

The Simplified Employee Pension — SEP



Suitability Profile

- Business is young
- Profits are unpredictable and inconsistent
- Owner compensation is unpredictable and inconsistent
- Employer cannot commit to regular plan contributions

*A word about SIMPLEs... The **S**avings **I**ncentive **M**atch **P**lan for **E**mployees, or **S**IMPLE is type of retirement plan for employers with 100 or fewer employees. Because of certain restrictions intrinsic to SIMPLEs, the SEP is often a more flexible option for employers with fewer than 20-25 employees. For this reason, we do not consider SIMPLEs here.*

Limits

The SEP allows only employer contributions. The maximum annual contribution limit for any year, is 25% of eligible payroll. The maximum annual allocation for a single participant is the lesser of 100% of compensation or the dollar amount in the table below. In addition to the employer's contribution, each employee may also make contributions to a separately owned individual retirement account (IRA) plus catch-up amounts if age 50 or more. Note that this individual contribution may be non-deductible, depending on the IRA phase-out rules as applied to the participant.

Advantages

The single greatest advantage of the SEP is its low cost. In fact, there is no cost if the employer adopts a **model SEP**. Adopting a model SEP means using IRS Form 5305-SEP, which is what most employers do. IRS Form 5305-SEP is simply a plan document that the business owner completes and maintains on file — generally as a part of the financial institution's account setup process.

Contributions to the SEP are completely discretionary. In other words, the employer isn't required to contribute for any given year. Other than making, allocating and accounting for contributions to participants, there is no appreciable procedural impact to the business. An individual SEP-IRA account is set up for each participant — generally a mutual fund.

Disadvantages

While equal percent-of-pay allocations to participants are central to the simplicity of the SEP, it can become a burden on business owners who seek to increase their own allocations while controlling the cost of allocations to non-owners. For example, a business can increase the owner's W2 salary to get a larger dollar amount allocation in the plan, but this generally comes at the cost of increasing self-employment tax and increasing allocations to non-owners.

2026 Individual Limits

SEP Allocation	\$72,000
IRA Contribution	\$7,500
IRA Catch-Up	\$1,100

SEP Allocations

While the employer's contribution is completely discretionary, whenever a contribution is made it must be allocated equivalently among eligible participants. This means that the employer allocates the same percent of pay for all participants. If each owner gets 25% of pay, so does each non-owner. An owner's allocation can be increased or decreased individually by adjusting that owner's earned income (i.e., W2 salary).

A SEP Case Study

To illustrate how a SEP works, we examine a sample employer with the following characteristics:

Recently formed business

- S-Corporation

Two owners

- Owners relatively young
- Take low W2 salary to minimize their own self-employment taxes
- May also receive earnings distributions in addition to salary
- Total owner compensation is unpredictable
- Five non-owners
- Business earnings are unpredictable
- Any plan, if at all, must be flexible, non-committal

The illustration shows employee census and compensation. Here, the employer chooses to make a 3% of pay SEP contribution ("ER SEP %" and "ER SEP \$" columns). Pay specific attention to the total plan contribution the percent of the overall contribution attributing to the owners--the "% to Owners" field.

Simplified Employee Pension — SEP				
Position	Age	W2 Pay	ER SEP %	ER SEP \$
Owner A	20s-30s	\$50,000	3%	\$1,500
Owner B	20s-30s	\$50,000	3%	\$1,500
Staff 1	50	\$65,000	3%	\$1,950
Staff 2	55	\$40,000	3%	\$1,200
Staff 3	35	\$30,000	3%	\$900
Staff 4	30	\$25,000	3%	\$750
Staff 5	25	\$20,000	3%	\$600
			Owners	\$3,000
			Non-Owners	\$5,400
			Total	\$8,400
			% to Owners	36%

For illustrative purposes only.

ER SEP %: Employer's SEP contribution expressed as a percent of pay.

ER SEP \$: Employer's SEP contribution expressed as a dollar amount.

SEP Allocations

But what if the owners need more?

The primary method for a business to increase SEP allocations to the owners is by increasing the owners' income — W2 salary in this case — which is typical as this business grows. The chart illustrates the plan allocations reflecting a \$100,000 W2 salary for each owner. This increases each owner's allocation without raising the non-owner cost.

Simplified Employee Pension — SEP				
Position	Age	W2 Pay	ER SEP %	ER SEP \$
Owner A	20s-30s	\$100,000	3%	\$3,000
Owner B	20s-30s	\$100,000	3%	\$3,000
Staff 1	50	\$65,000	3%	\$1,950
Staff 2	55	\$40,000	3%	\$1,200
Staff 3	35	\$30,000	3%	\$900
Staff 4	30	\$25,000	3%	\$750
Staff 5	25	\$20,000	3%	\$600

For illustrative purposes only.

ER SEP %: Employer's SEP contribution expressed as a percent of pay.

ER SEP \$: Employer's SEP contribution expressed as a dollar amount.

Owners	\$6,000
Non-Owners	\$5,400
Total	\$11,400
% to Owners	53%

Simplified Employee Pension — SEP				
Position	Age	W2 Pay	ER SEP %	ER SEP \$
Owner A	20s-30s	\$288,000	3%	\$8,640
Owner B	20s-30s	\$288,000	3%	\$8,640
Staff 1	50	\$65,000	3%	\$1,950
Staff 2	55	\$40,000	3%	\$1,200
Staff 3	35	\$30,000	3%	\$900
Staff 4	30	\$25,000	3%	\$750
Staff 5	25	\$20,000	3%	\$600

For illustrative purposes only.

ER SEP %: Employer's SEP contribution expressed as a percent of pay.

ER SEP \$: Employer's SEP contribution expressed as a dollar amount.

Owners	\$17,280
Non-Owners	\$5,400
Total	\$22,680
% to Owners	76%

Increasing the W2 magnifies this affect, so long as non-owner pay remains constant. Now the owners share of the total plan contribution of the total allocation is even greater.

SEP Allocations

But, increasing the overall SEP contribution percentage, will have no effect on the owners' share of the total. Increasing the SEP contribution to 25% of pay only increases the total dollar amount of the contribution. Each owner now receives the maximum dollar amount, and the percent of the total plan contribution attributing to owners remains the same as before — 76%.

More importantly, most business owners consider a 25% of pay allocation to be overly generous, and simply can't afford to spend so much on non-owners.

Outgrowing the SEP

It's easy to see that, as this business progresses, earnings grow and become more predictable, the SEP becomes unwieldy because maximizing owner allocations is too expensive in terms of the cost of allocations to non-owners. Can owners get higher allocations with less W2, while reducing the non-owner cost simultaneously? The answer is yes; but this involves a more complex plan — [the §401\(k\) Plan](#).

Simplified Employee Pension — SEP				
Position	Age	W2 Pay	ER SEP %	ER SEP \$
Owner A	20s-30s	\$288,000	25%	\$72,000
Owner B	20s-30s	\$288,000	25%	\$72,000
Staff 1	50	\$65,000	25%	\$16,250
Staff 2	55	\$40,000	25%	\$10,000
Staff 3	35	\$30,000	25%	\$7,500
Staff 4	30	\$25,000	25%	\$6,250
Staff 5	25	\$20,000	25%	\$5,000
For illustrative purposes only.			Owners	\$144,000
ER SEP %: Employer's SEP contribution expressed as a percent of pay.			Non-Owners	\$45,000
ER SEP \$: Employer's SEP contribution expressed as a dollar amount.			Total	\$189,000
			% to Owners	76%

Conclusion

The Simplified Employee Pension (SEP) is no-low-cost plan type that allows the employer to make annual contributions of up to 25% of pay on a discretionary basis. The SEP is appropriate for new businesses or those with unpredictable earnings. SEP participants may also make annual IRA contributions, which may be non-deductible, but still have the advantage of tax-deferred growth.

Businesses outgrow the SEP, when owners are unable to maximize their own allocations while also controlling the cost of allocations to non-owners, as is often the case when an owner's net earned income or W2 salary climbs beyond \$150,000 or so. For these situations, businesses often turn to a §401(k) plan, which you can learn about [here](#).

If you're considering or need help with a qualified retirement plan, Manning & Napier has professionals on staff with decades of experience evaluating and implementing a wide range of plan designs. Contact your Manning & Napier representative today to learn more.