2]

EARLY WITHDRAWAL

- A 25% penalty tax generally applies if withdrawals are made within two years and before age 59½.[3]
- Some exceptions to penalty tax are available.
- Earnings and contributions are taxed as ordinary income in the year received.

RETIREMENT

- Distributions must begin by April 1 of the year following the year the owner reaches age 72.[4]
- Required minimum distribution rules apply.
- Earnings and contributions are taxed as ordinary income when received.

DEATH

- Value of IRA is included in owner's gross estate.
- Proceeds can pass to beneficiaries with payments over varying time periods.
- Income and estate taxes can severely reduce IRA funds left to nonspousal beneficiaries.

[1] Alternately, employer may choose to contribute 2% of compensation to all eligible employees, whether they defer or not.
[2] For those age 50 and older, additional "catch-up" contributions of $3,500 may be made.
[3] Premature distributions (before age 59½) made after the first two years of participation are generally subject to a 10% penalty tax, unless an exception applies.
[4] Applies to distributions required to be made after December 31, 2019, to individuals who reach age 70½ after that date.