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Tax-Sheltered Annuity Programs for Employees of Public Schools and Certain Tax-Exempt Organizations

For use in preparing

1996 Returns

Contents

Important Changes For 1996

Multiple salary reduction agreements. For years beginning after 1995, you can enter into more than one salary reduction agreement during a year. For more information see *Salary Reduction Agreement* , later.

Tax-sheltered annuity contracts purchased by Indian tribal governments. Any tax-sheltered annuity contract (TSA) that was purchased by an Indian tribal government for its employees in a plan year beginning before January 1, 1995, is treated as having been purchased by a tax-exempt organization that is qualified to provide TSAs for its employees. An Indian tribal government includes any political subdivisions, agencies, and instrumentalities of it, as well as any corporations that are chartered under Federal, State, or tribal law and owned by it. See *Tax-Exempt Organizations,* later.

Important Changes For 1997

Required beginning date for distributions. For years beginning after 1996, required minimum distributions of your interest accruing after 1986 in a tax-sheltered annuity contract, generally do not have to be made until April 1 of the later of the calendar year in which you become age 70 $^{1}/_{2}$ or the calendar year in which you retire. See *Minimum Distributions,* later.

Certain ministers treated as employed by tax-exempt organization. For years beginning after 1996, a duly ordained or licensed minister of a church who is working as a minister or chaplain, but is self-employed or is working for an employer that is not a qualified tax-exempt organization, is treated as employed by a qualified tax-exempt organization for purposes of participating in a tax-sheltered annuity plan. See *Employees of Certain Tax-Exempt Organizations,* later.

Contributions by self-employed ministers and chaplains. For years beginning after 1996, contributions made by a self-employed minister or chaplain who is treated as employed by a qualified tax-exempt organization to a retirement income account that is treated as a tax-sheltered annuity are deductible up to the limits for elective contributions to tax-sheltered annuities. For this purpose, all plans in which the minister participates are treated as one plan. See *Limits on exclusion,* under *Introduction,* later.

Includible compensation — self-employed minister. For tax years beginning after 1996, compensation of a self-employed minister who is treated as employed by a tax-exempt organization, is the minister's net earnings from self-employment reduced by contributions to retirement plans and the deduction for one-half of the self-employment tax. See *Includible Compensation,* later.

Years of service — self-employed minister. For tax years beginning after 1996, years of service for purposes of section 403(b) includes full years (and fractional years) in which a self-employed minister is treated as employed by a qualified tax-exempt organization. See *Years of Service,* later.

Introduction

This publication explains the Federal tax provisions that apply to tax-sheltered annuities offered to employees of public schools and certain tax-exempt organizations. The publication is for employees who participate in tax-sheltered annuity plans. It is not for custodians or plan administrators because it does not cover many of the operating requirements of these plans.

Tax-sheltered annuity (TSA). A tax-sheltered annuity plan, often referred to as a ''403(b) plan, '' ''tax-deferred annuity plan,'' or simply ''TSA ''(which is used in this publication), is a retirement plan that, if operated properly by a qualified employer, is tax-exempt.

The TSA can invest funds for participating employees in:

- Annuity contracts,
- Custodial accounts holding mutual fund shares, or
- Retirement income accounts (defined contribution plans maintained by churches or certain church-related organizations).

Throughout this publication, wherever ''TSA'' appears, it refers to any one of these funding arrangements, unless otherwise specified.

Tax advantage for employee. Generally, contributions by a qualified employer to purchase an annuity contract for you under a TSA plan (and earnings on them) are excluded from your taxable income until you begin to receive annuity payments, usually after retiring, from your TSA. Because of this tax postponement, these plans are described as ''tax-deferred'' or ''tax-sheltered'' annuities.

Employer contributions to TSA. This publication primarily covers ***elective deferrals,*** (discussed next) that are made under a salary reduction agreement.

Elective deferrals. Employers contribute to a TSA primarily through a ***salary reduction agreement.*** (See *Salary Reduction Agreement,* later, for more information.) Under this agreement, you (the employee) agree to take a reduction in salary or to forego a salary increase and your employer agrees to contribute the amount of the salary reduction or the foregone salary increase toward the purchase of your TSA. These employer contributions are excluded (within limits discussed next) from your income when made and, generally, are called ''elective deferrals.'' See *Limit on Elective Deferrals,* later, for more information.

Limits on exclusion. You can exclude from income employer contributions (including elective deferrals) to your TSA. However, the amount you exclude for a tax year cannot exceed any of the following limits discussed later:

1) The exclusion allowance,
2) Limit on employer contributions, and
3) Limit on elective deferrals.

You may be able to use an alternative limit to increase the amount you can exclude. See *Catch-up Election — Alternative Limits for Certain Employees.*

TIP *For years beginning after 1996, contributions made by a self-employed minister or chaplain who is treated as employed by a qualified tax-exempt organization to a retirement income account that is treated as a tax-sheltered annuity are deductible up to these limits for tax-sheltered annuities.*

Excess contributions. If the contributions to your TSA exceed any of the preceding limits for a tax year, you must include the excess in your income for that year. Further, if you have an excess because the contributions exceed limit (2), that excess reduces the amount of your exclusion allowance for future years, even though the excess has already been included in your income.

For more information on the treatment of excess contributions, see *Excess Deferrals, Exclusion from Gross Income, Limit on Employer Contributions,* and *Tax on Excess Contributions to a Custodial Account,* later.

Only elective deferrals. If the contributions are solely elective deferrals, the total must not exceed the smallest of the three limits in the preceding list.

Only nonelective contributions. If the contributions are solely nonelective contributions, only limits (1) and (2) apply.

Both elective deferrals and nonelective contributions. If the total contributions include both elective deferrals and nonelective contributions and limit (3) is the smallest of the limits in the preceding list, any part of the elective deferrals that exceeds limit (3) is an excess deferral. Any part of the total of all contributions (including the elective deferrals) that exceeds the smaller of limit (1) or (2) is an excess contribution.

More than one TSA. If for any tax year elective deferrals are contributed to more than one TSA for you (whether or not with the same employer), you must combine all the elective deferrals to determine whether the total exceeds the limit for that year. See *Limit on Elective Deferrals,* later.

TIP *You can use the* ***worksheets*** *at the end of this publication to figure the following contribution limits that generally apply to you.* For limit (1), use Worksheet 1. For limit (2), use Worksheet 2. For limit (3), use Worksheet 3. However, you may qualify to choose an alternative limit (worksheet 4, 5, or 6). See *Catch-up Election — Alternative Limits for Certain Employees,* later.

Other information. The *Other Rules* section includes discussions on the taxability of the cost of insurance under a TSA, and on employer contributions subject to social security and Medicare taxes. For detailed information on the tax treatment of retirement income (including income from a TSA) and how to report it on your federal income tax return, get Publication 575, *Pension and Annuity Income (Including Simplified General Rule)* .

Useful Items

You may want to see:

Publication

- ☐ **575** Pension and Annuity Income (Including Simplified General Rule)
- ☐ **590** Individual Retirement Arrangements (IRAs)

Form (and Instructions)

- ☐ **W–2** Wage and Tax Statement
- ☐ **1099-R** Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc.
- ☐ **5330** Return of Excise Taxes Related to Employee Benefit Plans

See *How To Get More Information,* near the end of this publication for information about getting these publications and forms.

Exclusion from Gross Income

Generally, if you are an ***eligible employee,*** you can exclude from gross income your ***qualified employer's*** contributions to a tax-sheltered annuity (TSA) to the extent that the contributions (including elective deferrals) do not exceed any of the following:

The ***exclusion allowance*** for your tax year,

The ***annual employer contribution limit*** for the ***limitation year*** ending with or within your tax year, or

The ***limit on elective deferrals*** for the tax year.

For purposes of applying these limits, your employer's contributions do not include a rollover contribution from another TSA or an individual retirement arrangement (IRA).

Qualified Employer

A qualified employer can purchase tax-sheltered annuities for eligible employees. Two types of employers qualify — public schools and certain tax-exempt organizations.

Public Schools

A state or local government or any of its agencies or instrumentalities can be a qualified employer. For this purpose, an Indian tribal government is a state government. Also, see *Indian tribal governments,* under *Tax-Exempt Organizations,* later. These employers are qualified employers only for employees who perform (or have performed) services, directly or indirectly, for an ***educational organization.***

Educational organization. An educational organization is one that normally maintains a regular faculty and curriculum, and normally has a regularly enrolled body of students in attendance at the place where it regularly carries on educational activities.

Tax-Exempt Organizations

Generally, a qualified employer includes an organization that is tax exempt because it is organized and operated exclusively for religious, charitable, scientific, public safety testing, literary, or educational purposes. A qualified employer also includes a tax-exempt organization that is organized and operated exclusively to encourage national or international amateur sports competition, or for the prevention of cruelty to children or animals. The organization can be a corporation, community chest, fund, or foundation.

Indian tribal governments. Any tax sheltered annuity contract (TSA) that was purchased by an Indian tribal government for its employees in a plan year beginning before January 1, 1995, is treated as having been purchased by a tax-exempt organization that is qualified to provide TSAs for its employees. An Indian tribal government includes any political subdivisions, agencies, and instrumentalities of it, as well as any corporations that are chartered under Federal, State, or tribal law and owned by it.

Government instrumentalities. Wholly-owned instrumentalities (other than public schools, described earlier) of state or municipal governments generally are not qualified employers. However, if an instrumentality has been ***separately organized*** and has been recognized as tax-exempt by the Internal Revenue Service because it is organized and operated ***exclusively for*** one or more of the exempt purposes described earlier, it is a qualified employer. A separately organized school, college, university, or hospital may qualify if it is not an activity essential to and conducted under a branch or department of a state or municipal government.

A cooperative hospital service organization that meets certain requirements is a qualified employer.

Uniformed Services University of the Health Sciences. This is a federal organization authorized to train medical students for the uniformed services. The rules in this publication apply to annuities bought for civilian faculty and staff for work they performed after 1979.

Eligible Employees

A qualified employer can purchase tax-sheltered annuities only for eligible employees. If you are subject to the will and control of an employer regarding what work you do and how you do it, you are an employee. If you are subject to the control or direction of another as to the result only, and not how you do the work, you will generally be an independent contractor, and not an eligible employee.

Your employer may be able to help you determine whether you are an eligible employee.

Employees of Public School Systems

You are considered eligible if you perform services as an employee, either directly or indirectly, for a public school. For example, the principal, clerical employees, custodial employees, and teachers at a public elementary school are employees performing services directly for an educational organization.

If you do not work in a school, but are involved in the operation or direction of the educational program carried out in public schools, you are an eligible employee performing services indirectly for public schools. Also, you are an eligible employee if you are participating in an ***in-home*** teaching program since the program is merely an extension of the activities carried on by public schools.

Department of Education employees appointed by a state commissioner of education. Janitorial, custodial, and general clerical employees indirectly perform services for an educational organization and are eligible employees. If you have a significant degree of executive or policymaking authority, and your appointment is based on required training or experience in the field of education, you also indirectly perform service for an educational organization and are an eligible employee.

Elected or appointed to office. If you occupy an elective or appointive office, you may be an eligible employee. You are an eligible employee if your office is one to which a person is elected or appointed only if he or she has received training, or is experienced, in the field of education.

A commissioner or superintendent of education generally is considered an employee performing services for an educational organization. However, a university regent or trustee, or a member of a board of education, is not an eligible employee.

Employees of a state teachers' retirement system. Employees of a retirement system that administers a state teachers' retirement program are ***not*** eligible to participate in a tax-sheltered annuity program because employees are not performing services directly or indirectly for an educational organization.

Employees of Certain Tax-Exempt Organizations

Certain tax-exempt organizations (described under *Qualified Employer,* earlier) can purchase tax-sheltered annuities for some or all of their employees. Employees of these tax-exempt organizations include individuals who perform services as social workers, members of the clergy, teachers, professors, clerks, secretaries, etc.

TIP *For years beginning after 1996, a duly ordained or licensed minister of a church who is working as a minister or chaplain, but is self-employed or is working for an employer that is not a qualified tax-exempt organization, is treated as employed by a qualified tax-exempt organization for purposes of participating in a tax-sheltered annuity plan.*

A physician who works in a hospital as an employee may be eligible. Eligibility depends upon the amount of supervision and control of the services performed and other factors.

A physician is an employee, for example, if, by agreement, he or she:

- Does not take on outside duties that would negatively affect primary services to the hospital,
- Does not furnish services to other hospitals without the employer's consent,
- Obeys all rules and regulations of the hospital, ***and***

- Receives a pay adjustment if the percentage of pay is less than an amount guaranteed by the agreement.

However, not all physicians who perform services for a hospital are employees. For example, a physician who performs services as a director of a hospital's department of pathology is ***not*** an employee if he or she:

- Receives a percentage of the department's income for the services,
- Pays an associate or substitute,
- Is allowed to privately practice medicine,
- Is not entitled to regular employee fringe benefits, and
- Is not subject to the general rules that apply to the hospital's employees.

Each case must be decided on its own facts and circumstances. No set rule will apply to all cases.

Contributions To TSA

Employers contribute to a TSA primarily through a ***salary reduction agreement.*** These contributions are generally referred to as elective deferrals. However, a TSA can also be funded through non-elective employer contributions, after-tax employee contributions, or a combination of these.

Salary Reduction Agreement

The most common way to contribute to tax-sheltered annuities is through a salary reduction agreement. A salary reduction agreement is an agreement between the employer and employee under which the employee agrees to take a reduction in salary or to forego a salary increase and the employer contributes that amount to a tax-sheltered annuity (TSA) for that employee.

Treatment of contributions. Amounts contributed by the employer under the salary reduction agreement and invested in a TSA for the employee are generally treated as ***elective deferrals*** (See *Elective deferrals defined,* under *Limit on Elective Deferrals,* later.)

However, an employer contribution to a TSA is ***not*** treated as an elective deferral ***if*** it is made as a condition of employment or as a one-time choice by the employee when he or she first becomes eligible to participate in the agreement. ***But,*** if the employee can change or end the election to participate, the election is not a one-time choice and the contributions are elective deferrals.

TIP *Beginning in 1996, you can enter into **more than one** salary reduction agreement during a tax year. **In addition,*** for salary reduction purposes, you can use compensation that has not yet been made available to you. (However, to determine what compensation can be used to figure the maximum exclusion allowance, see *Includable Compensation,* later, under *The Exclusion Allowance.*).

Avoid excess contributions. Your employer may contribute under the salary reduction agreement an amount in excess of the limits. To avoid excess contributions, which you must include in income, be careful to ensure that (if the employer's contributions are only elective deferrals) the total for the year is no greater than the smallest of the:

1) Limit on elective deferrals,
2) Limit on employer contributions, and
3) Exclusion allowance.

which are discussed later. In no event may the elective deferrals exceed $9,500 for the year (or $12,500 if the discussion on the *Increase for 15-year employees* under *Limit on Elective Deferrals,* later, applies to you).

Alternative limits. To increase the amount that can be contributed to your TSA without having any of the contribution included in your income as an excess contribution, you may want to consider electing one of the alternative limits available (if you qualify). These limits are discussed later under *Catch-up Election — Alternative Limits for Certain Employees.*

Limit on Elective Deferrals

In addition to the ***the exclusion allowance*** and the ***limit on employer contributions*** (these limits are discussed later), which apply to tax-sheltered annuity (TSA) contributions, there is an annual limit on combined elective deferrals.

Elective deferrals defined. Your employer's plan may permit you to have part of your pay contributed by your employer to a retirement fund, rather than have it paid to you. These employer contributions are called ''elective deferrals '' because

1) You choose (elect) to set aside part of your pay, and
2) Payment of tax owed on that part of your pay is postponed (deferred) until it is distributed to you.

Deferrals subject to limit. The limit applies to the total of all elective deferrals contributed (even if contributed by different employers) for the year on your behalf to:

- Cash or deferred arrangements (known as section 401(k) plans) to the extent excluded from your gross income,
- Section 501(c)(18) plans created before June 25, 1959, and only to the extent excluded from your gross income,
- Simplified employee pension (SEP) plans, and
- Tax-sheltered annuities.

Dollar limit. Generally, you cannot defer more than an allowable amount each year for all plans covering you, including TSAs. For 1996, the allowable amount (limit) is $9,500. (This limit applies without regard to community property laws.) If you defer more than the allowable amount for a tax year, you must include the excess in your gross income for that year (see *Excess Deferrals,* later).

Increase for 15-year employees. If you have a TSA and you have completed at least 15 years of service with an educational organization, hospital, home health service agency, health and welfare service agency, church, or convention or association of churches (or associated organization), the $9,500 limit for the TSA is increased each tax year. The limit is increased by the ***smallest*** of the following:

1) $3,000, or
2) $15,000, reduced by increases to the $9,500 limit you were allowed in earlier years because of this rule, or
3) $5,000 times the number of your years of service for the organization, minus the total elective deferrals made by the organization for you for earlier years.

For example, if you qualify, you may increase your elective deferrals to $12,500. For the computation, see Step 2 of Worksheet 3.

Cost-of-living adjustment. Under current law, the $9,500 limit is to be increased to reflect any increases in the Consumer Price Index in future years.

WORKSHEET 3 at the end of this publication will help you figure the **Limit on Elective Deferrals**.

Excess Deferrals

Excess deferrals are elective deferrals that exceed the limit on elective deferrals.

Tax Treatment

If the total you defer for a tax year is more than the limit for the year, you must include the excess in your gross income for that year on line 7 of Form 1040.

Distribution of excess. If the plan permits and you want to receive the excess amount, you must notify the plan as explained next.

One plan. If only one plan is involved, you must notify the plan by March 1 after the end of the tax year that an excess was deferred. The plan must then pay you the excess, along with any income on that amount, by April 15.

TIP *Because you are responsible for notifying the plan, you must monitor contributions to the plan.*

More than one plan. If more than one plan is involved, you must notify each plan by March 1 of the amount to be paid from that particular plan, and the plan must then pay you that amount by April 15.

If you take out the excess by the required date, do not include it again in your gross income and do not subject it to the additional 10% tax for premature distributions. However, any ***income earned*** on the excess that is taken out is taxable in the tax year you take it out.

If you take out ***part*** of the excess deferral and the income earned on it, you must treat the distribution as if ratably received from the excess deferral and the income earned on it. For example, assume that your excess deferral is $1,800 and the income earned on it is $200. If your distribution is $1,000, $900 is from the excess deferral and $100 is from the income earned that must be separately reported.

Excess left in the plan. If you leave the excess deferral in the plan, you must include the excess amount in your gross income for the tax year in which the amount was deferred. You cannot treat the excess amount as an investment in the contract (tax-free return of cost) when you figure the taxable amount of any future benefits or distributions. Thus, an excess deferral left in the plan would be taxed twice, once when contributed and again when distributed.

Limit on Employer Contributions

Limits are placed on the contributions that can be made by an employer to tax-sheltered annuity (TSA) programs for each ***limitation year***. Every TSA is treated as a defined contribution plan for purposes of this limit (which is also called the ''general rule''). Under the ***general rule,*** an employer's contributions (including elective deferrals) to an employee's account under a defined contribution plan should not be more than the lesser of:

1) $30,000 , or
2) 25% of the employee's ***compensation*** for the year.

This limit is in addition to the exclusion allowance (discussed later) and the limit on elective deferrals (discussed earlier). Also, see *Catch-up Election — Alternative Limits for Certain Employees,* later.

> ***WORKSHEET 2*** at the end of this publication will help you figure the **Limit on Employer Contributions** and the amount you can exclude from gross income.

Limitation year. Generally, your limitation year is the calendar year. However, you can elect to change to a different limitation year consisting of a period of 12 consecutive months by attaching a statement to your individual income tax return for the tax year you make the change.

Contributions in excess of employer limit. An excess employer contribution must be included in your gross income in the tax year when it is made. For future tax years, the exclusion allowance must be reduced by this excess contribution even though it was not excludable from your gross income in the tax year when it was made.

TSA and qualified plan. If because you must combine a TSA with a qualified plan, the limit is exceeded, the same rule applies. You must include the excess in your gross income for the tax year the excess contribution is made and reduce your exclusion allowance for any future years in which you are a participant in a TSA program.

If you are a participant in both a TSA program and a qualified plan, see *Limit for Contributions to More Than One Program,* later.

Excess contribution in earlier years. If in earlier years your employer made annual contributions to a TSA for you that were more than the annual maximum permitted under this limit on employer contributions, your ***exclusion allowance is reduced*** by the excess.

Reduction procedure. The exclusion allowance is reduced by including the excess contributions from prior years in ***amounts previously excludable,*** discussed later, under *The Exclusion Allowance.* Include prior years' excess contributions in amounts previously excludable only if the limit was exceeded for a tax year beginning after January 24, 1980.

Compensation. Generally, for the 25% limit (item (2) at the beginning of this discussion), compensation ***includes:***

- Wages, salaries, and fees for personal services with the employer maintaining the plan, even if excludable as foreign earned income,
- Certain taxable accident and health insurance payments,
- Moving expense payments or reimbursements paid by employer if such payments are not deductible by you, and
- The value of nonqualified stock options granted to you that are includible in your gross income in the year granted.

Generally, compensation ***does not include:***

- Contributions toward a tax-sheltered annuity contract,
- Contributions toward a deferred compensation plan if, before applying the limit on employer contributions, the contributions are not taxable,
- Distributions from a deferred compensation plan,
- Proceeds from the disposition of stock acquired under a qualified stock option, and
- Certain other amounts that are excludable from your income, such as group term life insurance premiums that are not taxable.

More than one annuity contract. For each year you apply this limit, you must combine the contributions to all TSAs made on your behalf by your employer. This is done whether or not you elect one of the alternative limits discussed under *Catch-up Election — Alternative Limits for Certain Employees,* later. You may also have to combine contributions to qualified plans of the same employer or an employer that you control (for purposes of applying this limit). See *Limit for Contributions to More Than One Program,* later.

The Exclusion Allowance

The exclusion allowance is the amount of employer contributions (including elective deferrals) to your tax-sheltered annuity (TSA) that you can exclude from income. You pay tax on these excluded amounts when you receive a distribution from the TSA.

More than one TSA. If, during any tax year, you have two or more TSA contracts, custodial accounts, or retirement income accounts, maintained by your employer, ***figure only one exclusion allowance*** for the TSAs because you must consider them as one TSA.

More than one employer. If more than one qualified employer contributes to a TSA for you, you must ***figure a separate exclusion allowance for each*** qualified employer. Do not include amounts contributed, compensation, or years of service for one qualified employer in the computation for another qualified employer. Special rules apply to church employees, as discussed under *Years of Service,* later.

Employer must remain qualified. The exclusion allowance applies only to those contributions made while your employer was a qualified employer. If, for example, your employer loses tax-exempt status and is no longer qualified, your exclusion allowance will not apply to the employer's contributions made after losing the exemption.

How to Figure

You determine the exclusion allowance at the end of your tax year as follows:

1)	**Includible compensation** (discussed later)	$
2)	Percentage limit	20%
3)	**Years of service** (discussed later)	
4)	Multiply (1) × (2) × (3)	$
5)	Minus: **Amounts previously excludable** (discussed later)	
6)	**Exclusion allowance** (before reduction for any excess contributions)	$

Reduction of the exclusion allowance. You must reduce your exclusion allowance by the amount that your employer's contributions (for tax years beginning after January 24, 1980) were more than the limit on employer contributions for those years. (See *Contributions in excess of employer limit* under *Limit on Employer Contributions,* earlier.) For future years, treat the excess as though it were an amount previously excludable.

Example. At the end of 1996, you had completed 3 years of service with your employer. Your salary for 1996 was $20,000 after being reduced under a revocable salary reduction agreement by $2,400 to finance your employer's contributions toward the purchase of a TSA for you. Your employer's contributions for the year totaled $2,400, $100 of which was for current term life insurance protection.

In previous years, your employer's contributions to the regular retirement plan totaled $7,200, all of which you properly excluded from gross income. You figure your exclusion allowance (the amount excludable from gross income) and the amount of any employer contributions includible in your gross income for 1996 as follows:

Step 1—Limit on Employer Contributions

1)	a) Maximum	$30,000	
	b) 25% of employee's compensation (25% × $20,000 = $5,000)	$ 5,000	
	c) **Limit** (Lesser of (a) or (b))		$ 5,000

Step 2—Contributions in Excess of Employer Limit

2)	1996 contribution for purchase of TSA	$ 2,400	
3)	Minus: Portion of line 2, if any, representing cost of term life insurance (treated as paid by employee)	100	
4)	Employer contribution		$ 2,300
5)	Minus: Limit on employer contributions (line 1)		5,000
6)	**Excess contribution** (if any)		$ –0–

Step 3—Exclusion Allowance

7)	Includible compensation	$20,000
8)	Percentage limit	20%
9)	Years of service	3
10)	Multiply (7) × (8) × (9)	$12,000
11)	Minus: Amounts previously excludable	7,200
12)	**Exclusion allowance**	$ 4,800

Step 4—Amount Excludable From Gross Income

13)	a) Employer contribution [line 4]	$ 2,300	
	b) Limit on employer contributions [line 1(c)]	$ 5,000	
	c) Exclusion allowance [line 12]	$ 4,800	
	d) Limit on elective deferrals	$ 9,500	
14)	**Amount excludable** [least of 13(a), (b), (c), or (d)]		$ 2,300

Step 5—Amount Includible in Gross Income

15)	Employer contribution [line 4]	$ 2,300
16)	Minus: Amount excludable [line 14]	2,300
17)	**Amount includible**	$ –0–

WORKSHEETS 1 THROUGH 6 at the end of this publication will help you figure the amount of employer contributions that you can exclude from gross income and the amount you must include.

Catch-up election for certain employees. Certain employees can elect to substitute the limit on employer contributions for the exclusion allowance under an alternate rule called the ***Overall Limit*** (explained under *Catch-up Election — Alternative Limits for Certain Employees* , later). Only employees of educational organizations, hospitals, home health service agencies, health and welfare service agencies, churches, and certain church-related organizations can make the election.

Minimum exclusion allowance for church employees. If you are a church employee (defined later under *Years of Service*) and your adjusted gross income (figured without regard to community property laws) is not more than $17,000, you are entitled to exclude from your gross income a certain minimum amount called a minimum exclusion allowance. The minimum is your exclusion allowance figured as explained earlier, but not less than the smaller of:

1) $3,000, or
2) Your ***includible compensation*** (defined next).

Includible Compensation

As a first step in figuring your exclusion allowance for a tax year, you must figure 20% of your includible compensation. Generally, your includible compensation is the salary (not including employer contributions to your TSA) from your employer who made contributions to your TSA that is:

1) Earned during your ***most recent*** period that may be counted as ***one year of service,*** and
2) Includible in your gross income.

For tax years beginning after 1996, compensation of a self-employed minister who is treated as employed by a tax-exempt organization, is the minister's earnings from self-employment reduced by contributions to retirement plans and the deduction for one-half of the self-employment tax.

Special Rules

When figuring your includible compensation you should examine the following exceptions and definitions.

Employer not qualified. Only the compensation earned from the qualified employer purchasing your TSA contract can qualify as includible compensation. ***Do not count*** compensation earned while your employer was not a qualified employer. However, your employer's status is immaterial when you actually receive the compensation.

Other employers. Compensation from other employers who either are not qualified or are not purchasing your TSA contract, or compensation from other sources, generally, is not includible compensation. However, see *Service with one employer,* under *Years of Service,* later.

Contributions for a TSA. Contributions by your employer (including elective deferrals) for a tax-sheltered annuity are not part of includible compensation.

However, If you are a ***foreign missionary*** during the tax year, your includible compensation includes contributions by the church during the year toward your tax-sheltered annuity.

You are a foreign missionary if your principal duties are spreading religious doctrine, or performing sacerdotal functions or humanitarian good works for the church outside the United States.

Contributions to a TSA and a qualified retirement plan. If your employer makes contributions for you toward both a TSA contract and a ***qualified*** retirement plan, the contributions to the qualified retirement plan are not part of includible compensation for figuring your exclusion allowance.

Contributions that are more than your exclusion allowance are not part of compensation for figuring your exclusion allowance, but they must be included in your gross income.

Example. After taking a reduction in salary to pay for your employer's contribution for an annuity during your first year of employment, you received a salary of $12,000. According to your agreement, $2,800 ($400 more than your exclusion allowance) is contributed for your annuity. Use $12,000 as includible compensation in figuring the exclusion allowance, even though you must include $12,400 in gross income.

The cost of incidental life insurance provided under a TSA contract is not includible compensation even though this cost is taxable to you. This part of the cost of your TSA contract is treated as contributed by you, rather than your employer, and is part of your cost (basis) in the contract.

Foreign earned income exclusion. Excludable foreign earned income is part of includible compensation.

Most Recent One-Year Period of Service

Your includible compensation is only the compensation earned during your most recent period of service that ends on or before the end of the tax year for which the exclusion allowance is being determined. The period must be a full year of service if the total time you worked for your employer equals at least one full year. A part-time employee or a full-time employee who works part of a year, discussed below, must combine earnings for fractional parts of a year until they equal a full year's earnings. Thus, your most recent period of service will include more than one tax year if you were a part-time employee or if you were a full-time employee who worked only part of a tax year and you worked for your employer at least one full year over a period of more than one tax year.

If you worked less than a full year for your employer by the end of a tax year for which you are figuring the exclusion allowance, consider the actual period of your employment as your most recent one-year period of service for figuring your includible compensation.

For example, if you became employed on October 1, 1996, your most recent one-year period of service for figuring your includible compensation for your 1996 exclusion allowance is the period from October 1 through December 31, 1996. If your annual salary is $20,000, your includible compensation would be $5,000 ($1/4$ of $20,000).

Earned in a prior tax year. Your includible compensation may include all or part of your compensation earned in a tax year before the one for which the exclusion allowance is being determined. What is important is when you perform the service, not when you actually receive the compensation or the tax year in which it is includible in your gross income.

For example, if you are figuring your exclusion allowance for your 1996 tax year, and you were employed half time by your employer for all of 1995 and 1996, your includible compensation will include the amounts earned in 1995 and 1996.

In figuring your includible compensation, you must first take into account the service you performed during the tax year for which the exclusion allowance is being determined. Therefore, your most recent one-year period of service may not be the same as your employer's most recent annual work period.

Example. You are employed as a professor at a university and you use the calendar year as your tax year. You are employed on a full-time basis during the university's 1995–96 and 1996–97 academic years (October through May). In figuring your exclusion allowance for your 1996 tax year, your most recent one-year period of service consists of the service performed from January through May 1996 (which is part of the 1995–96 academic year), and the service performed from October through December 1996 (which is part of the 1996–97 academic year).

CAUTION *Your most recent one-year period of service for figuring includible compensation may not be the same period as your limitation year for figuring the limit on employer contributions. See the discussion of Limitation year,* under *Limit on Employer Contributions,* earlier.

Full-time employee for a full year. If you are a full-time employee for the full year, your most recent one-year period of service generally will be your current tax year.

To determine whether you are employed full time, compare the amount of work you are required to do with that required of individuals holding the same position with the same employer, and who receive most of their compensation from that position. If your position with your employer is the only one of its kind with your employer, you cannot make this comparison. You should consider the same position with similar employers, or similar positions with your employer.

In measuring the amount of work required by a particular position, any method that reasonably and accurately reflects the amount of work can be used. For example, the fact that a full-time English professor at your school normally performs 16 hours of classroom teaching each week may be used as a measure of the amount of work required in the position.

A full year of service for a particular position means the usual annual work period of individuals employed full time in that general type of employment at the place of employment. For example, if you are a doctor employed by a hospital 12 months of the year, except for a one-month vacation, and the other doctors at the hospital work 11 months of the year with a one-month vacation, you will be considered employed for a full year. Similarly, if the usual annual work period at a university consists of the fall and spring semesters, and you teach at the university during these semesters, you will be considered as working a full year.

Part-time employee, or full-time employee working for part of a year — treatment of fractional years. If you are a part-time employee, or a full-time employee who worked for part of a year, you are treated as having a fraction of a year of service for each year you were so employed. You must total these fractional periods of service to determine your most recent one-year period of service. You first take into account your service during the current tax year, then the next preceding tax year, and so forth, until your service equals one year of service.

Example. You are figuring your exclusion allowance for your 1996 tax year (which also is a calendar year). You worked full time one-fourth of a year for the last 10 years. Your most recent one-year period of service includes the service you performed in the period 1993 through 1996, figured as follows:

1996 fractional period of service	1/4
1995 fractional period of service	1/4
1994 fractional period of service	1/4
1993 fractional period of service	1/4
1 year of service equals	4/4

Full-time employee for part of a year. If you were a full-time employee for part of a year, the numerator of the fraction that represents your fractional year of service is the number of weeks (or months) that you were a full-time employee during that year. The denominator is the number of weeks (or months) considered to be the usual work period for your position.

Example. You are employed full time as an instructor by a university for the 1996 spring semester (which lasts from February through May). The academic year of the university is 8 months long, beginning in October and ending the following May. You are considered as having completed four-eighths of a year of service.

Part-time employee for a full year. If you are a part-time employee for a full year, the numerator of the fraction that represents your fractional year of service is the amount of work you are required to perform. The denominator is the amount of work normally required of individuals who hold the same position.

Example. You are a practicing physician teaching one course at a local medical school 3 hours a week for two semesters, and other faculty members at that medical school teach 9 hours a week for two semesters. You are considered to have completed three-ninths of a year of service.

Part-time employee for part of a year. If you are a part-time employee for part of a year, you figure the fraction that represents your fractional year of service by:

1) Figuring a fractional year as if you were a ***full-time*** employee for ***part of a year,***
2) Figuring a fractional year as if you were a ***part-time*** employee for a ***full year,*** and
3) Multiplying the fractions in (1) and (2).

Example. You are an attorney and a specialist in federal tax law. In addition to your private practice, you teach tax law for 3 hours a week for one semester (the 4-month spring semester) at a nearby law school. Full-time instructors at the law school teach 12 hours a week for two semesters (or an 8-month academic year).

A fractional year of service figured as if you were a full-time employee for part of a year is four-eighths or one-half (the numerator being the period you worked, or 4 months, and the denominator being the usual work period, or 8 months).

A fractional year of service figured as if you were a part-time employee for a full year is three-twelfths of a year (the numerator being the number of hours you are employed, and the denominator being the usual number of hours required for that position).

Your fractional year of service as a part-time employee for part of the year is $3/24$ ($1/2 \times 3/12$) or one-eighth of a year.

Years of Service

Your next step in figuring your exclusion allowance is to figure your years of service with the employer that contributes to a TSA on your behalf.

Your years of service are the total number of years you worked for your employer figured as of the end of the tax year for which you are figuring an exclusion allowance. Your years of service cannot be less than one year (if your ''most recent one-year period of service'' (discussed earlier) is less than a year, your ''years of service'' is one year). The service need not be continuous.

CAUTION *For tax years beginning after 1996, years of service includes full years (and fractional years) in which a self-employed minister is treated as employed by a qualified tax-exempt organization.*

Rules for Figuring

The following rules must be taken into account when figuring years of service.

Status of employer. Your years of service will only include periods that your employer was a ***qualified employer,*** as defined earlier.

Service with one employer. Generally, you cannot count service for any other employer. However, if you are a ***church employee*** treat all of your years of service with related church organizations as years of service with one employer. Therefore, if during your church career you transfer from one organization to another within that church or to an associated organization, treat all this service as service with a single employer. When these organizations make contributions to your annuity contracts, treat them as made by the same employer.

A church employee includes anyone who is an employee of a church or a convention or association of churches. This includes an employee of a tax-exempt organization controlled by or associated with a church or a convention or association of churches.

Full-time employee for a full year. Count a year of service for each full year you have worked full-time for the employer that contributes to the tax-sheltered annuity on your behalf. See the discussions of *full-time employee for a full year* and *a full year of service,* earlier under *Most Recent One-Year Period of Service.*

Part-time or full-time employee for part of a year. You must figure the fraction that represents your fractional year of service. The rules for doing this are the same as those for figuring your *Most Recent One-Year Period of Service,* discussed earlier.

Amounts Previously Excludable

The next step in figuring your exclusion allowance is to subtract the amounts previously excludable from the result of multiplying 20% of includible compensation by your years of service.

Amounts previously excludable refers to the total of all contributions for retirement benefits made for you by your employer that were excludable from your gross income. Include only amounts for tax years before the one for which the current exclusion allowance is being figured.

Amounts previously excludable include contributions in earlier years by your employer to:

- A tax-sheltered annuity,
- A qualified annuity plan or a qualified pension, profit-sharing, or stock bonus trust,
- A qualified bond-purchase plan,
- A retirement plan under which the contributions originally were excludable by you only because your rights to the contributions were forfeitable when made, and which also were excludable by you when your rights became nonforfeitable (this does not apply to contributions made after 1957 to purchase an annuity contract if your employer was an exempt organization when the contributions were made), or
- An eligible deferred compensation plan (under Code section 457) of a state or local government or tax-exempt organization, even if maintained by a separate employer.

You must treat contributions to a state teachers retirement system made for you in earlier tax years, up to the amount that was excludable, as amounts previously excludable.

You must treat employer contributions and other additions in earlier years (beginning after January 24, 1980) that were more than the limit as if they were amounts previously excludable. See *Limit on Employer Contributions,* earlier.

Contributed amount unknown.

If you do not know the amount that an employer contributes to a plan on your behalf, you can figure your part of your employer's contributions by any method using recognized actuarial principles that are consistent with your employer's plan and the method used by your employer for funding the plan. You may also use the following formula.

Formula to figure. The contributions your employer made for you as of the end of any tax year are the result of multiplying the following four items:

1) The projected annual amount of your pension (as of the end of the tax year) to be provided at normal retirement age from employer contributions, based on your plan in effect at that time, and assuming your continued employment with that employer at your then current salary rate,
2) The value from Table I based on the normal retirement age as defined in the plan,
3) The amount from Table II for the sum of —
   a) The number of years remaining from the end of the tax year to normal retirement age, plus
   b) The lesser of the number of years of service credited through the end of the tax year or the number of years that the plan has been in existence at that time, and
4) The lesser of the number of years of service credited through the end of the tax year or the number of years that the plan has been in existence at that time.

An example of the use of these four items to figure an employer's contribution for you for a year follows Table I and Table II.

Table I

[Value at normal retirement ages of annuity of $1 per year payable in equal monthly installments during the life of the employee.]
[For tax years beginning after July 1, 1986.]

Ages	Value
40	11.49
41	11.40
42	11.31
43	11.22
44	11.12
45	11.01
46	10.91
47	10.79
48	10.68
49	10.56
50	10.43
51	10.30
52	10.18
53	10.04
54	9.89
55	9.75
56	9.60
57	9.44
58	9.28
59	9.13
60	8.96
61	8.79
62	8.62
63	8.44
64	8.25
65	8.08
66	7.88
67	7.70
68	7.50
69	7.29
70	7.10
71	6.88
72	6.68
73	6.46
74	6.25
75	6.03
76	5.82
77	5.61
78	5.40
79	5.20
80	4.99

Note: If the normal form of retirement benefit under the plan is other than a straight-life annuity, divide the value from Table I by the appropriate figure as follows:

Annuity for 5 years certain and life thereafter	0.97
Annuity for 10 years certain and life thereafter	0.90
Annuity for 15 years certain and life thereafter	0.80
Annuity for 20 years certain and life thereafter	0.70
Life annuity with installment refund	0.80
Life annuity with cash refund	0.75

The term ***cash refund*** refers to a refund of accumulated employer contributions, not to a refund of employee contributions only, often referred to as ***modified cash refund.***

Table II

[Level annual contribution which will accumulate to $1.00 at the end of a number of years.]
[For tax years beginning after July 1, 1986.]

Number of years	Amount	Number of years	Amount
1	$1.0000	26	$.0125
2	.4808	27	.0114
3	.3080	28	.0105
4	.2219	29	.0096
5	.1705	30	.0088
6	.1363	31	.0081
7	. 1121	32	.0075
8	.0940	33	.0069
9	.0801	34	.0063
10	.0690	35	.0058
11	.0601	36	.0053
12	.0527	37	.0049
13	.0465	38	.0045
14	.0413	39	.0042
15	.0368	40	.0039
16	.0330	41	.0036
17	.0296	42	.0033
18	.0267	43	.0030
19	.0241	44	.0028
20	.0219	45	.0026
21	.0198	46	.0024
22	.0180	47	.0022
23	.0164	48	.0020
24	.0150	49	.0019
25	.0137	50	.0017

Example. Joe Blue, who was 29 at the end of 1996, has been employed by the Oak County school system since 1993. In 1993, Joe's employer contributed to a TSA program. Since 1993, Joe's employer has contributed to both the TSA program and a statewide retirement system that provides a straight-life annuity upon retirement. Joe is covered by both plans.

For 1996, Joe wishes to figure the amounts previously excludable under both plans so that he can figure the exclusion allowance for that year. His employer's contributions to the statewide retirement system were not allocated among the individual employees.

Joe's employer gives him the following information:

Employer contributions to the TSA that were excludable from gross income in prior years:

1993	$2,000
1994	2,400
1995	2,800

The projected annual amount of Joe's retirement system pension (as of the end of 1995 when Joe was 28) is $12,000. The pension begins at age 65 from his employer's contributions. This is based on 1995 plan provisions and assumes that Joe works for the same employer until age 65 at his 1995 salary. Normal retirement age is 65.

Joe figures the ***amounts previously excludable*** under the pension plan as follows:

A.	Projected annual amount of pension at normal retirement age (65)		$12,000
B.	Table I value at normal retirement age (65)		8.08
C.	Table II amount for the sum of:		
	1) Number of years from end of the preceding tax year (1995) to normal retirement age (65 minus 28)	37	
	2) Plus: Lesser of years of plan existence or years of service	3	
		40	
	Table II amount for total of 40		.0039
D.	Lesser of years of plan existence or years of service		3

Joe multiplies A times B times C times D.

$12,000 × 8.08 × .0039 × 3 = $1,134.43

Joe then adds $1,134.43 to the amounts contributed to the tax-sheltered annuity plan in years prior to the 1996 tax year ($7,200) to determine the ***amounts previously excludable*** of **$8,334.43.**

Note: See *Contributions in excess of employer limit,* earlier, under *Limit on Employer Contributions.*

Catch-up Election — Alternative Limits for Certain Employees

If you are an employee of an educational organization, a hospital, a home health service agency, a health and welfare service agency, or a church or church-related organization that contributes to a tax-sheltered annuity (TSA) for you, you can make a ''catch-up ''election (see *Background,* later) to increase the limit on your employer's contributions by using one of three alternative limits. See also *Special Election for Church Employees,* later.

An ***educational organization*** and a church employee have been defined earlier.

A ***home health service agency*** is a tax-exempt organization that has been determined by the Secretary of Health and Human Services to be a home health agency as defined in section 1861(o) of the Social Security Act.

A ***church,*** for this purpose, includes a church, convention or association of churches, or a tax-exempt organization controlled by or associated with a church or a convention or association of churches.

Background. Employees of these organizations typically have a pattern of low employer contributions in the early years of their careers and relatively high catch-up contributions later. The three alternative limits were established for these employees to allow them to elect these higher catch-up contributions.

Alternative limits. The three alternative limits are:

1) The year of separation from service limit,
2) The any year limit, and
3) The overall limit (general rule).

Electing (choosing) a limit. You can elect any one of the three limits, but with certain restrictions, as explained later under *Making the Election.* For example, you cannot make more than one election and, once one is made, it is irrevocable and limits elections for future years.

Effect of election. Generally, the election to use one of the first two alternative limits listed above will permit you to exclude from gross income a larger amount of employer contributions than allowed under the part of the ''overall limit'' that limits employer contributions to 25% of your compensation. The overall limit is sometimes referred to as the ***general rule*** (discussed earlier under *Limit on Employer Contributions*). If you elect to use the overall limit, you may be able to exclude a larger amount because you can disregard the ***exclusion allowance*** (discussed earlier) that would otherwise apply.

Excess contributions. If employer contributions are included in your income for a tax year because they exceed any of these alternative limits for that year, the excess reduces the amount of your exclusion allowance for future years, even though the excess has already been included in your income.

Year of Separation from Service Limit

For the limitation year (defined under *Limit on Employer Contributions,* earlier) that ends with or within the tax year you separate from the service of an educational organization, hospital, church, or other organization listed above, ***you can elect to substitute*** your exclusion allowance (modified as discussed below) for the 25% of your compensation limit on employer contributions under the general rule. (See *Limit on Employer Contributions,* earlier.) The $30,000 limit on employer contributions still applies. The limit on elective deferrals also still applies to the extent the contributions consist of elective deferrals. See *Limit on Elective Deferrals,* earlier.

Figuring the limit.

Figure your exclusion allowance as explained earlier, except, for your years of service, count only the service you performed during the 10-year period ending on the date of separation. Do not use a period longer than 10 years even if the 10-year period is less than your actual number of years of service. Your amounts previously excludable are the amounts excludable during your years of service (limited to 10 years). All service for your employer performed within the 10-year period must be taken into account.

Limit. Compare this ***modified*** exclusion allowance to the $30,000 limit on employer contributions and the limit on elective deferrals, if it applies. Your year of separation from service limit is the least of these.

If your employer's contributions for the year are more than the least of your modified exclusion allowance, $30,000, or the limit on elective deferrals, if it applies, you must include the excess in gross income.

Example. Frank Green, who is president of a university, plans to retire on December 31, 1996, after 20 years of service. His compensation for 1996, which was not reduced by any elective deferrals, is $50,000. During the 10-year period before the date of separation from service, Frank's employer contributed $20,000 to Frank's TSA. The contributions, which were ***non-elective,*** were excludable from Frank's gross income. During all his years of service, his employer contributed a total of $30,000 that was excludable from Frank's gross income. For 1996, Frank elects to have his employer contribute the maximum amount permitted for ***non-elective employer contributions*** to his TSA. He figures that amount using the *Year of Separation from Service Limit* as follows:

Step 1—Exclusion Allowance (before modification)

Includible compensation	$ 50,000
2) Percentage limit	20%
3) Years of service	20
4) Multiply (1) × (2) × (3)	$200,000
5) Minus: Amounts previously excludable	30,000
6) Exclusion allowance	$170,000

Step 2—Limit on Employer Contributions

1) Maximum		$ 30,000
2) 25% of compensation limit		
(a) Compensation		$ 50,000
(b) Percentage limit		25%
(c) Limit		$ 12,500
3) Limit on Employer Contributions (lesser of (1) or (2))		$ 12,500

Step 3—Year of Separation from Service Limit

1) Employer Limit on Contributions — Maximum		$ 30,000
2) Exclusion allowance (modified)		
(a) Includible compensation	$ 50,000	
(b) Percentage limit	20%	
(c) Years of service (Limited to 10 years)	10	
(d) Multiply (i) × (ii) × (iii)	$100,000	
(e) Minus: Amounts previously excludable during 10-year period	20,000	
(f) Exclusion allowance (modified)		$ 80,000
3) Alternative Limit — Year of Separation from Service Limit [lesser of (1) or (2)(f)]		$ 30,000

Because Frank elected this alternative limit, and because there are no elective deferrals, his employer can contribute $30,000 to Frank's TSA during the year of his separation from service without making an excess contribution. In Step 1, Frank's unadjusted exclusion allowance is $170,000. In Step 2, employer contributions to Frank's TSA are limited to $12,500. If it were not for this election, the limit on employer contributions for Frank would be $12,500 (Step 2). Instead, the limit is $30,000.

> ***WORKSHEET 4*** at the end of this publication will help you figure the **Year of Separation from Service Limit** and the amount you can exclude from gross income.

Any Year Limit

For any limitation year (defined under *Limit on Employer Contributions,* earlier), ***you can substitute*** for the 25% of employee's compensation limit the ***least*** of the following:

1) $4,000, plus 25% of your includible compensation for the tax year in which the limitation year ends;

2) The exclusion allowance for the tax year in which the limitation year ends; or

3) $15,000.

If you elect this limit, the maximum permitted contribution to your TSA is $15,000, not the $30,000 that may apply under other limits.

If your employer's annual contributions are more than the least of your *Any Year Limit,* exclusion allowance, or the limit on elective deferrals (to the extent the contributions are elective deferrals), you must include the excess in your gross income.

Example. Bill Black is a principal with the Maple County school system. In 1996, his 17th year of service, Bill's salary is $29,000 without reduction for an amount under a salary reduction agreement. Bill's employer had contributed $34,400 to the tax-sheltered annuity program in earlier years, and all the contributions were excluded from Bill's income. Under a salary reduction agreement, Bill and his employer agree to elective deferral contributions of $9,000 that may be excluded from Bill's gross income. To find the maximum employer contribution allowed, Bill figured the *Any Year Limit* as follows:

Step 1—Exclusion Allowance

1) Includible compensation	$20,000
2) Percentage limit	20%
3) Years of service	17
4) Multiply (1) × (2) × (3)	$68,000
5) Minus: Amounts previously excludable	34,400
6) Exclusion allowance	$33,600

Step 2—Any Year Limit

7) a) $4,000 plus 25% of includible compensation $4,000 + (25% × $20,000)	$ 9,000
b) Exclusion allowance (from Line (6)	$33,600
c) Maximum under this election	$15,000
d) Alternative limit (Least of (a), (b), or (c))	$ 9,000

Under this alternative limit, Bill's employer can contribute $9,000 to the annuity program. Bill can exclude that amount because it is also within the limit on elective deferrals (discussed earlier). In Step 1, the exclusion allowance is $33,600; in Step 2, the maximum amount the employer can contribute on Bill's behalf is $9,000. Since this is less than the amount in Step 1, and within the limit on elective deferrals, $9,000 is the amount that can be excluded from gross income.

If it were not for this alternative limit, the maximum amount Bill's employer could contribute under the general rule would be $5,000 (25% × $20,000).

> ***WORKSHEET 5*** at the end of this publication will help you figure the **Any Year Limit** and the amount you can exclude from gross income.

Overall Limit

You can elect to have the limit on your employer's contributions and your exclusion allowance be equal to the lesser of $30,000 or 25% of compensation (see *Compensation* under *Limit on Employer Contributions,* earlier) for the limitation year ending in the tax year. Under this election, you disregard the computation of the exclusion allowance discussed under *The Exclusion Allowance,* earlier.

Include in your gross income any contribution to your TSA that is more than the lesser of the limit on employer contributions ($30,000 or 25% of compensation) or the elective deferral limit ($9,500), if it applies.

If you elect the *Overall Limit* as your alternative limit, you must combine employer contributions to your TSA with your employer's contributions to a qualified plan to determine whether the limits on employer contributions have been exceeded. See *Limit for Contributions to More Than One Program,* later.

Example. Mary White is employed as a nurse with Apple City General Hospital. In her 11th year of service, she agrees to have her employer contribute additional amounts to her tax-sheltered annuity program for catch-up contributions.

Her compensation for 1996 is $25,000. She figures the overall limit on contributions to be $6,250, as follows:

1) Maximum employer contributions	$30,000
2) 25% of compensation (25% × $25,000)	$ 6,250
3) Overall limit on employer contributions—(lesser of (1) or (2))	$ 6,250

WORKSHEET 6 at the end of this publication will help you figure the **Overall Limit** and the amount you can exclude from gross income.

Examples of Catch-up Elections

The following examples show how you can use the three alternative limits just discussed to maximize the amount of employer contributions to a tax-sheltered annuity (TSA) that you can exclude from income.

Example 1. Eli Green was an employee of Maple Hospital, a tax-exempt charitable organization, for the entire 1996 calendar year. His employer's contributions to a TSA for him are not subject to the elective deferral limit. Eli has a salary of $30,000 for the year. He has 4 years of service with his employer as of December 31, 1996. During Eli's prior service with Maple Hospital, his employer had contributed $12,000 on Eli's behalf to a TSA, and Eli excluded the amount from gross income in earlier years. Thus, for 1996, Eli's exclusion allowance is $12,000, figured as follows:

1) Includible compensation	$30,000
2) Percentage limit	20%
3) Years of service	4
4) (1) × (2) × (3)	$24,000
5) Minus: Amounts previously excludable	12,000
6) Exclusion allowance	$12,000

The limit under the general rule (see *Limit on Employer Contributions,* earlier) is $7,500 (the lesser of $30,000 or $7,500 (25% × $30,000).

Without the catch-up elections provided for certain employees, $7,500 would be the maximum contribution Maple Hospital could make for TSAs on behalf of Eli for 1996 without increasing Eli's gross income for that year.

Since Eli is an employee of a hospital, he can elect one of the catch-up limits. Eli can elect either the *Any Year Limit* or the *Overall Limit.* He cannot elect the *Year of Separation from Service Limit* since he does not separate from service in 1996.

If Eli elects the *Any Year Limit,* Maple Hospital could contribute $11,500 on his behalf for 1996 to a TSA, figured as follows:

1) $4,000, plus 25% of includible compensation	$11,500
2) Exclusion allowance	$12,000
3) Maximum	$15,000
4) Any year limit [least of (1), (2), or (3)]	$11,500

If Eli elects the *Overall Limit,* Maple Hospital could contribute only a maximum of $7,500 without increasing Eli's gross income for the year figured as follows:

1) Maximum	$30,000
2) 25% of compensation	$ 7,500
3) Overall limit [lesser of (1) or (2)]	$ 7,500

Example 2. Assume the same facts as in Example 1, except that Maple Hospital contributed $18,000 on Eli's behalf in earlier years to the TSA. The contributions were excludable from his gross income. Thus, for 1996, Eli's exclusion allowance is $6,000 figured as follows:

1) Includible compensation	$30,000
2) Percentage limit	20%
3) Years of service	4
4) (1) × (2) × (3)	$24,000
5) Minus: Amounts previously excludable	18,000
6) Exclusion allowance	$ 6,000

The limit under the general rule (the limit on employer contributions) for 1996 is the lesser of $30,000 or $7,500 (25% × $30,000).

Without the catch-up elections, $6,000 (the lesser of the two limits that apply) would be the maximum amount Maple Hospital could contribute on Eli's behalf for TSAs without increasing Eli's gross income. However, if Eli elects the *Overall Limit,* Maple Hospital could contribute up to $7,500 without increasing Eli's gross income for 1996. This is because the election of this limit substitutes the limit under the general rule for the exclusion allowance.

Example 3. Bob White, a teacher, is employed by Elm School, a tax-exempt educational organization. Bob has a salary, after reduction for elective deferrals, of $24,000 for 1996.

Bob has 20 years of service with Elm School as of May 30, 1996, the date he separates from the service of Elm School. During Bob's service with Elm School before tax year 1996, Elm School had contributed elective deferrals of $68,000 toward the purchase of TSAs on behalf of Bob. The amount was excludable from his gross income for the prior years. Of this amount, $38,000 was contributed and excluded during the 10-year period ending on May 30, 1996. For the tax year 1996, Bob's limit on elective deferrals is $12,500 determined as follows:

1) General limit		$ 9,500
2) Maximum additional		3,000
3) $15,000 less ''additional'' deferrals allowed in prior years		$15,000
4) Prior year deferrals limit:		
a) Annual amount	$5,000	
b) Years of service	20	
c) Multiply (a) x (b)	$100,000	
d) Less elective deferrals made under plan for earlier years	68,000	
e) Balance		32,000
5) Least of lines 2, 3, or 4		3,000
6) Increased elective deferrals limit (line 1 plus line 5)		$12,500

Bob's limit on employer contributions is $6,000 determined as follows:

1) Maximum	$30,000
2) 25% of compensation ($24,000 x 25%)	6,000
3) Lesser of line 1 or 2	$ 6,000

Bob's exclusion allowance is $28,000 figured as follows:

1) Includible compensation	$24,000
2) Percentage limit	20%
3) Years of service	20
4) Multiply (1) × (2) × (3)	$96,000
5) Minus: Amounts previously excludable	68,000
6) Exclusion allowance	$28,000

Bob's limit under the general rule (limit on employer contributions) is the lesser of $30,000 or $6,000 (25% of $24,000).

Without the catch-up elections, $6,000 — the least of the exclusion allowance ($28,000), the general rule ($6,000), or the increased elective deferral limit ($12,500) because he completed at least 15 years of service — would be the maximum excludable contribution Elm School could make to a TSA on Bob's behalf for 1996.

However, because Bob was an employee of an educational organization and has separated from service, he can elect any one of the three catch-up elections (alternative limits) to increase his allowable 1996 contribution.

Catch-up elections for Example 3. Before deciding which *catch-up election* to make, Bob considers the following.

If Bob elects the *Year of Separation from Service Limit* for 1996, Elm School could contribute up to $10,000 for that year without increasing Bob's gross income, figured as follows:

1)	Includible compensation	$24,000
2)	Percentage limit	20%
3)	Years of service (not to exceed 10)	10
4)	Multiply (1) × (2) × (3)	$48,000
5)	Minus: Amounts previously excludable	38,000
6)	Maximum contribution under *Year of Separation from Service Limit*	$10,000

If Bob elects the *Any Year Limit* for 1996, Elm School could contribute up to $10,000, which is the least of the following:

1)	$4,000, plus 25% of includible compensation	$10,000
2)	Exclusion allowance	$28,000
3)	Maximum under this alternative	$15,000
4)	Maximum contribution under *Any Year Limit* (least of lines 1, 2, or 3)	$10,000

If Bob elects the *Overall Limit* for 1996, Elm School could contribute up to $6,000, which is the lesser of the following:

1)	Maximum under this alternative	$30,000
2)	25% of compensation	$ 6,000
3)	Maximum contribution under the *Overall Limit* (lesser of line 1 or 2)	$ 6,000

Comparing Example 3 limits. Although Bob has two choices that allow catch-up contributions of $10,000 for 1996, Bob elects the any year limit, which can be used again in the future. The year of separation from service limit cannot be used again. See *Making the Election,* later for more information.

Special Election for Church Employees

If you are a church employee and the *minimum exclusion allowance for church employees* (described earlier under *The Exclusion Allowance*) applies to you, your employer can make contributions for the year up to the minimum exclusion allowance even though the contributions would otherwise be more than the limit on employer contributions to a defined contribution plan, discussed earlier.

In addition to the "any year" or "overall" limit, you can make a special election that allows your employer to contribute up to $10,000 for the year, even if this is more than 25% of your compensation for the year. The total contributions over your lifetime under this election cannot be more than $40,000. In this situation, the exclusion allowance limit still applies, unless you also elect the *Overall Limit,* described earlier. If the contributions are elective deferrals, they are also subject to the limit on elective deferrals, discussed earlier.

You cannot make this special election for a tax year in which you use the *Year of Separation from Service Limit,* described earlier.

Making the Election

You make the election to apply one of the three alternative limits by figuring your tax using the limit you choose. However, the election is treated as made only when needed to support the exclusion from gross income reflected on the income tax return.

Election is irrevocable. If you elect to use an alternative limit, you cannot change the election.

If you elect one of the alternative limits, you cannot elect to have any of the others apply for any future year for any TSA purchased for you by any employer. If you elect the *Any Year Limit* or the *Overall Limit,* it is the only alternative limit you can use for later years.

If you elect the *Year of Separation from Service Limit,* you cannot elect any alternative limit in any later year for any tax-sheltered annuity. You can use this limit only once.

Failure to pay estimated income tax. If you amend an earlier year's return to elect an alternative limit, and that limit increases your tax for that year, the difference in tax due to the use of the alternative limit is not treated as an underpayment of tax for the penalty for failure to pay estimated income tax.

Limit for Contributions to More Than One Program

Special rules may apply in determining the limit on employer contributions for you to a tax-sheltered annuity (TSA) program if you also are covered by a qualified plan.

Combining contributions. Generally, contributions to TSA programs must be combined with contributions to qualified plans of all corporations, partnerships, and sole proprietorships in which you have ***more than 50% control*** to determine whether the limits on contributions and benefits of qualified plans (section 415 limits) have been exceeded.

If you elect the *Overall Limit,* discussed earlier, you must combine contributions whether or not you have this control.

Example 1. You have an HR–10 plan (sometimes called a Keogh plan) for a sole proprietorship business, and you are also a participant in a charity's TSA program. You must combine contributions under the two defined contribution plans to determine whether the limit on employer contributions is satisfied.

Example 2. You are employed by an educational organization that provides a TSA program. You are also a shareholder owning more than 50% of a professional corporation. You must combine any qualified plan of the professional corporation with the TSA to determine if the section 415 limits have been satisfied.

Excess contributions. If you combine the TSA contract and a qualified plan, the limit on employer contributions may be exceeded. The excess is includible in your gross income for the tax year the excess contribution was made, and it reduces your exclusion allowance for all future years.

Other Rules

The following additional rules generally relate to contributions to your tax-sheltered annuity (TSA), and to other transactions affecting your annuity before you retire or receive annuity benefits.

Voluntary Employee Contributions

For tax years beginning after 1986, you cannot deduct voluntary employee contributions you make to your TSA.

However, there may be amounts in your TSA that are from deductible voluntary employee contributions you made in earlier years. If these amounts are distributed to you, you must include them in gross income unless you roll them over into an IRA or into another TSA.

Tax on Excess Contributions to a Custodial Account

You are liable for a 6% excise tax on contributions in excess of the exclusion allowance or the limit on employer contributions made under a TSA plan investing in mutual fund shares through a custodial account. The tax ***does not apply*** to excess contributions made to pay premiums on an annuity contract. Also see *Taxability of Excess Contributions,* later.

You cannot deduct the tax. It is due each year until the year the excess contribution is corrected. Excess contributions may be corrected by contributing less in future years. For example, if there is an excess contribution in 1996 and no corrective action is taken for that year, you are liable for the tax for 1996. If after 1996 you do not withdraw the excess (if not otherwise restricted) or reduce it by carrying it over to a later year (or years) in which you contribute less than your allowable contribution for that later year (or years), you will continue to be liable for the tax on the excess each year it remains. This tax will be in addition to any tax due because of additional excess contributions in a later year.

How to figure tax. You figure the excess contributions tax for the current year as follows:

1)	Total amount contributed for current year, minus rollovers	______
2)	Lesser of exclusion allowance or annual limit on employer's contribution	______
3)	Current year excess contributions (line 1 minus line 2, but not less than zero)	______
4)	Preceding year excess contributions not previously eliminated. If zero, proceed to line 8	______

5) Contribution credit (if line 2 is more than line 1, enter the excess, otherwise enter zero) .... ______

6) Total of all prior years' distributions out of the account included in your gross income (not including amounts received as an annuity) and not previously used to reduce excess contributions .... ______

7) Adjusted preceding year's excess contributions (line 4 minus the total of lines 5 and 6) .... ______

8) Taxable excess contributions (line 3 plus line 7) .... ______

9) Excess contributions tax—Enter the lesser of 6% of line 8 or 6% of the value of your account as of the last day of the year .... ______

Reporting requirement. You must file Form 5330, *Return of Excise Taxes Related to Employee Benefit Plans,* if there has been an excess contribution to a ***custodial account*** and that excess has not been corrected in any year.

When to file. File Form 5330 by July 31 following the close of your tax year. You may be granted an extension (not to exceed 6 months) by filing Form 5558, *Application for Extension of Time To File Certain Employee Plan Returns,* early enough to give IRS time to consider and act on it before the due date of Form 5330.

Where to file. You should file Form 5330 with the Internal Revenue Service Center where you normally file your income tax return.

Cost of Insurance Protection

If your annuity contract provides you with incidental life insurance protection, you must include in your income each year the one-year cost of the life insurance premium. This cost should be included with salaries and wages on Form W–2.

Your current life insurance protection under an ordinary retirement income life insurance policy is the amount payable upon your death minus the cash value of the contract at the end of the year.

Example. Your new contract provides that your beneficiary will receive $10,000 if you should die anytime before retirement, and your cash value in the contract at the end of the first year is zero. Your current life insurance protection for the first year is $10,000 ($10,000 minus 0).

The one-year cost of the protection can be figured by using the following table. The premium rate is determined according to your age on your birthday nearest the beginning of the policy year.

If the current published premium rates per $1,000 of insurance protection charged by an insurer for individual one-year term life insurance premiums available to all standard risks are lower than those in the following table, you can use the lower rates for figuring the cost of insurance in connection with individual policies issued by the same insurer.

Uniform One-Year Term Premiums for $1,000 Life Insurance Protection

(Based on Table 38, U.S. Life Table and Actuarial Table (U.S. Government Printing Office, Washington, D.C.—1946), and 2 1/2% interest.)

Age	Premium	Age	Premium
15	$1.27	49	$ 8.53
16	1.38	50	9.22
17	1.48	51	9.97
18	1.52	52	10.79
19	1.56	53	11.69
20	1.61	54	12.67
21	1.67	55	13.74
22	1.73	56	14.91
23	1.79	57	16.18
24	1.86	58	17.56
25	1.93	59	19.08
26	2.02	60	20.73
27	2.11	61	22.53
28	2.20	62	24.50
29	2.31	63	26.63
30	2.43	64	28.98
31	2.57	65	31.51
32	2.70	66	34.28
33	2.86	67	37.31
34	3.02	68	40.59
35	3.21	69	44.17
36	3.41	70	48.06
37	3.63	71	52.29
38	3.87	72	56.89
39	4.14	73	61.89
40	4.42	74	67.33
41	4.73	75	73.23
42	5.07	76	79.63
43	5.44	77	86.57
44	5.85	78	94.09
45	6.30	79	102.23
46	6.78	80	111.04
47	7.32	81	120.57
48	7.89		

Example. Lynn Green and her employer enter into a tax-sheltered annuity purchase agreement that will provide her with a $500 a month annuity upon retirement at age 65. The agreement also provides that if she should die before retirement, her beneficiary will receive the greater of $20,000 or the cash surrender value in the retirement income life insurance contract.

Since the cash surrender value at the end of the first year is zero, her net insurance is $20,000 ($20,000 minus 0). Her age on the nearest birthday is 44. Using the preceding table, she determines that her one-year term premium cost for $1,000 of insurance is $5.85. Thus, she must include in gross income $117.00 ($5.85 × 20) as the premium for her net insurance coverage of $20,000.

Lynn's cash value in the contract at the end of the 2nd year is $1,000. Thus, her life insurance coverage is $19,000 ($20,000 minus $1,000). Since the one-year term cost rate per $1,000 for age 45 in the 2nd year is $6.30, the amount to be included in income is $119.70 ($6.30 × 19).

Federal Insurance Contributions Act (FICA)

The contributions toward the tax-sheltered annuity (TSA) ***under a salary reduction agreement*** are considered wages for the FICA (social security and Medicare) tax. The employer must take into account the entire amount of these contributions for FICA tax purposes, whether they are wholly or partially excludable for income tax purposes. These wages are credited to the employee's social security account for benefit purposes.

However, if the employer makes a contribution to purchase an annuity, which is ***not under a salary reduction agreement,*** that amount is not considered wages for social security tax purposes.

Religious exemption. A church or church-related organization may have chosen, for religious reasons, to have its employees be exempt from the FICA tax on all their earnings from that employment, including any TSA contributions. If this choice is in effect, the wages from church employment are generally subject to the self-employment tax (SECA) discussed next.

Self-Employment Contributions Act (SECA)

Generally, a person who renders services to a church as a ***minister*** is treated as a self-employed individual for the social security and Medicare self-employment tax, even though the minister may be an employee for other tax purposes.

Certain income not taken into account. For social security and Medicare tax purposes (assuming the minister does not elect to be exempt from social security), some items of income excludable from the minister's gross income are not taken into account in determining the net earnings from self employment. Contributions for the minister toward a tax-sheltered annuity (TSA) contract are not taken into account as net earnings from self employment to the extent the contributions are not more than the exclusion allowance or employer contribution limit.

Effect of FICA tax exemption. If you are an employee of a church or church-related organization and you chose exemption from FICA tax, as mentioned above, you must include wages from that employment in net earnings from self employment. However, do not include TSA contributions in figuring self-employment tax. The self-employment tax on wages from church employment is figured under special rules. See Schedule SE (Form 1040) and its instructions.

For information on FICA and SECA taxes, get Publication 517, *Social Security and Other Information for Members of the Clergy and Religious Workers*.

Reporting by Employer

If you participate in a tax-sheltered annuity (TSA) plan, your employer must report this participation by checking the "Pension plan" box on the Form W–2, *Wage and Tax Statement,* given to you and the IRS after the end of the year. If you have an individual retirement arrangement (IRA) and you or your spouse participate in a TSA or certain other retirement plans, the deduction for your IRA contributions may be reduced or eliminated. For information on IRAs, get Publication 590, *Individual Retirement Arrangements (IRAs).*

Also, your employer must report in box 13 of your Form W–2 your ***total*** elective deferrals, including any excess contributions to a TSA.

Employers and plan administrators must report contributions in excess of the limits that apply. Form 1099–R includes boxes for reporting ''gross'' and ''taxable'' amounts of total distributions.

Income Tax Withholding by Employer

Your employer's contributions to your tax-sheltered annuity, to the extent excludable from your gross income, are not subject to income tax withholding. However, any amount contributed to the plan in excess of the applicable limits, or used to purchase current life insurance protection, is subject to withholding.

Taxability of Excess Contributions

If your employer makes contributions to (pays the premium for) a tax-sheltered annuity contract for your benefit, the contributions are ***taxable to the extent*** they are more than the amount excludable from your gross income (see *Exclusion from Gross Income,* earlier), but only to the extent they are (or become) substantially vested at the time of payment. See also *Partial vesting,* later in this discussion.

The ***amount excludable*** is the least of your exclusion allowance, the limit on employer contributions, or the limit on elective deferrals.

Your rights are ***substantially vested*** when they are transferable or are not subject to a substantial risk of forfeiture.

Your rights are ***transferable*** if you can transfer any interest in any property to any person other than the transferor, but only if your rights in the property are not subject to a substantial risk of forfeiture.

Property is transferable if you can sell, assign, or pledge your interest in it to anyone other than the transferor and if you do not have to give up the property or its value if the substantial risk of forfeiture materializes. Property is not transferable merely because you may designate a beneficiary to receive it in the event of your death.

A ***substantial risk of forfeiture*** exists when your rights in property that are transferred are directly or indirectly conditioned upon future performance (or refraining from performance) of substantial services by any person. A substantial risk of forfeiture also exists when rights in property depend on the occurrence of a condition related to the purpose of the transfer and the possibility of forfeiture is substantial if the condition is not satisfied.

Taxability of rights that change from nonvested to vested. The amount includible in your gross income, when your rights change from nonvested to substantially vested, is the value of the annuity contract that, on the date of change, is:

1) From contributions made by your employer before the date of change, and
2) More than the amount excludable from gross income.

The ***value of an annuity contract*** on the date your rights become substantially vested means the cash surrender value of the contract on that date.

Partial vesting. If, during your tax year, only part of the beneficial interest in an annuity contract becomes substantially vested, only a portion of the annuity contract value on the date of the change is includible in your gross income for the tax year.

Figuring the amount includible. The amount includible in your gross income is figured as follows:

1) Find the amount includible in gross income if, without regard to the exclusion allowance, the ***entire*** beneficial interest in the annuity contract had changed to a substantially vested interest during the tax year.
2) Multiply the amount in (1) by the percent of your beneficial interest that became substantially vested during the tax year.

The resulting amount in (2) is taxable to the extent it is more than the amount excludable from gross income.

Gift Tax

If, by choosing or not choosing an election or option, you provide an annuity for your beneficiary at or after your death, you may have made a taxable gift for gift tax purposes equal to the value of the annuity.

Joint and survivor annuity. If the gift is an interest in a joint and survivor annuity where ***only*** you and your spouse have the right to receive payments, the gift will generally be treated as qualifying for the unlimited marital deduction.

More information. For information on the gift tax, see Publication 950, *Introduction to Estate and Gift Taxes.*

Distributions and Rollovers

Generally, a distribution cannot be made from a TSA contract until the employee:

- Attains age $59\frac{1}{2}$,
- Separates from service,
- Dies, or
- Becomes disabled.

In most cases, the payments you receive, or that are made available to you, under your TSA contract are taxable in full as ordinary income. In general, the same tax rules apply to distributions from tax-sheltered annuities that apply to distributions from other retirement plans. These rules are explained in Publication 575, *Pension and Annuity Income (Including Simplified General Rule).* Publication 575 also discusses the additional tax on early distributions from retirement plans.

Minimum Distributions

You must receive all, or at least a certain minimum, of your interest accruing after 1986 in the tax-sheltered annuity program by April 1 of the year immediately following the year in which you reach age $70\frac{1}{2}$. Check with your employer, plan administrator, or provider to find out whether this rule also applies to pre-1987 accruals. If not, a minimum amount of these accruals must begin to be distributed no later than the end of the calendar year in which you attain age 75. For each year thereafter, the minimum distribution must be made by the last day of the year. If you do not receive the required minimum distribution, you are subject to a nondeductible 50% excise tax.

TIP *For years beginning after 1996, required minimum distributions of your interest accruing after 1986, generally do not have to be made until April 1 of the later of the calendar year in which you become age $70\frac{1}{2}$ or the calendar year in which you retire.*

For more information on minimum distribution requirements and the additional tax that applies if too little is distributed each year, see Publication 575, *Pension and Annuity Income (Including Simplified General Rule).*

No Special 5– or 10–Year Tax Option

A distribution from a tax-sheltered annuity does **not** qualify as a lump-sum distribution. This means you cannot use the special 5– or 10–year tax option.

Transfer of Interest in Tax-Sheltered Annuity

If you transfer all or part of your interest from a tax-sheltered annuity contract or account to another tax-sheltered annuity contract or account, the transfer is tax free. However, this treatment applies only if the transferred interest is subject to the same or stricter distribution restrictions. This rule applies regardless of whether you are a current employee, a former employee, or a beneficiary of a former employee. Transfers that do not satisfy this rule are plan distributions.

Tax-free transfers for certain cash distributions. A tax-free transfer may also apply to a cash distribution for your annuity contract or account from an insurance company that is subject to a rehabilitation, conservatorship, insolvency, or similar state proceeding. To receive tax-free treatment, you must do all of the following:

1) Reinvest the cash in an annuity contract or account issued by another insurance company.
2) Withdraw all the cash to which you are entitled in full settlement of your contract rights or the maximum permitted by the state.
3) Reinvest the cash distribution into another annuity contract or account issued by another insurance company or single custodial account not later than 60 days after you receive the cash distribution.
4) Assign all future distribution rights to the new contract or account for investment in that contract or account if you received an amount that is less than what you are entitled to because of state restrictions.
5) Reinvest in an annuity contract or account subject to the same or stricter distribution restrictions as the original contract.

In addition to the preceding requirements, you must provide the new insurer with a written statement containing the following information:

1) The gross amount of cash distributed under the old contract,
2) The amount of cash reinvested in the new contract, and
3) Your investment in the old contract on the date you receive your first cash distribution.

Also, you must attach the following items to your timely filed income tax return in the year you receive the first distribution of cash.

1) A copy of the statement you gave the new insurer.
2) A statement that includes:
   a) The words ''ELECTION UNDER REV. PROC. 92-44,''
   b) The name of the company that issued the new contract, and
   c) The new policy number.

Tax-Free Rollovers

You can generally roll over tax free all or any part of a distribution from a tax-sheltered annuity (TSA) plan to an IRA or another TSA plan. The most you can roll over is the amount that, except for the rollover, would be taxable. The rollover must be completed by the 60th day following the day on which you receive the distribution.

Nonqualifying distributions. Under these rules, you cannot roll over:

1) Minimum distributions (generally required to begin at age 70 ½),
2) Substantially equal payments over your life or life expectancy,
3) Substantially equal payments over the joint lives or life expectancies of you and your beneficiary, or
4) Substantially equal payments for a period of 10 years or more.

Direct rollovers for TSA distributions. You have the option of having your TSA plan make the rollover directly to the IRA or new plan. Before you receive a distribution, your plan will give you information on this. It is generally to your advantage to choose this option because your plan will not withhold tax on the distribution if you choose it.

Withholding. If you ***receive*** a distribution that qualifies to be rolled over, the payer must withhold 20% of it for taxes (even if you plan to roll the distribution over). You can no longer choose to have no withholding unless you elect the direct rollover option.

Distribution received by you. If you receive a distribution that qualifies to be rolled over, you can roll over all or any part of the distribution. Generally, you will receive only 80% of the distribution because 20% must be withheld. If you roll over only the 80% you receive, you must pay tax on the 20% you did not roll over. You can replace the 20% that was withheld with other money within the 60-day period to make a 100% rollover.

Voluntary deductible contributions. For tax years 1982 through 1986, employees could make deductible contributions to a tax-sheltered annuity under the individual retirement arrangement (IRA) rules instead of deducting contributions to an IRA.

If you made voluntary deductible contributions to a tax-sheltered annuity under these IRA rules, the distribution of all or part of the accumulated deductible contributions may be rolled over assuming it otherwise qualifies as a distribution you can roll over. Accumulated deductible contributions are the deductible contributions plus income and gain allocable to the contributions, minus expenses and losses allocable to the contributions, and minus distributions from the contributions, income, or gain.

Excess employer contributions. The portion of a distribution from a TSA transferred to an individual retirement account (IRA) that was previously included in income as excess employer contributions (discussed earlier) is not an eligible rollover distribution.

Its transfer does not affect the rollover treatment of the eligible portion of the transferred amounts. However, the ineligible portion is subject to the IRA contribution limits and may create an excess IRA contribution subject to a 6% excise tax (see chapter 7 of Publication 590, *Individual Retirement Arrangements (IRAs)).*

Qualified Domestic Relations Order. You may be able to roll over tax free all or any part of an eligible rollover distribution from a TSA plan that you receive under a qualified domestic relations order (QDRO). If you receive the interest in the TSA as an employee's spouse or former spouse under a QDRO, all of the rollover rules apply to you as if you were the employee. You can roll over your interest in the plan to an IRA or another TSA plan. For more information on the treatment of an interest received under a QDRO, see Publication 575, *Pension and Annuity Income (Including Simplified General Rule)* .

Spouses of deceased employees. If you are the spouse of a deceased employee, you can roll over the qualifying distribution attributable to the employee. You can make the rollover only to an IRA, not to another TSA or qualified plan.

Second rollover. If you roll over a qualifying distribution to an IRA, you can, if certain conditions are satisfied, later roll the distribution into another TSA. For more information, see *IRA as a holding account* in Publication 590, *Individual Retirement Arrangements (IRAs).*

Frozen deposits. The 60-day period usually allowed for completing a rollover is extended for any time that the amount distributed is a ***frozen deposit*** in a financial institution. The 60-day period cannot end earlier than 10 days after the deposit ceases to be a frozen deposit.

A ***frozen deposit*** is any deposit that on any day during the 60-day period cannot be withdrawn because:

The financial institution is bankrupt or insolvent, or

The state where the institution is located has placed limits on withdrawals because one or more banks in the state are (or are about to be) bankrupt or insolvent.

How To Get More Information

You can get help from IRS in several ways.

Free publications and forms. To order free publications and forms, call 1–800–TAX–FORM (1–800–829–3676). You can also write to the IRS Forms Distribution Center nearest you. Check your income tax package for the address. Your local library or post office also may have the items you need.

For a list of free tax publications, order Publication 910, *Guide to Free Tax Services.* It also contains an index of tax topics and related publications and describes other free tax information services available from IRS, including tax education and assistance programs.

If you have access to a personal computer and modem, you also can get many forms and publications electronically. See *Quick and Easy Access to Tax Help and Forms* in your income tax package for details. If space permitted, this information is at the end of this publication.

Tax questions. You can call the IRS with your tax questions. Check your income tax package or telephone book for the local number, or you can call 1–800–829–1040.

TTY/TDD equipment. If you have access to TTY/TDD equipment, you can call 1–800–829–4059 to ask tax questions or to order forms and publications. See your income tax package for hours of operation.

Worksheets

You can use the following worksheets to figure the annual limits that apply to employer contributions to your tax-sheltered annuity (TSA).

Limits. The contribution limits that generally apply to your TSA are the:

1) Exclusion allowance (Worksheet 1),
2) Limit on employer contributions (Worksheet 2), and
3) Limit on elective deferrals (Worksheet 3).

The smallest of these limits is the maximum amount that can be contributed to your TSA for the year and excluded from your gross income.

To determine the amount of contributions that you can exclude from your gross income, you must complete Worksheet 2 (or Worksheet 4, 5, or 6 if you elect one of the alternative limits covered next).

Alternative limits. You may be able to use an alternative limit instead of the limit in 1) or 2) of the preceding list. The limit in 1) can be replaced with the limit in 2) by electing the *Overall Limit* (Worksheet 6). The limit in 2) can be figured in a different way by electing the *Year of Separation from Service Limit* (Worksheet 4) or the *Any Year Limit* (Worksheet 5). To make any of these elections, you must meet the requirements described under *Catch-up Election — Alternative Limits for Certain Employees,* earlier.

How to use worksheets. Since the smallest of the limits that apply to you is your limit for the year, first determine the amounts of these limits by completing the worksheets for the limits.

Worksheets to complete. You need to complete no more than four worksheets. You must complete Worksheet 1 and Worksheet 2. If elective deferrals were contributed to your TSA, also complete Worksheet 3. If you choose an alternative limit because you can make a catch-up election, complete Worksheet 4, 5, or 6, whichever one applies to the alternative limit you choose. Each worksheet includes steps for figuring the amount of contributions you can exclude from your income and any contributions you must include in income.

Worksheet 1—Computation of Exclusion Allowance

Step 1—Exclusion Allowance

1) Includible compensation	$
2) Percentage limit	20%
3) Years of service	
4) Multiply (1) × (2) × (3)	$
5) Minus: Amounts previously excludable	
6) Exclusion allowance	$

Worksheet 2—Limit on Employer Contributions

Step 1—Limit on Employer Contributions

1) Maximum ($30,000) [See *Limit on Employer Contributions*.]	$
2) 25% of compensation	$
3) Limit on employer contributions [lesser of (1) or (2)]	$

Step 2—Contributions in Excess of Employer Limit

4) Current year contribution by employer (excluding cost of life insurance)*	$
5) Minus: Limit on employer contributions (line 3)	
6) Excess (if any)	$

Step 3 —Amount Excludable from Gross Income

7) a) Employer contribution (line 4)	$
b) Limit on employer contributions (line 3)	$
c) Exclusion allowance (Worksheet 1, line 6)	$
d) Limit on elective deferrals (Worksheet 3, line 16)	$
8) Amount excludable from gross income [least of (a), (b), (c), or (d)]	$

Step 4—Amount Includible in Gross Income

9) Employer contribution (line 4)	$
10) Minus: Amount excludable (line 8)	
11) Amount includible in gross income	$

* The cost of life insurance is includible in gross income.

Worksheet 3—Limit on Elective Deferrals

Step 1—Total Elective Deferrals

1) Contributions to tax-sheltered annuities $________
2) Contributions to cash or deferred arrangements (section 401(k) plans) or section 501(c)(18) plans ________
3) Elective contributions to salary reduction simplified employee pension (SEP) plans ________
4) Total deferrals for year (add lines (1), (2), and (3)) $________

Step 2—Increase in Limit for Long Service

Note: Skip this step if you do not have at least 15 years service with a qualifying organization (see *Increase for 15-year employees* under *Limit on Elective Deferrals*)

5) Number of years service with the qualifying organization ________
6) Multiply $5,000 by the number of years in (5) $________
7) Total elective deferrals for prior years made for you by the qualifying organization ________
8) Subtract line (7) from line (6) $________
9) Enter all increases in the limit for long service (as figured in this Step 2) for prior years $________
10) Subtract line (9) from $15,000 $________
11) Enter the smaller of line (8) or line (10), but not more than $3,000 $________

Step 3—Limit on Elective Deferrals

12) Enter $9,500 plus the amount from line (11) $________
13) Basic allowable amount (enter $9,500 for 1996) ________
14) Subtract line (13) from line (12) $________
15) Enter the smaller of line (1) or line (14) ________
16) Add lines (13) and (15). This is your limit on elective deferrals for the year $________
17) Excess elective deferrals—Subtract line (16) from line (4). Do not enter less than zero. Include this amount in your income for the year the excess deferrals were made (see *Excess Deferrals* under *Limit on Elective Deferrals*) $________

Worksheet 4—Year of Separation from Service Limit Election [1]

Step 1—Limit on Employer Contributions

1) Maximum [See *Limit on Employer Contributions.*] $ 30,000

2) Exclusion allowance (modified)

   a) Includible compensation $ ______

   b) Percentage limit 20%

   c) Years of service (limited to 10 years) ______

   d) Multiply (a)× (b)× (c) $ ______

   e) Minus: Amounts previously excludable during 10 years (including prior year excess contributions) ______

   f) Exclusion allowance (modified) $ ______

3) Limit on employer contributions [lesser of (1) or (2)(f)] $ ______

Step 2—Contributions in Excess of Employer Limit

4) Current year contribution by employer (excluding cost of life insurance) [2] $ ______

5) Minus: Limit on employer contributions (line 3) ______

6) Excess (if any) $ ______

Step 3—Amount Excludable from Gross Income

7) a) Employer contribution (line 4) $ ______

   b) Limit on employer contributions (line 3) $ ______

   c) Exclusion allowance (Worksheet 1, line 6) $ ______

   d) Limit on elective deferrals (Worksheet 3, line 16) $ ______

8) Amount excludable from gross income [least of (a), (b), (c), or (d)] $ ______

Step 4—Amount Includible in Gross Income

9) Employer contribution $ ______

10) Minus: Amount excludable (line 8) ______

11) Amount includible in gross income $ ______

[1] Election applies only to employees of certain organizations. See *Catch-up Election–Alternative Limits for Certain Employees.*
[2] The cost of life insurance is includible in gross income.

Worksheet 5—Any Year Limit Election [1]

Step 1—Limit on Employer Contributions

1) $4,000 plus 25% of includible compensation $ ________

2) Exclusion allowance

a) Includible compensation $ ________

b) Percentage limit ________ 20%

c) Years of service ________

d) (a)× (b)× (c) $ ________

e) Minus: Amounts previously excludable (including prior year excess contributions) ________

f) Exclusion allowance $ ________

3) Maximum ________ $ 15,000

4) Limit on employer contributions [least of (1), (2)(f), or (3)] $ ________

Step 2—Contributions in Excess of Employer Limit

5) Current year contribution by employer (excluding cost of life insurance) [2] $ ________

6) Minus: Limit on employer contributions (line 4) ________

7) Excess (if any) $ ________

Step 3—Amount Excludable from Gross Income

8) a) Employer contribution (line 5) $ ________

b) Limit on employer contributions (line 4) $ ________

c) Exclusion allowance (Worksheet 1, line 6) $ ________

d) Limit on elective deferrals (Worksheet 3, line 16) $ ________

9) Amount excludable from gross income [least of (a), (b), (c), or (d)] $ ________

Step 4—Amount Includible in Gross Income

10) Employer contribution (line 5) $ ________

11) Minus: Amount excludable (line 9) ________

12) Amount includible in gross income $ ________

[1] Election applies only to employees of certain organizations. See *Catch-up Election–Alternative Limits for Certain Employees*.

[2] The cost of life insurance is includible in gross income.

Worksheet 6—Overall Limit Election [1&2]

Step 1—Limit on Employer Contributions

1) Maximum [See *Limit on Employer Contributions*] $ 30,000

2) 25% × compensation [See *Compensation*, earlier, under *Limit on Employer Contributions*.] $______

3) Limit on employer contributions [lesser of (1) or (2)] $______

Step 2—Contributions in Excess of Employer Limitation

4) Current year contribution by employer (excluding cost of life insurance)[3] $______

5) Minus: Limit on employer contributions (line 3) ______

6) Excess (if any) $______

Step 3—Amount Excludable from Gross Income

7) a) Employer contribution (line 4) $______

b) Limit on employer contributions (line 3) $______

c) Limit on elective deferrals, (Worksheet 3, line 16) $______

8) Amount excludable from gross income [least of (a), (b), or (c)] $______

Step 4—Amount Includible in Gross Income

9) Employer contribution (line 4) $______

10) Minus: Amount excludable (line 8) ______

11) Amount includible in gross income $______

[1] Election applies only to employees of certain organizations. See *Catch-up Election–Alternative Limits for Certain Employees*.
[2] Limit on employer contributions is substituted for the exclusion allowance.
[3] The cost of life insurance is includible in gross income.