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SEPs for Self Employeds?

-by Neil E. Harl*

A frequently asked question: can self-employed individuals set up a simplified employee pension and make contributions to the plan?¹ The name of the plan – simplified employee pension suggests that such plans are only for employees.² Although the answer to that question has been clear for some time,³ a recent Tax Court case has provided additional guidance on eligibility for self-employed individuals.⁴

Features of Simplified Employee Pensions

A simplified employee pension (SEP) is a type of retirement plan under which an employer makes contributions to individual retirement accounts or individual retirement annuities of employees.⁵ An employer must contribute to the SEP for each employee – (1) who has reached the age of 21, (2) has performed service for the employer during at least three of the immediately preceding five years and (3) received at least $450 in compensation from the employer for the year.⁶ Contributions cannot discriminate in favor of highly compensated individuals.⁷

For 2005, annual contributions by an employer to a SEP are excluded from the employee’s gross income to the extent the contributions do not exceed the lesser of (1) 25 percent of the participant’s compensation (a maximum of $210,000 for 2005) or (2) $42,000.⁸ In the event an employer exceeds the annual limit on contributions, the employee is taxed on the excess contribution.⁹

Employees may make contributions to their SEP-IRA apart from the employer’s contributions but the employee’s total contributions to a SEP-IRA, a traditional IRA or a Roth IRA are subject to an annual maximum.¹⁰ That maximum is $4,000 for 2005 through 2007¹¹ with an additional $500 catch-up contribution for 2005 for those who have attained age 50 before the close of the taxable year.¹² Distributions from a SEP are taxed under rules applicable to IRA distributions.¹³

Eligibility of self-employed individuals

Individuals who have net earnings from self-employment¹⁴ are treated as their own employers for purposes of establishing and funding a SEP plan.¹⁵ Note that the Internal Revenue Code defines “net earnings from self-employment” as the “gross income derived by an individual from any trade or business carried on by such individual . . . .”¹⁶ Note also, with several specified exceptions, the performance of service by an individual as an employee does not constitute a trade or business.¹⁷

However, I.R.C. § 408(k)(7)(A) states that the term “employee” has the meaning given the term in I.R.C. § 401(c). That subsection specifies that the term “employee” includes an individual who is a self-employed individual for the taxable year and “self-employed individual” means an individual with earned income.¹⁸ The term “earned income” is defined

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as net earnings from self-employment under I.R.C. § 1402(a) but that net earnings are determined only with respect to a trade or business in which personal services of the taxpayer are a material income-producing factor.\(^{20}\)

Therefore, self-employed individuals, where their personal services are a material income-producing factor, are eligible to establish and contribute to a SEP.

**Levine v. Commissioner**

In the 2005 case of Levine v. Commissioner,\(^{21}\) the taxpayer was employed on a full-time basis as an industrial hygienist by the United States Department of State under two personal service contracts.\(^22\) Some features of her employment resembled an employer-employee relationship—the taxpayer was paid an annual salary calculated on a work year of 2,087 hours, was paid overtime for hours worked in excess of 40 hours per week, was entitled to paid leave for Federal holidays and accrued annual leave and sick leave. The Department of State withheld payroll taxes in the same manner as for employees. When in Washington, the taxpayer was under contract to work eight hours per day, Monday through Friday with the precise hours specified. However, the taxpayer performed approximately 40 percent of the services outside the United States and was subject to relatively little control by the Department of State as employer.

The taxpayer contributed $8,638 to her SEP for 1999, figured on the basis of the income earned under the personal service contracts and specifically noted on the return that she was an independent contractor.\(^{23}\) As such, she was entitled to a SEP deduction.

**FOOTNOTES**

1. See I.R.C. § 408(k).
2. Id.
3. See I.R.C. Secs. 401(c), 401(c)(1)(A).
5. I.R.C. § 408(k)(1).
7. I.R.C. § 408(k)(3).
15. I.R.C. Secs. 401(c)(4), 408(k)(7).
17. I.R.C. § 1402(c)(2).
22. Id.
23. Id.

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**CASES, REGULATIONS AND STATUTES**

by Robert P. Achenbach, Jr

**ADVERSE POSSESSION**

**PAYMENT OF TAX.** The plaintiffs sought to quiet title to a strip of land between the plaintiffs’ and defendants’ lands. The plaintiff had shown that they used the disputed strip for various farming and ranching purposes for many years and the trial court had granted title to the plaintiffs by adverse possession. The appellate court reversed, holding that the Indiana adverse possession statute, Ind. Code § 31-21-7-1, prohibited passage of title by adverse possession unless the adverse possessor had paid all taxes attributable to the disputed land. Because the plaintiffs had not demonstrated that they paid all the taxes, the court held that the statute prevented them from acquiring the land by adverse possession, even if all other elements had been met. **Fraley v. Minger, 2005 Ind. LEXIS 539 (Ind. 2005), aff’d, 786 N.E.2d 288 (Ind. Ct. App. 2003).**

**BANKRUPTCY**

**FEDERAL TAX**

**DISCHARGE.** The debtor filed Form 4868 “Automatic Extension of Time to File U.S. Individual Income Tax Return” for the debtor’s 2000 tax return, extending the filing date to August 15, 2001. The debtor filed the 2000 return on April 22, 2001. The debtor filed for Chapter 7 on June 15, 2004, less than three years after the extended due date for the 2000 tax return. The court held that the three year period of Section 523(a)(1)(A) applied to the due date of the tax return, including extensions, and not the actual date of the filing. In addition, the court held that the filing of the return early did not remove the extension; therefore, the court held