SEP IRA for Small Businesses

Over 70% of businesses in the United States have four or fewer employees1. This means that self-employed small-business owners need to plan accordingly to save and invest for their own retirement. There are various types of employer sponsored retirement plans including 401(k), pension plans, SIMPLE IRA and SEP IRA plans. For the employer, offering a retirement plan can attract and retain employees, offer tax benefits, and provide an opportunity to save for their own retirement. One of the more common small business retirement plans is a SEP IRA, which will be detailed in this article.

Any size employer can establish a SEP IRA; however, this plan type is most commonly used with small businesses and sole proprietors. SEP IRA plans are employer funded, easy to establish and maintain, and have minimal IRS filings and paperwork. Contributions by the employer are not mandatory and the employer can decide on a periodic basis (generally yearly) what levels of contributions are to be. SEP IRA contributions cannot be made on a discriminatory basis. This means that SEP contributions by the employer must be made in the same percentage (same percentage, not same dollar amount) to every eligible employee. For example, if the employer elects to contribute 10% of compensation to their own SEP IRA account, then 10% of each employee’s compensation amount must be contributed by the employer to each eligible employee’s SEP IRA account.

The deadline to establish and fund a SEP IRA is the employer’s tax-filing deadline, including extensions. This means that the SEP IRA may be funded in the calendar year after which the compensation has been earned, a unique benefit of this plan type. Contribution limits for 2023 are the lessor of 25% of the participants compensation or $66,000.

A SEP IRA is an account type, not an investment itself. The rate of return earned on a SEP IRA is dependent on the investment returns of the investments within the account itself. SEP IRAs may be funded with individual stocks and bonds, certificates of deposit (CDs), mutual funds, exchange traded funds (ETFs) and even real estate or commodities. The participant, not the employer, controls and makes investment decisions. As is the case with most retirement plan types, the participant generally must be age 59 ½ or older to take withdrawals from the SEP IRA without penalty.

The SEP IRA can also offer substantial tax advantages. For example, a sole proprietor with compensation of $100,000 may defer $20,000 of that compensation into their SEP IRA thus only pay income tax on $80,000 of compensation. When SEP IRA withdrawals are made, they are subject to taxation to the account holder.

SEP IRA plans are an excellent choice for sole proprietor or a closely held small business. SEP IRA plans offer small businesses flexibility, ease, and opportunity to invest and save for retirement.

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1 – North American Industry Classification System, as of March 2023. www.naics.com/business-lists/counts-by-company-size/