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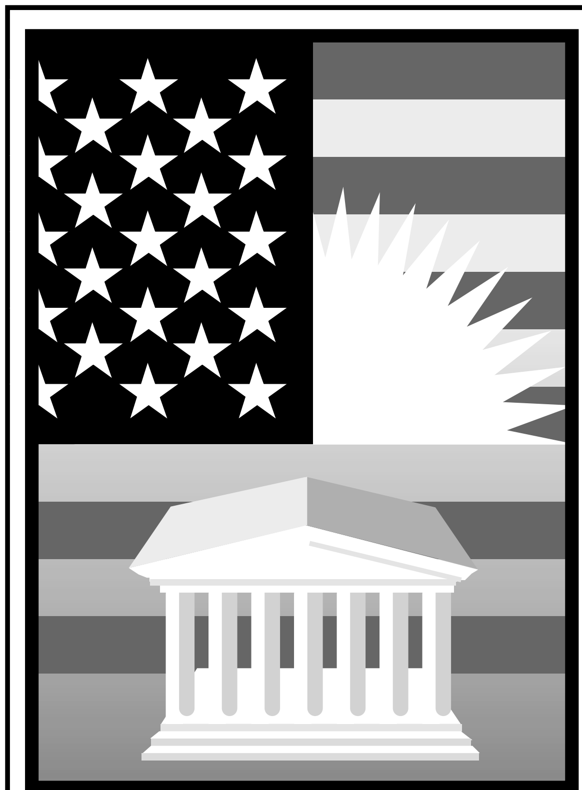
Retirement Plans for Small Business
(SEP, SIMPLE, and Keogh Plans)

For use in preparing

1999 Returns



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See *How To Get More Information* in this publication.

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Important Changes for 1999

Hardship distributions are not eligible rollover distributions. Certain hardship distributions from a 401(k) plan or tax-sheltered annuity plan (section 403(b) plan) that occur after 1998 cannot be rolled over into an IRA or other eligible retirement plan. They are subject to the 10% additional tax on premature distributions. However, they are not subject to the 20% withholding tax that generally applies to eligible rollover distributions that are not transferred directly to another retirement plan or IRA.

The IRS has made application of this new rule optional for 1999. For more information, see Notice 99–5 in Internal Revenue Bulletin No. 1999–3.

Safe harbor 401(k) plans. Beginning in 1999, a 401(k) plan under which participants receive a certain level of matching or nonelective contributions does not have to pass the special nondiscrimination tests that apply to elective deferrals and matching contributions. For more information, see Notice 98–52 in Internal Revenue Bulletin No. 1998–46.

Photographs of missing children. The Internal Revenue Service is a proud partner with the National Center for Missing and Exploited Children. Photographs of missing children selected by the Center may appear in this publication on pages that would otherwise be blank. You can help bring these children home by looking at the photographs and calling **1–800–THE–LOST (1–800–843–5678)** if you recognize a child.

Important Reminders

Repeal of a salary reduction arrangement under a SEP (SARSEP). You may no longer set up a salary reduction simplified employee pension (SARSEP) plan. However, if you have employees who are *participants* (including new participants), defined under *Definitions You Need To Know,* in a SARSEP that was set up before 1997, the employees can continue to have you contribute part of their pay to the plan.

Plan amendments required by changes in the law. If you must revise your qualified plan to conform to recent legislation, you may choose to get a determination letter from the IRS approving the revision. Generally, master and prototype plans are amended by sponsoring organizations. However, there are instances when you may need to request a determination letter regarding a master or prototype plan that is a nonstandardized plan that you maintain. Your request should be made on the appropriate form (generally Form 5300, or Form 5307 for a master or prototype plan). The request should be filed with Form 8717, *User Fee for Employee Plan Determination Letter Request,* and the appropriate user fee.

You may have to amend your plan to comply with tax law changes made by the following laws.

- Uruguay Round Agreements Act, Public Law 103–465.
- Small Business Job Protection Act of 1996, Public Law 104–188.
- Taxpayer Relief Act of 1997, Public Law 105–34.
- Internal Revenue Service Restructuring and Reform Act of 1998, Public Law 105–206.

You need to make these amendments on or before the last day of the first plan year beginning after 1999.

Introduction

This publication discusses retirement plans that you can set up and maintain for yourself and your employees. In this publication, "you" refers to the **employer.** See *Definitions You Need To Know,* later. It covers the following types of retirement plans.

- SEP (Simplified Employee Pension) plans.
- SIMPLE (Savings Incentive Match Plan for Employees) plans.
- Qualified plans (also called H.R. 10 plans or Keogh plans when covering self-employed individuals).

SEP, SIMPLE, and qualified plans offer you and your employees a tax favored way to save for retirement. You can deduct contributions you make to the plan for your employees. If you are a sole proprietor, you can deduct contributions you make to the plan for yourself. You can also deduct trustees' fees if contributions to the plan do not cover them. Earnings on the contributions are generally tax free until you or your employees receive distributions from the plan in later years.

Under some plans, employees can have you contribute limited amounts of their before-tax pay to a plan. These amounts (and earnings on them) are generally tax free until your employees receive distributions from the plan in later years.

What this publication covers. This publication contains the information you need to understand the following topics.

- What type of plan to set up.
- How to set up a plan.
- How much you can contribute to a plan.
- How much of your contribution is deductible.
- How to treat certain distributions.
- How to report information about the plan to the IRS and your employees.

Basic features of retirement plans. Some basic features of SEP, SIMPLE, and qualified plans are discussed below. The key rules for SEP, SIMPLE, and qualified plans are outlined in *Table 1.*

SEP plan. SEPs provide a simplified method for you to make contributions to a retirement plan for your employees. Instead of setting up a profit-sharing or money purchase plan with a trust, you can adopt a SEP agreement and make contributions directly to a traditional individual retirement account or a traditional individual retirement annuity (SEP-IRA) set up for each eligible employee.

SIMPLE plan. A SIMPLE plan can be set up by an employer who had 100 or fewer employees who earned at least $5,000 in compensation for the preceding calendar year and meets certain other requirements. Under a SIMPLE plan, employees can choose to make salary reduction contributions rather than receiving these amounts as part of their regular pay. In addition, you will contribute matching or nonelective contributions. The two types of SIMPLE plans are the SIMPLE IRA plan and the SIMPLE 401(k) plan.

Qualified plan. The qualified plan rules are more complex than the SEP plan and SIMPLE plan rules. However, there are some advantages available to qualified plans, such as the special tax treatment that may apply to qualified plan lump-sum distributions.

What is not covered in this publication. Although the purpose of this publication is to provide general information about retirement plans that an employer (including a sole proprietor) can set up for its employees, this publication does not contain all of the rules and exceptions that apply to these plans. You may also need professional help and guidance.

Also, this publication does not cover all the rules that may be of interest to employees. For example, it does not cover the following topics.

- The comprehensive IRA rules an employee needs to know. These rules are covered in Publication 590, *Individual Retirement Arrangements (IRAs) (Including Roth IRAs and Education IRAs).*
- The comprehensive rules that apply to distributions from retirement plans. These rules are covered in Publication 575, *Pension and Annuity Income.*

Useful Items

You may want to see:

Publications

- ☐ **535** Business Expenses
- ☐ **575** Pension and Annuity Income
- ☐ **590** Individual Retirement Arrangements (IRAs) (Including Roth IRAs and Education IRAs)

Forms (and Instructions)

- ☐ **W–2** Wage and Tax Statement
- ☐ **1099–R** Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc.
- ☐ **5304–SIMPLE** Savings Incentive Match Plan for Employees of Small Employers (SIMPLE) (Not Subject to the Designated Financial Institution Rules)
- ☐ **5305–SEP** Simplified Employee Pension-Individual Retirement Accounts Contribution Agreement
- ☐ **5305A–SEP** Salary Reduction and Other Elective Simplified Employee Pension-Individual Retirement Accounts Contribution Agreement
- ☐ **5305–SIMPLE** Savings Incentive Match Plan for Employees of Small Employers (SIMPLE) (for Use With a Designated Financial Institution)
- ☐ **5329** Additional Taxes Attributable to IRAs, Other Qualified Retirement Plans, Annuities, Modified Endowment Contracts, and MSAs
- ☐ **5330** Return of Excise Taxes Related to Employee Benefit Plans
- ☐ **5500–EZ** Annual Return of One-Participant (Owners and Their Spouses) Retirement Plan

Help from the Internal Revenue Service (IRS). See *How To Get More Information* near the end of this publication for information about getting publications and forms. Additionally, for further information, contact employee plans taxpayer assistance telephone service between the hours of 1:30 p.m. and 3:30 p.m. Eastern Time, Monday through Thursday at **(202) 622–6074/6075.** (These are not toll-free numbers.) Or you can call customer service at **1–877–829–5500** (toll-free) from 8:00 a.m. to 4:30 p.m. Eastern Time, Monday through Friday.

Note: All references to "section" in the following discussions are to sections of the Internal Revenue Code (which can be found at most libraries) unless otherwise indicated.

Table 1. **Key Retirement Plan Rules**

Type of Plan	Last Date for Contribution	Maximum Contribution	Maximum Deduction	When To Set Up Plan
SEP	Due date of employer's return (including extensions).	Smaller of $30,000 or 15%[1] of participant's compensation.[2]	15% of all participants' compensation[2] excluding SEP contributions.	Any time up to due date of employer's return (including extensions).
SIMPLE IRA and SIMPLE 401(k)	**Elective employer contributions:** 30 days following the end of the month with respect to which the contributions are to be made.[3]	**Employee:** Salary reduction contribution, *up* to $6,000.	Same as maximum contribution.	Any time between 1/1 and 10/1 of the calendar year. For a new employer coming into existence after 10/1, as soon as administratively feasible.
	Matching contributions or nonelective contributions: Due date of employer's return (including extensions).	**Employer contribution:** *Either* dollar-for-dollar matching contributions, up to 3% of employee's compensation,[4] *or* fixed nonelective contributions of 2% of compensation.[2]	Same as maximum contribution.	
Qualified	Due date of employer's return (including extensions). **Note:** For a defined benefit plan subject to minimum funding requirements, contributions are due in quarterly installments. See *Minimum Funding Requirements* under *Qualified Plans (Keogh Plans).*	Defined Contribution Plans **Money Purchase:** Smaller of $30,000 or 25%[1] of participant's compensation.[2] **Profit-Sharing:** Smaller of $30,000 or 25%[1] of participant's compensation.[2]	Defined Contribution Plans **Money Purchase:** Same as maximum contribution. **Profit-Sharing:** 15% of all participants' compensation excluding plan contributions.[2]	By the end of the tax year.
		Defined Benefit Plans Amount needed to provide an annual benefit no larger than the smaller of $130,000 or 100% of the participant's average taxable compensation for his or her highest 3 consecutive years.	Defined Benefit Plans Based on actuarial assumptions and computations.	

[1] Net earnings from self-employment must take the contribution into account.
[2] Compensation is generally limited to $160,000.
[3] Does not apply to SIMPLE 401(k) plans. The deadline for qualified plans applies instead.
[4] Under a SIMPLE 401(k) plan, compensation is generally limited to $160,000.

Definitions You Need To Know

Some of the terms used in this publication are defined below. The same term used in another publication may have a slightly different meaning.

Annual additions. Annual additions are the total amounts of all your contributions in a year, employee contributions (not including rollovers), and forfeitures allocated to a participant's account.

Annual benefits. Annual benefits are the benefits to be paid yearly in the form of a straight life annuity (with no extra benefits) under a plan to which employees do not contribute and under which no rollover contributions are made.

Business. A business is an activity in which a profit motive is present and some type of economic activity is involved. Service as a newspaper carrier under age 18 is not a business, but service as a newspaper dealer is. Service as a sharecropper under an owner-tenant arrangement is a business. Service as a public official is not.

Common-law employee. A common-law employee is any individual who, under common law, would have the status of an employee. A leased employee can also be a common-law employee.

A common-law employee is a person who performs services for an employer who has the right to control and direct both the results of the work and the way in which it is done. For example, the employer:

- Provides the employee's tools, materials, and workplace, and
- Can fire the employee.

Common-law employees are not self-employed and cannot set up retirement plans with respect to income from their work, even if that income is self-employment income for social security tax purposes. For example, common-law employees who are ministers, members of religious orders, full-time insurance salespeople, and U.S. citizens employed in the United States by foreign governments cannot set up retirement plans with respect to their earnings from those employments, even though their earnings are treated as self-employment income.

However, a common-law employee can be self-employed as well. For example, an attorney can be a corporate common-law employee during regular working hours and also practice law in the evening as a self-employed person. In another example, a minister employed by a congregation for a salary is a common-law employee even though the salary is treated as self-employment income for social security tax purposes.

However, fees reported on Schedule C (Form 1040) for performing marriages, baptisms, and other personal services are self-employment earnings for qualified plan purposes.

Compensation. Compensation for plan allocations is the pay a participant received from you for personal services for a year. You can generally define compensation as including all the following payments.

1) Wages and salaries.
2) Fees for professional services.
3) Other amounts received (cash or noncash) for personal services actually rendered by an employee, including, but not limited to, the following items.
   a) Commissions and tips.
   b) Fringe benefits.
   c) Bonuses.

For a self-employed individual, compensation means the ***earned income,*** discussed later, of that individual.

Compensation also includes amounts deferred in the following employee benefit plans, unless you choose not to include any amount contributed under a salary reduction agreement (that is not included in the gross income of the employee).

- Qualified cash or deferred arrangement (section 401(k) plan).
- Salary reduction agreement to contribute to a tax-sheltered annuity (section 403(b) plan), a SIMPLE IRA plan, or a SARSEP.
- Section 457 nonqualified deferred compensation plan.
- Section 125 cafeteria plan.

The limit on elective deferrals is discussed later under *Salary Reduction Simplified Employee Pension (SARSEP)* and *Qualified Plans (Keogh Plans).*

Other options. In figuring the compensation of a participant, you can treat ***any*** of the following amounts as the employee's compensation.

- The employee's wages as defined for income tax withholding purposes.
- The employee's wages that you report in box 1 of Form W–2.
- The employee's social security wages (including elective deferrals).

Compensation generally cannot include either of the following items.

- Reimbursements or other expense allowances (unless paid under a nonaccountable plan).
- Deferred compensation (either amounts going in or amounts coming out), other than certain elective deferrals, unless you choose not to include those elective deferrals in compensation.

Contribution. A contribution is an amount you pay into a plan for all those (including self-employed individuals) participating in the plan. Limits apply to how much, under the contribution formula of the plan, can be contributed each year for a participant.

Deduction. A deduction is the amount of plan contributions you can subtract from gross income on your federal income tax return. Limits apply to the amount deductible.

Earned income. Earned income is ***net earnings from self-employment,*** discussed later, from a business in which your services materially helped to produce the income.

You can also have earned income from property that your personal efforts helped create, such as books or inventions on which you earn royalties. Earned income includes net earnings from selling or otherwise disposing of the property, but it does not include capital gains. It includes income from licensing the use of property other than goodwill.

If you have more than one business, but only one has a retirement plan, only the earned income from that business is considered for that plan.

Employer. An employer is generally any person for whom an individual performs or did perform any service, of whatever nature, as an employee. A sole proprietor is treated as his or her own employer for retirement plan purposes, and a partnership is the employer of each partner. A partner is not an employer for retirement plan purposes.

Highly compensated employees. Highly compensated employees are individuals who:

- Owned more than 5% of the capital or profits in your business at any time during the year or the preceding year, or
- For the preceding year, received compensation from you of more than $80,000 and, if you so choose, was in the top 20% of employees when ranked by compensation.

Leased employee. A leased employee who is not your common-law employee must generally be treated as your employee for retirement plan purposes if he or she does all the following.

- Provides services to you under an agreement between you and a leasing organization.
- Has performed services for you (or for you and related persons) substantially full time for at least 1 year.
- Performs services under your primary direction or control.

Exception. A leased employee is not treated as your employee if the employee is covered by the leasing organization under its qualified pension plan and leased employees are not more than 20% of your nonhighly compensated work force. The leasing organization's plan must be a money purchase pension plan that has all the following provisions.

- Immediate participation.
- Full and immediate vesting.
- A nonintegrated employer contribution rate of at least 10% of compensation for each participant.

However, if the leased employee is your common-law employee, that employee will be your employee for all purposes, regardless of any pension plan of the leasing organization.

Net earnings from self-employment. For SEP and qualified plans, net earnings from self-employment is your gross income from your trade or business (provided your personal services are a material income-producing factor) minus allowable deductions for your business. Allowable deductions include contributions to SEP and qualified plans for common-law employees and the deduction allowed for one-half of your self-employment tax.

Net earnings from self-employment do not include items that are excluded from gross income (or their related deductions) other than foreign earned income and foreign housing cost amounts.

For the deduction limits, earned income is net earnings for personal services actually rendered to the business. You take into account the income tax deduction for one-half of self-employment tax and the deduction for contributions to the plan made on your behalf when figuring net earnings.

Net earnings include a partner's distributive share of partnership income or loss (other than separately stated items, such as capital gains and losses). It does not include income passed through to shareholders of S corporations. ***Guaranteed payments to limited partners*** are net earnings from self-employment if they are paid for services to or for the partnership. Distributions of other income or loss to limited partners are not net earnings from self-employment.

For SIMPLE plans, net earnings from self-employment is the amount on line 4 of Short Schedule SE (Form 1040) before subtracting any contributions made to the SIMPLE IRA plan for yourself.

Participant. A participant is an *eligible employee* who is covered by your retirement plan. See the discussions of the different types or plans for the definition of an employee eligible to participate in the plan.

Partner. A partner is an individual who shares ownership of an unincorporated trade or business with one or more persons. For retirement plans, a partner is treated as an employee of the partnership.

Self-employed individual. An individual in business for himself or herself is self-employed. Sole proprietors and partners are self-employed. Self-employment can include part-time work.

Not everyone who has net earnings from self-employment for social security tax purposes is self-employed for qualified plan purposes. See *Common-law employee,* earlier. Also see *Net earnings from self-employment.*

In addition, certain fishermen may be considered self-employed for setting up a qualified plan. See Publication 595, *Tax Highlights for Commercial Fishermen,* for the special rules that are used to determine whether fishermen are self-employed.

Sole proprietor. A sole proprietor is an individual who owns an unincorporated business by himself or herself. For retirement plans, a sole proprietor is treated as both an employer and an employee.

Simplified Employee Pension (SEP)

A simplified employee pension (SEP) is a written plan that allows you to make contributions toward your own (if you are self-employed) and your employees' retirement without getting involved in the more complex qualified plan. But, some advantages available to qualified plans, such as the special tax treatment that may apply to qualified plan lump-sum distributions, do not apply to SEPs.

Under a SEP, you make the contributions to a traditional individual retirement arrangement (called a SEP-IRA) set up by or for each eligible employee. SEP-IRAs are owned and controlled by the employee, and you make contributions to the financial institution where the SEP-IRA is maintained.

SEP-IRAs are set up for, at a minimum, each eligible employee (defined later). A SEP-IRA may have to be set up for a *leased employee* (defined earlier under *Definitions You Need To Know*), but does not need to be set up for *excludable employees* (defined later).

Eligible employee. An eligible employee is an individual who has:

- Reached age 21,
- Worked for you in at least 3 of the last 5 years, and
- Received at least $400 in compensation from you for 1999.

You can use less restrictive participation requirements than those listed, but not more restrictive ones.

Excludable employees. The following employees can be excluded from coverage under a SEP.

- Employees who are covered by a union agreement and whose retirement benefits were bargained for in good faith by their union and you.
- Nonresident alien employees who have no U.S.-source wages, salaries, or other personal services compensation from you. For more information about nonresident aliens, see Publication 519, *U.S. Tax Guide for Aliens.*

Setting Up a SEP

There are three basic steps in setting up a SEP.

1) You must execute a formal written agreement to provide benefits to all eligible employees.
2) You must give each eligible employee certain information about the SEP.
3) A SEP-IRA must be set up by or for each eligible employee.

Many financial institutions will help you set up a SEP.

Formal written agreement. You must execute a formal written agreement to provide benefits to all eligible employees under a SEP. You can satisfy the written agreement requirement by adopting an IRS model SEP using **Form 5305–SEP.** However, see *When not to use Form 5305–SEP,* later.

If you adopt an IRS model SEP using Form 5305–SEP, no prior IRS approval or determination letter is required. Keep the original form. Do not file it with the IRS. Also, using Form 5305–SEP will usually relieve you from filing annual retirement plan information returns with the IRS and the Department of Labor. See the Form 5305–SEP instructions for details.

When not to use Form 5305–SEP. You cannot use Form 5305–SEP if any of the following apply.

- You currently maintain any other qualified retirement plan. This does not prevent you from maintaining another SEP.
- You have maintained a defined benefit plan (defined later under *Qualified Plans (Keogh Plans)*), even if it is now terminated.
- You have any eligible employees for whom IRAs have not been set up.
- You use the services of *leased employees* (as described earlier under *Definitions You Need to Know*).
- You are a member of an affiliated service group (as described in section 414(m)), a controlled group of corporations (as described in section 414(b)), or trades or businesses under common control (as described in section 414(c)), unless all eligible employees of all the members of these groups, trades, or businesses participate under the SEP.
- You do not pay the cost of the SEP contributions.

Information you must give to employees. You must give each eligible employee a copy of Form 5305–SEP, its instructions, and the other information listed in the Form 5305–SEP instructions. An IRS model SEP is not considered adopted until you give each employee this information.

Setting up the employee's SEP-IRA. A SEP-IRA must be set up by or for each eligible employee. SEP-IRAs can be set up with banks, insurance companies, or other qualified financial institutions. You send SEP contributions to the financial institution where the SEP-IRA is maintained.

Deadline for setting up a SEP. You can set up a SEP for a year as late as the due date (including extensions) of your income tax return for that year.

How Much Can I Contribute?

The SEP rules permit you to contribute a limited amount of money each year to each employee's SEP-IRA. If you are self-employed, you can contribute to your own SEP-IRA. Contributions must be in the form of money (cash, check, or money order). You cannot contribute property. However, participants may be able to transfer or roll over certain property from one retirement plan to another. See Publication 590 for more information about rollovers.

You do not have to make contributions every year. But if you make contributions, they must be based on a written allocation formula and must not discriminate in favor of highly compensated employees (defined earlier under *Definitions You Need To Know*). When you contribute, you must contribute to the SEP-IRAs of all participants who actually performed personal services during the year for which the contributions are made, even employees who die or terminate employment before the contributions are made.

The contributions you make under a SEP are treated as if made to a qualified pension, stock bonus, profit-sharing, or annuity plan. Consequently, contributions are deductible within limits, as discussed later, and generally are not taxable to the plan participants.

A SEP-IRA cannot be designated as a Roth IRA. Employer contributions to a SEP-IRA will not affect the amount that an individual can contribute to a Roth IRA.

Time limit for making contributions. To deduct contributions for a year, you must make the contributions by the due date (including extensions) of your tax return for the year.

Contribution Limits

Contributions you make for a year to a common-law employee's SEP-IRA cannot be more than the smaller of 15% of the employee's compensation or $30,000. Compensation generally does not include your contributions to the SEP. However, if you have a salary reduction arrangement, see *Employee compensation* under *Salary Reduction Simplified Employee Pension (SARSEP),* later.

Example. Your employee, Mary Plant, earned $21,000 for the year. The maximum contribution you can make to her SEP-IRA is $3,150 (15% x $21,000).

Contributions for yourself. The annual limits on your contributions to a common-law employee's SEP-IRA also apply to contributions you make to your own SEP-IRA. However, special rules apply when figuring your maximum deductible contribution. See *Deduction Limit for Self-Employed Individuals,* later.

Annual compensation limit. You cannot consider the part of an employee's compensation that is over $160,000 when figuring your contribution limit for that employee. Therefore, $24,000 is the maximum contribution amount for an eligible employee whose compensation is $160,000 or more.

More than one plan. If you contribute to a defined contribution plan (defined later under *Qualified Plans (Keogh Plans)*), annual additions to an account are limited to the lesser of $30,000 or 25% of the participant's compensation. When you figure this limit, you must add your contributions to all defined contribution plans. Because a SEP is considered a defined contribution plan for this limit, your contributions to a SEP must be added to your contributions to other defined contribution plans.

Tax treatment of excess contributions. Excess contributions are your contributions to an employee's SEP-IRA (or to your own SEP-IRA) for a year that are more than the lesser of the following amounts.

- 15% of the employee's compensation (or, for you, 13.0435% of your net earnings from self-employment).

- $30,000.

Excess contributions are included in the employee's income for the year and are treated as contributions by the employee to his or her SEP-IRA. For more information on employee tax treatment of excess contributions, see chapter 4 in Publication 590.

Reporting on Form W–2. Do not include SEP contributions on your employee's Form W–2, *Wage and Tax Statement,* unless contributions were made under a salary reduction arrangement (discussed later).

How Much Can I Deduct?

Generally, you can deduct the contributions you make each year to each employee's SEP-IRA. If you are self-employed, you can deduct the contributions you make each year to your own SEP-IRA.

Deduction Limit for Your Contributions on Behalf of Employees

The most you can deduct for your contributions for participants is ***the lesser of*** the following amounts.

- Your contributions (including any elective deferrals and excess contributions carryover).
- 15% of the compensation (limited to $160,000 per participant) paid to them during the year from the business that has the plan.

Deduction Limit for Self-Employed Individuals

If you contribute to your own SEP-IRA, you need to make a special computation to figure your maximum deduction for these contributions. When figuring the deduction for contributions made to your own SEP-IRA, compensation is your net earnings from self-employment (defined under *Definitions You Need To Know*), which takes into account both the following deductions.

- The deduction for one-half of your self-employment tax.
- The deduction for contributions to your own SEP-IRA.

The deduction for contributions to your own SEP-IRA and your net earnings depend on each other. For this reason, you determine the deduction for contributions to your own SEP-IRA indirectly by reducing the contribution rate called for in your plan. To do this, use the *Rate Table for Self-Employed* or the *Rate Worksheet for Self-Employed,* whichever is appropriate for your plan's contribution rate, in the *Appendix.* Then figure your maximum deduction by using the *Deduction Worksheet for Self-Employed* in the *Appendix.*

Deduction Limits for Multiple Plans

For the deduction limits, treat all of your qualified defined contribution plans as a single plan and all of your qualified defined benefit plans as a single plan. See *Kinds of Plans,* later under *Qualified Plans (Keogh Plans)* for the definitions of defined contribution plans and defined benefit plans. If you have both kinds of plans, a SEP is treated as a separate profit-sharing (defined contribution) plan. A *qualified plan* is a plan that meets the requirements discussed later under *Qualification Rules.* For information about the special deduction limits, see *Deduction limit for multiple plans* under *Qualified Plans (Keogh Plans),* later.

SEP and profit-sharing plans. If you also contribute to a qualified profit-sharing plan, you must reduce the 15% deduction limit for that profit-sharing plan by the allowable deduction for contributions to the SEP-IRAs of those participating in both the SEP plan and the profit-sharing plan.

Carryover of Excess SEP Contributions

If you made SEP contributions in excess of the deduction limit (nondeductible contributions), you can carry over and deduct the excess in later years. However, the excess contributions carryover, when combined with the contribution for the later year, cannot be more than the deduction limit for that year. If you also contributed to a defined benefit plan or defined contribution plan, see *Carryover of Excess Contributions,* under *Qualified Plans (Keogh Plans),* later, for the carryover limit.

Excise tax. If you made nondeductible (excess) contributions to a SEP, you may be subject to a 10% excise tax. For information about the excise tax, see *Excise Tax for Nondeductible (Excess) Contributions* under *Qualified Plans (Keogh Plans),* later.

When To Deduct Contributions

When you can deduct contributions made for a year depends on the tax year on which the SEP is maintained.

- If the SEP is maintained on a calendar year basis, you deduct contributions made for a year on your tax return for the year with or within which the calendar year ends.
- If you file your tax return and maintain the SEP using a fiscal year or short tax year, you deduct contributions made for a year on your tax return for that year.

Where To Deduct Contributions

Deduct contributions for yourself on line 29 of Form 1040. You deduct contributions for your employees on Schedule C (Form 1040), on Schedule F (Form 1040), on Form 1120S, or on Form 1065, whichever applies to you.

If you are a partner, the partnership passes its deduction to you for the contributions it made for you. The partnership will report these contributions on Schedule K–1 (Form 1065). You deduct the contributions on line 29 of Form 1040.

Salary Reduction Simplified Employee Pension (SARSEP)

A SARSEP is a SEP set up ***before 1997*** that includes a salary reduction arrangement. (See the *Caution,* next). Under a SARSEP, your employees can choose to have you contribute part of their pay to their SEP-IRAs. The income tax on the part contributed is deferred. This choice is called an *elective deferral,* which remains tax free until distributed (withdrawn).

*You are **not** allowed to set up a SARSEP **after 1996.** However, participants (including employees hired after 1996) in a SARSEP that was set up before 1997 can continue to have you contribute part of their pay to the plan. If you are interested in setting up a retirement plan that includes a salary reduction arrangement, see* SIMPLE Plans, *later.*

Who can have a SARSEP? A SARSEP that was set up before 1997 is available to you and your eligible employees only if all the following requirements are met.

- At least 50% of your employees eligible to participate choose the salary reduction arrangement.
- You have 25 or fewer employees who were eligible to participate in the SEP (or would have been eligible to participate if you had maintained a SEP) at any time during the preceding year.
- The SEP meets the ***SARSEP ADP test.***

SARSEP ADP test. Under the ADP test, the amount deferred each year by each eligible highly compensated employee as a percentage of pay (the deferral percentage) cannot be more than 125% of the average deferral percentage (ADP) of all other employees eligible to participate. A highly compensated employee is defined earlier under *Definitions You Need To Know.*

Deferral percentage. The deferral percentage for an employee for a year is figured as follows.

$$\frac{\text{The amount of elective employer contributions paid to the SEP for the employee for the year}}{\text{The employee's compensation (limited to \$160,000)}}$$

Who cannot have a SARSEP? A state or local government or any of its political subdivisions, agencies, or instrumentalities, or a tax-exempt organization cannot have a SEP that includes a salary reduction arrangement.

Limits on Elective Deferrals

The most a participant can choose to defer for calendar year 1999 is the lesser of the following amounts.

- 15% of the participant's compensation (limited to $160,000 of the participant's compensation).
- $10,000.

The $10,000 limit applies to the ***total*** elective deferrals the employee makes for the year to a SEP and any of the following.

- Cash or deferred arrangement (section 401(k) plan).
- Salary reduction arrangement under a tax-sheltered annuity plan (section 403(b) plan).
- SIMPLE IRA plan.

Overall limit on SEP contributions. If you also make nonelective contributions to a SEP-IRA, the total of the nonelective and elective contributions to that SEP-IRA cannot be more than the lesser of $30,000 or 15% of the employee's compensation. The same rule applies to contributions you make to your own SEP-IRA. See *Contribution Limits,* earlier.

Employee compensation. For figuring the elective deferral amount, compensation is generally the amount you pay to the employee for the year. Compensation includes the elective deferral amount and other amounts deferred in certain employee benefit plans. See *Compensation,* earlier under *Definitions You Need To Know.* These amounts are included in figuring your employees' total contributions even though they are not included in the income of your employees for income tax purposes.

*You can choose **not** to treat the deferral amount as compensation, as discussed later.*

To figure the deferral amount, multiply the employee's compensation by the deferral contribution rate. However, you must always use the reduced rate method to determine the maximum deductible contribution (13.0435% of unreduced compensation). This is the same method you use to figure your deduction for contributions you make to your own SEP-IRA.

Example 1. Jim's SARSEP calls for a deferral contribution rate of 10% of his salary. Jim's salary for the year is $30,000 (before reduction for the deferral). You multiply Jim's salary by 10% to get his deferral amount of $3,000. Your maximum deduction for elective deferrals and any nonelective contributions would be $3,913.05 ($30,000 × .130435).

On Jim's Form W–2, you show his total wages as $27,000 ($30,000 – $3,000). Social security wages and Medicare wages will each be $30,000. Jim will report $27,000 as wages on his individual income tax return.

Choice not to treat deferrals as compensation. You can choose not to treat elective deferrals (and other amounts deferred in certain employee benefit plans) for a year as compensation under your SARSEP. You may use this method for calculating deferral percentages for the SARSEP ADP test defined earlier.

The deferral amount and the compensation (minus the deferral) depend on each other. For this reason, you figure the deferral amount indirectly by reducing the contribution rate for deferrals called for under the salary reduction arrangement. This method is the same one that you use to figure your deduction for contributions you make to your own SEP-IRA. You must also use the reduced rate method to determine the maximum deductible contribution (13.0435% of unreduced compensation).

To figure the deferral amount, use either the rate table or rate worksheet in the *Appendix.* Use the rate table if the deferral contribution rate called for under the SARSEP is a whole number. Otherwise, use the rate worksheet. When using the rate table, first locate the deferral contribution rate in *Column A.* Then read across to find the reduced rate in *Column B.* Multiply the reduced rate by your employee's compensation to get the deferral amount.

Example 2. The facts are the same as in Example 1 except that you chose not to treat deferrals as compensation under the arrangement. To figure the deferral amount, you multiply Jim's salary of $30,000 by 0.090909 (the reduced rate equivalent of 10%) to get the deferral amount of $2,727.27. Your maximum deduction for elective deferrals and any nonelective contributions would be $3,913.05 ($30,000 × .130435).

On Jim's Form W–2, you show his total wages as $27,272.73 ($30,000 minus $2,727.27). Social security wages and Medicare wages will each be $30,000. Jim will report $27,272.73 as wages on his individual income tax return.

Alternative definitions of compensation. In addition to the general definition of compensation under *Definitions You Need To Know* and the choice described in the preceding paragraphs, you can use any definition of compensation that meets all the following conditions.

- It is reasonable.
- It is not designed to favor highly compensated employees.
- It provides that the average percentage of total compensation used for highly compensated employees as a group for the year is not more than minimally higher than the average percentage of total compensation used for all other employees as a group.

Compensation of self-employed individuals. If you are self-employed, compensation is your net earnings from self-employment as defined earlier under *Definitions You Need To Know.*

To figure the deferral amount, you must use a reduced rate instead of the deferral contribution rate called for under the SARSEP. Use either the rate table or rate worksheet in the *Appendix* to get the reduced rate. Then use the deduction worksheet to figure the deferral amount.

Compensation does not include tax-free items (or deductions related to them) other than foreign earned income and housing cost amounts.

Compensation of disabled participants. You may be able to choose to use special rules to determine compensation for a participant who is permanently and totally disabled. Under these rules, compensation means the compensation the participant would have received if paid at the rate paid immediately before becoming permanently and totally disabled. See Internal Revenue Code section 415(c)(3)(C) for details.

Tax treatment of deferrals. You can deduct your deferrals that, when added to your other SEP contributions, are not more than the limits under *How Much Can I Deduct?,* earlier.

Elective deferrals that are not more than the limit discussed earlier are excluded from your employees' wages subject to federal income tax in the year of deferral. However, these deferrals are included in wages for social security, Medicare, and federal unemployment (FUTA) tax.

Excess deferrals. For 1999, excess deferrals are the elective deferrals for the year that are more than the $10,000 limit discussed earlier. The treatment of excess deferrals made under a SARSEP is similar to the treatment of excess deferrals made under a qualified plan. See *Treatment of Excess Deferrals* under *Qualified Plans (Keogh Plans),* later.

Excess SEP contributions. Excess SEP contributions are elective deferrals of highly compensated employees that are more than the amount permitted under the SARSEP ADP test. You must notify your highly compensated employees within 2½ months after the end of the plan year of their excess SEP contributions. If you do not notify them within this time period, you must pay a 10% tax on the excess. For an explanation of the notification requirements, see Revenue Procedure 91–44 in Cumulative Bulletin 1991–2. If you adopted a SARSEP using Form 5305A–SEP, the notification requirements are explained in the instructions for that form.

Reporting on Form W–2. Do not include elective deferrals in the "Wages, tips, other compensation" box of Form W–2. You must, however, include them in the "Social security wages" and "Medicare wages and tips" boxes. You must also include them in box 13. Mark the "Deferred compensation" checkbox in box 15. For more information, see the Form W–2 instructions.

Distributions (Withdrawals)

As an employer, you cannot prohibit distributions from a SEP-IRA. Also, you cannot make your contributions on the condition that any part of them must be kept in the account.

Distributions are subject to IRA rules. For information about IRA rules, including the tax treatment of distributions, rollovers, required distributions, and income tax withholding, see Publication 590.

Additional Taxes

The tax advantages of using SEP-IRAs for retirement savings can be offset by additional taxes. There are additional taxes for all the following actions.

- Making excess contributions.
- Making early withdrawals.
- Not making required withdrawals.

For information about these taxes, see chapter 1 in Publication 590. Also, a SEP-IRA may be disqualified, or an excise tax may apply, if the account is involved in a prohibited transaction, discussed next.

Prohibited transaction. If an employee improperly uses his or her SEP-IRA, such as by borrowing money from it, the employee has engaged in a prohibited transaction. In that case, the SEP-IRA will no longer qualify as an IRA. For a list of prohibited transactions, see *Prohibited Transactions* under *Qualified Plans (Keogh Plans),* later.

Effect on employee. If a SEP-IRA is disqualified because of a prohibited transaction, the assets in the account will be treated as having been distributed to the employee of that SEP-IRA on the first day of the year in which the transaction occurred. The employee must include in income the assets' fair market value (on the first day of the year) that is more than any cost basis in the account. Also, the employee may have to pay the additional tax for making early withdrawals. For more information, see *Tax on*

Prohibited Transactions under *Qualified Plans (Keogh Plans),* later.

Reporting and Disclosure Requirements

If you set up a SEP using Form 5305–SEP or Form 5305A–SEP (see the *Caution* later), you must give your eligible employees certain information about the SEP at the time you set it up. See *Setting Up a SEP,* earlier. Also, you must give your eligible employees a statement each year showing any contributions to their SEP-IRAs. If you set up a salary reduction SEP, you must also give them notice of any excess contributions. For details about other information you must give them, see the instructions for either of these forms.

Even if you did ***not*** use Form 5305–SEP or Form 5305A–SEP to set up your SEP, you must give your employees information similar to that described above. For more information, see the instructions for either Form 5305–SEP or Form 5305A–SEP.

Form 5305A–SEP is used to set up a SEP that includes a salary reduction arrangement. SEPs that include a salary reduction arrangement ***cannot*** *be set up after 1996. However, eligible employees hired after 1996 can have you contribute part of their pay to a SARSEP set up before 1997. See* Salary Reduction Simplified Employee Pension (SARSEP), *earlier.*

SIMPLE Plans

A Savings Incentive Match Plan for Employees (SIMPLE plan) is a written arrangement that provides you and your employees with a simplified way to make contributions to provide retirement income. Under a SIMPLE plan, employees can choose to make salary reduction contributions to the plan rather than receiving these amounts as part of their regular pay. In addition, you will contribute matching or nonelective contributions.

SIMPLE plans can only be maintained on a calendar-year basis.

A SIMPLE plan can be set up in either of the following ways:

- Using SIMPLE IRAs (SIMPLE IRA plan).
- As part of a 401(k) plan (SIMPLE 401(k) plan).

Many financial institutions will help you set up a SIMPLE plan.

SIMPLE IRA Plan

A SIMPLE IRA plan is a retirement plan that uses SIMPLE IRAs for each eligible employee. Under a SIMPLE IRA plan, a SIMPLE IRA must be set up for each eligible employee. For the definition of an eligible employee, see *Who Can Participate in a SIMPLE IRA Plan?,* later.

Who Can Set Up a SIMPLE IRA Plan?

You can set up a SIMPLE IRA plan if you meet both of the following requirements.

- You meet the employee limit.
- You do not maintain another qualified plan unless the other plan is for collective bargaining employees.

Employee limit. You can set up a SIMPLE IRA plan only if you had 100 or fewer employees who earned $5,000 or more in compensation during the preceding year. Under this rule, you must take into account ***all*** employees employed at any time during the calendar year regardless of whether they are eligible to participate. Employees include self-employed individuals who received earned income and leased employees (defined earlier under *Definitions You Need To Know*).

Once you set up a SIMPLE IRA plan, you must continue to meet the 100-employee limit each year that you maintain the plan.

Grace period for employers who cease to meet the 100-employee limit. If you maintain the SIMPLE IRA plan for at least one year and you cease to meet the 100-employee limit in a later year, you will be treated as meeting it for the 2 calendar years immediately following the calendar year for which you last met it.

A different rule applies if you do not meet the 100-employee limit because of an acquisition, disposition, or similar transaction. Under this rule, the SIMPLE IRA plan will be treated as meeting the 100-employee limit for the year of the transaction and the 2 following years if both the following conditions are satisfied.

- Coverage under the plan has not significantly changed during the grace period.
- The SIMPLE IRA plan would have continued to qualify after the transaction if you had remained a separate employer.

The grace period for acquisitions, dispositions, and similar transactions also applies if, because of these types of transactions, you do not meet the rules explained under Other qualified plan *or* Who Can Participate in a SIMPLE IRA Plan?, *below.*

Other qualified plan. The SIMPLE IRA plan generally must be the only retirement plan to which you make contributions, or benefits accrue, for service in any year beginning with the year the SIMPLE IRA plan becomes effective.

Exception. If you maintain a qualified plan for collective bargaining employees, you are permitted to maintain a SIMPLE IRA plan for other employees.

Who Can Participate in a SIMPLE IRA Plan?

Eligible employee. Any employee who received at least $5,000 in compensation during any 2 years preceding the current calendar year and is reasonably expected to earn at least $5,000 during the current calendar year is eligible to participate. The term "employee" includes a self-employed individual who received earned income.

You can use less restrictive eligibility requirements (but not more restrictive ones) by eliminating or reducing the prior year compensation requirements, the current year compensation requirements, or both. For example, you can allow participation for employees who received at least $3,000 in compensation during any preceding calendar year. However, you cannot impose any other conditions on participating in a SIMPLE IRA plan.

Excludable employees. The following employees do not need to be covered under a SIMPLE IRA plan.

- Employees who are covered by a union agreement and whose retirement benefits were bargained for in good faith by their union and you.
- Nonresident alien employees who have no U.S.-source wages, salaries, or other personal services compensation from you.

Compensation. Compensation for employees is the total amount of wages required to be reported on Form W–2, including elective deferrals (deferred amounts elected under any 401(k) plans, 403(b) plans, government (section 457(b)) plans, SEP plans, and SIMPLE IRA plans). If you are self-employed, compensation is your net earnings from self-employment (line 4 of Short Schedule SE (Form 1040)) before subtracting any contributions made to the SIMPLE IRA plan for yourself.

How To Set Up a SIMPLE IRA Plan

You can use **Form 5304–SIMPLE** or **Form 5305–SIMPLE** to set up a SIMPLE IRA plan. Each form is a model savings incentive match plan for employees (SIMPLE) plan document. Which form you use depends on whether you select a financial institution or your employees select the institution that will receive the contributions.

Use Form 5304–SIMPLE if you allow each plan participant to select the financial institution for receiving his or her SIMPLE IRA plan contributions. Use Form 5305–SIMPLE if you require that all contributions under the SIMPLE IRA plan be deposited initially at a designated financial institution.

The SIMPLE IRA plan is adopted when you have completed all appropriate boxes and blanks on the form and you have signed it. Keep the original form. Do not file it with the IRS.

Other uses of the forms. If you set up a SIMPLE IRA plan using Form 5304–SIMPLE or Form 5305–SIMPLE, you can use the form to satisfy other requirements, including the following.

- Meeting employer notification requirements for the SIMPLE IRA plan. Page 3 of Form 5304–SIMPLE and Page 3 of Form 5305–SIMPLE contain a *Model Notification to Eligible Employees* that provides the necessary information to the employee.
- Maintaining the SIMPLE IRA plan records and proving you set up a SIMPLE IRA plan for employees.

Deadline for setting up a SIMPLE IRA plan. You can set up a SIMPLE IRA plan effective on any date between January 1 and October 1 of a year, provided that you did not previously maintain a SIMPLE IRA plan. If you previously maintained a SIMPLE IRA plan, you can set up a SIMPLE IRA plan effective only on January 1 of a year. This requirement does not apply if you are a new employer that comes into existence after October 1 of the year the SIMPLE IRA plan is set up and you

set up a SIMPLE IRA plan as soon as administratively feasible after you come into existence. A SIMPLE IRA plan cannot have an effective date that is before the date you actually adopt the plan.

Setting up a SIMPLE IRA. SIMPLE IRAs are the individual retirement accounts or annuities into which the contributions are deposited. A SIMPLE IRA must be set up for each eligible employee. **Forms 5305–S and 5305–SA** are model trust and custodial account documents that the participant and the trustee (or custodian) can use for this purpose.

A SIMPLE IRA *cannot* be designated as a Roth IRA. Contributions to a SIMPLE IRA will not affect the amount that an individual can contribute to a Roth IRA.

Deadline for setting up a SIMPLE IRA. A SIMPLE IRA must be set up for an employee before the first date by which a contribution is required to be deposited into the employee's IRA.

Notification Requirements

If you adopt a SIMPLE IRA plan, you must give each employee the following information before the beginning of the election period.

1) The employee's opportunity to make or change a salary reduction choice under a SIMPLE IRA plan.
2) Your choice to make either reduced matching contributions or nonelective contributions (discussed later).
3) A summary description and the location of the plan. The financial institution should provide you with this information.
4) Written notice that his or her balance can be transferred without cost or penalty if you use a designated financial institution.

Election period. The election period is generally the 60-day period immediately preceding January 1 of a calendar year (November 2 to December 31 of the preceding calendar year). However, the dates of this period are modified if you set up a SIMPLE IRA plan in mid-year (for example, on July 1) or if the 60-day period falls before the first day an employee becomes eligible to participate in the SIMPLE IRA plan.

A SIMPLE IRA plan can provide longer periods for permitting employees to enter into salary reduction agreements or to modify prior agreements. For example, a SIMPLE IRA plan can provide a 90-day election period instead of the 60-day period. Similarly, in addition to the 60-day period, a SIMPLE IRA plan can provide quarterly election periods during the 30 days before each calendar quarter, other than the first quarter of each year.

Contribution Limits

Contributions are made up of salary reduction contributions and employer contributions. You, as the employer, must make either matching contributions or nonelective contributions, defined later. No other contributions can be made to the SIMPLE IRA plan. These contributions, which you can deduct, must be made timely. See *Time limits for contributing funds,* later.

Salary reduction contributions. The amount the employee chooses to have you contribute to a SIMPLE IRA on his or her behalf cannot be more than $6,000 for 1999. These contributions must be expressed as a percentage of the employee's compensation unless you permit the employee to express them as a specific dollar amount. You cannot place restrictions on the contribution amount (such as limiting the contribution percentage), except to comply with the $6,000 limit.

If an employee is a participant in any other employer plan during the year and has elective salary reductions or deferred compensation under those plans, the salary reduction contributions under a SIMPLE IRA plan also are an elective deferral that counts toward the overall $10,000 annual limit on exclusion of salary reductions and other elective deferrals.

If the other plan is a deferred compensation plan of a state or local government or a tax-exempt organization, the limit on elective deferrals is $8,000.

Employer matching contributions. You are generally required to match each employee's salary reduction contributions on a dollar-for-dollar basis up to 3% of the employee's compensation. This requirement does not apply if you make nonelective contributions as discussed later.

Example. In 1999, your employee, John Rose, earned $25,000 and chose to defer 5% of his salary. You make a 3% matching contribution. The total contribution you can make for John is $2,000, figured as follows.

Salary reduction contributions ($25,000 × .05)	$1,250
Employer matching contribution ($25,000 × .03)	750
Total contributions	**$2,000**

Lower percentage. If you choose a matching contribution less than 3%, the percentage must be at least 1%. You must notify the employees of the lower match within a reasonable period of time before the 60-day election period (discussed earlier) for the calendar year. You cannot choose a percentage less than 3% for more than 2 years during the 5-year period that ends with (and includes) the year for which the election is effective.

Nonelective contributions. Instead of matching contributions, you can choose to make nonelective contributions of 2% of compensation on behalf of each eligible employee who has at least $5,000 of compensation from you for the year. Only $160,000 of the employee's compensation can be taken into account to figure the contribution limit.

If you choose this 2% contribution formula, you must notify the employees within a reasonable period of time before the 60-day election period (discussed earlier) for the calendar year.

Example 1. In 1999, your employee, Jane Wood, earned $36,000 and chose to have you contribute 10% of her salary. You make a 2% nonelective contribution. The total contributions you can make for her are $4,320, figured as follows.

Salary reduction contributions ($36,000 × .10)	$3,600
2% nonelective contributions ($36,000 × .02)	720
Total contributions	**$4,320**

Example 2. Using the same facts as in Example 1, above, the maximum contribution you can make for Jane if she earned $75,000 is $7,500, figured as follows.

Salary reduction contributions (maximum amount)	$6,000
2% nonelective contributions ($75,000 × .02)	1,500
Total contributions	**$7,500**

Time limits for contributing funds. You must make the salary reduction contributions to the SIMPLE IRA within 30 days after the end of the month in which the amounts would otherwise have been payable to the employee in cash. You must make matching contributions or nonelective contributions by the due date (including extensions) for filing your federal income tax return for the year.

When To Deduct Contributions

You can deduct contributions under a SIMPLE IRA plan in the tax year with or within which the calendar year for which contributions were made ends. You can deduct contributions for a particular tax year if they are made for that tax year and are made by the due date (including extensions) of your federal income tax return for that year.

Example 1. Your tax year is the fiscal year ending June 30. Contributions under a SIMPLE IRA plan for the calendar year 1999 (including contributions made in 1999 before July 1, 1999) are deductible in the tax year ending June 30, 2000.

Example 2. Your are a sole proprietor whose tax year is the calendar year. Contributions under a SIMPLE IRA plan for the calendar year 1999 (including contributions made in 2000 by April 17, 2000) are deductible in the 1999 tax year.

Tax Treatment of Contributions

You can deduct your contributions and your employees can exclude these contributions from their gross income. SIMPLE IRA contributions are not subject to federal income tax withholding. However, salary reduction contributions are subject to social security, Medicare, and federal unemployment (FUTA) taxes. Matching and nonelective contributions are not subject to these taxes.

Reporting on Form W–2. Do not include SIMPLE IRA contributions in the "Wages, tips, other compensation box" of Form W–2. However, salary reduction contributions must be included in the boxes for social security and Medicare wages. Also include the proper code in Box 13. For more information, see the instructions for Forms W–2 and W–3.

Distributions (Withdrawals)

Distributions from a SIMPLE IRA are subject to IRA rules and generally are includible in income for the year received. Tax-free rollovers can be made from one SIMPLE IRA into another SIMPLE IRA. A rollover from a SIMPLE IRA to another IRA can be made tax free only after a 2-year participation in the SIMPLE IRA plan.

Early withdrawals generally are subject to a 10% additional tax. However, the additional tax is increased to 25% if funds are withdrawn within 2 years of beginning participation.

More information. See Publication 590 for information about IRA rules, including those on the tax treatment of distributions, rollovers, required distributions, and income tax withholding.

More Information on SIMPLE IRA Plans

If you need more help to set up and maintain SIMPLE IRA plans, see the following IRS notice and revenue procedure.

Notice 98–4. This notice contains questions and answers about the implementation and operation of SIMPLE IRA plans, including the election and notice requirements for these plans. Notice 98–4 is in Internal Revenue Bulletin No. 1998–2.

Revenue Procedure 97–29. This revenue procedure provides guidance to drafters of prototype SIMPLE IRAs on obtaining opinion letters. Revenue Procedure 97–29 is in Cumulative Bulletin 1997–1.

SIMPLE 401(k) Plan

You can adopt a SIMPLE plan as part of a 401(k) plan if you meet the 100-employee limit as discussed earlier under SIMPLE IRA plans. A SIMPLE 401(k) plan generally must satisfy the rules that apply to a 401(k) plan, as discussed in *Qualification Rules* under *Qualified Plans (Keogh Plans),* later. However, contributions and benefits under a SIMPLE 401(k) plan will be considered not to discriminate in favor of highly compensated employees provided the plan meets the conditions listed below.

1) Under the plan, an employee can choose to have you make salary reduction contributions for the year to a trust in an amount expressed as a percentage of the employee's compensation, but not more than $6,000 for 1999.

2) You must make either:

   a) Matching contributions up to 3% of compensation for the year, or

   b) Nonelective contributions of 2% of compensation on behalf of each eligible employee who has at least $5,000 of compensation from you for the year.

3) No other contributions can be made to the trust.

4) No contributions are made, and no benefits accrue, for services during the year under any other qualified retirement plan of the employer on behalf of any employee eligible to participate in the SIMPLE 401(k) plan.

5) The employee's rights to any contributions are nonforfeitable.

No more than $160,000 of the employee's compensation can be taken into account in figuring salary reduction contributions, matching contributions, and nonelective contributions.

Top-heavy plan exception. A SIMPLE 401(k) plan that allows only contributions meeting the conditions listed above will not be treated as a top-heavy plan. Top-heavy qualified plans are discussed in *Top-heavy plan requirements* under *Qualified Plans (Keogh Plans),* later.

Employee notification. The notification rules that apply to SIMPLE IRA plans also apply to SIMPLE 401(k) plans. See *Notification Requirements,* earlier.

More Information on SIMPLE 401(k) Plans

If you need more help to set up and maintain SIMPLE 401(k) plans, see Revenue Procedure 97–9. Revenue Procedure 97–9 is in Cumulative Bulletin 1997–1. This revenue procedure provides a model amendment that you can use to adopt a plan with SIMPLE 401(k) provisions. This model amendment provides guidance to plan sponsors for incorporating 401(k) SIMPLE provisions in plans containing cash or deferred arrangements.

Qualified Plans (Keogh Plans)

A qualified employer plan set up by a self-employed individual is sometimes called a Keogh or HR–10 plan. A sole proprietor or a partnership can set up a qualified plan. A common-law employee or a partner cannot set up a qualified plan. The plans described here can also be set up and maintained by employers that are corporations. All the rules discussed here apply to corporations except where specifically limited to the self-employed.

The plan must be for the exclusive benefit of employees or their beneficiaries. A qualified plan ***can include coverage for a self-employed individual.*** A self-employed individual is treated as both an employer and an employee.

As an employer, you can usually deduct, subject to limits, contributions you make to a qualified plan, including those made for your own retirement. The contributions (and earnings and gains on them) are generally tax free until distributed by the plan.

Kinds of Plans

There are two basic kinds of qualified plans —***defined contribution plans*** and ***defined benefit plans***—and different rules apply to each. You can have more than one qualified plan, but your contributions to all the plans must not total more than the overall limits discussed under *Contributions* and *Employer Deduction,* later.

Defined Contribution Plan

A defined contribution plan provides an individual account for each participant in the plan. It provides benefits to a participant largely based on the amount contributed to that participant's account. Benefits are also affected by any income, expenses, gains, losses, and forfeitures of other accounts that may be allocated to an account. A defined contribution plan can be either a profit-sharing plan or a money purchase pension plan.

Profit-sharing plan. A profit-sharing plan is a plan for sharing your business profits with your employees. However, you do not have to make contributions out of net profits to have a profit-sharing plan.

The plan does not need to provide a definite formula for figuring the profits to be shared. But, if there is no formula, there must be systematic and substantial contributions.

The plan must provide a definite formula for allocating the contribution among the participants and for distributing the accumulated funds to the employees after they reach a certain age, after a fixed number of years, or upon certain other occurrences.

In general, you can be more flexible in making contributions to a profit-sharing plan than to a money purchase pension plan (discussed next) or a defined benefit plan (discussed later). But the maximum deductible contribution may be less under a profit-sharing plan (see *Limits on Contributions and Benefits,* later).

Forfeitures under a profit-sharing plan can be allocated to the accounts of remaining participants in a nondiscriminatory way or they can be used to reduce your contributions.

Money purchase pension plan. Contributions to a money purchase pension plan are fixed and are not based on your business profits. For example, if the plan requires that contributions be 10% of the participants' compensation without regard to whether you have profits (or the self-employed person has earned income), the plan is a money purchase pension plan. This applies even though the compensation of a self-employed individual as a participant is based on earned income derived from business profits.

Defined Benefit Plan

A defined benefit plan is any plan that is not a defined contribution plan. Contributions to a defined benefit plan are based on what is needed to provide definitely determinable benefits to plan participants. Actuarial assumptions and computations are required to figure these contributions. Generally, you will need continuing professional help to have a defined benefit plan.

Forfeitures under a defined benefit plan cannot be used to increase the benefits any employee would otherwise receive under the plan. Forfeitures must be used instead to reduce employer contributions.

Setting Up a Qualified Plan

There are two basic steps in setting up a qualified plan. First you adopt a written plan. Then you invest the plan assets.

You, the employer, are responsible for setting up and maintaining the plan.

TIP *If you are self-employed, it is not necessary to have employees besides yourself to sponsor and set up a qualified plan. If you have employees, see* Eligible Employees, *later.*

Set-up deadline. To take a deduction for contributions for a tax year, your plan must be set up (adopted) by the last day of that year (December 31 for calendar-year employers).

Adopting a Written Plan

You must adopt a written plan. The plan can be an IRS-approved master or prototype plan offered by a sponsoring organization. Or it can be an individually designed plan.

Written plan requirement. To qualify, the plan you set up must be in writing and must be communicated to your employees. The plan's provisions must be stated in the plan. It is not sufficient for the plan to merely refer to a requirement of the Internal Revenue Code.

Master or prototype plans. Most qualified plans follow a standard form of plan (a master or prototype plan) approved by the IRS. Master and prototype plans are plans that are made available by plan providers for adoption by employers (including self-employed individuals). Under a master plan, a single trust or custodial account is established, as part of the plan, for the joint use of all adopting employers. Under a prototype plan, a separate trust or custodial account is established for each employer.

Plan providers. The following organizations generally can provide IRS-approved master or prototype plans.

- Banks (including some savings and loan associations and federally insured credit unions).
- Trade or professional organizations.
- Insurance companies.
- Mutual funds.

Individually designed plans. If you prefer, you can set up an individually designed plan to meet specific needs. Although advance IRS approval is not required, you can apply for approval by paying a fee and requesting a determination letter. You may need professional help for this. Revenue Procedure 99–6 may help you decide whether to apply for approval of your plan. Revenue Procedure 99–6 is in Internal Revenue Bulletin No. 1999–1. It is also available at most IRS offices and at some libraries.

Investing Plan Assets

In setting up a qualified plan, you arrange how the plan's funds will be used to build its assets.

- You can establish a trust or custodial account to invest the funds.
- You, the trust, or the custodial account can buy an annuity contract from an insurance company. Life insurance can be included only if it is incidental to the retirement benefits.
- You, the trust, or the custodial account can buy face-amount certificates from an insurance company. These certificates are treated like annuity contracts.

You set up a trust by a legal instrument (written document). You may need professional help to do this.

You can set up a custodial account with a bank, savings and loan association, credit union, or other person who can act as the plan trustee.

You do not need a trust or custodial account, although you can have one, to invest the plan's funds in annuity contracts or face-amount certificates. If anyone other than a trustee holds them, however, the contracts or certificates must state that they are not transferable.

Eligible Employees

An employee must be allowed to participate in your plan if he or she meets both the following requirements.

- Has reached age 21.
- Has at least 1 year of service (2 years if the plan is not a 401(k) plan and provides that after not more than 2 years of service the employee has a nonforfeitable right to all of his or her accrued benefit).

A plan cannot exclude an employee because he or she has reached a specified age.

Other plan requirements. For information on other important plan requirements, see *Qualification Rules,* later.

Minimum Funding Requirements

In general, if your plan is a money purchase pension plan or a defined benefit plan, you must actually pay enough into the plan to satisfy the minimum funding standard for each year. Determining the amount needed to satisfy the minimum funding standard is complicated. The amount is based on what should be contributed under the plan formula using actuarial assumptions and formulas. For information on this funding requirement, see section 412 and its regulations.

Quarterly installments of required contributions. If your plan is a defined benefit plan subject to the minimum funding requirements, you must make quarterly installment payments of the required contributions. If you do not pay the full installments timely, you may have to pay interest on any underpayment for the period of the underpayment.

Due dates. The due dates for the installments are 15 days after the end of each quarter. For a calendar-year plan, the installments are due April 15, July 15, October 15, and January 15 (of the following year).

Installment percentage. Each quarterly installment must be 25% of the required annual payment.

Extended period for making contributions. Additional contributions required to satisfy the minimum funding requirement for a plan year will be considered timely if made by 8½ months after the end of that year.

Contributions

A qualified plan is generally funded by your contributions. However, employees participating in the plan may be permitted to make contributions.

Contribution deadline. You can make deductible contributions for a tax year up to the due date of your return (plus extensions) for that year.

Self-employed individual. You can make contributions on behalf of yourself only if you have net earnings (compensation) from self-employment in the trade or business for which the plan was set up. Your net earnings must be from your personal services, not from your investments. If you have a net loss from self-employment, you cannot make contributions for yourself for the year, even if you can contribute for common-law employees based on their compensation.

When Contributions Are Considered Made

You generally apply your plan contributions to the year in which you make them. But you can apply them to the previous year if all the following requirements are met.

1) You make them by the due date of your tax return for the previous year (plus extensions).
2) The plan was established by the end of the previous year.
3) The plan treats the contributions as though it had received them on the last day of the previous year.
4) You do either of the following.
   a) You specify in writing to the plan administrator or trustee that the contributions apply to the previous year.
   b) You deduct the contributions on your tax return for the previous year. (A partnership shows contributions for partners on Schedule K (Form 1065).)

Employer's promissory note. Your promissory note made out to the plan is not a payment that qualifies for the deduction. Also, issuing this note is a prohibited transaction subject to tax. See *Prohibited Transactions,* later.

Employer Contributions

There are certain limits on the contributions and other annual additions you can make each year for plan participants. There are also limits on the amount you can deduct. See *Deduction Limits,* later.

Limits on Contributions and Benefits

Your plan must provide that contributions or benefits cannot exceed certain limits. The limits differ depending on whether your plan is a defined contribution plan or a defined benefit plan.

Defined benefit plan. For 1999, the annual benefit for a participant under a defined benefit plan cannot be more than the **lesser** of the following amounts.

1) $130,000.
2) 100% of the participant's average compensation for his or her highest 3 consecutive calendar years.

Defined contribution plan. For 1999, a defined contribution plan's annual contributions and other additions (excluding earnings) to the account of a participant cannot be more than the **lesser** of the following amounts.

1) $30,000.
2) 25% of the compensation actually paid to the participant.

The maximum compensation that can be taken into account for this limit is $160,000.

Excess annual additions. Excess annual additions are the amounts contributed that are more than the limits discussed previously. A

plan can correct excess annual additions caused by any of the following actions.

- A reasonable error in estimating a participant's compensation.
- A reasonable error in determining the amount of elective deferrals permitted (discussed later).
- Forfeitures allocated to participants' accounts.

Correcting excess annual additions. A plan can provide for the correction of excess annual additions in the following ways.

1) Allocate and reallocate the excess to other participants in the plan to the extent of their unused limits for the year.
2) If these limits are exceeded, do one of the following.
   a) Hold the excess in a separate account and allocate (and reallocate) it to participants' accounts in the following year (or years) before making any contributions for that year (see also *Carryover of Excess Contributions,* later).
   b) Return employee after-tax contributions or elective deferrals (see *Employee Contributions* and *Elective Deferrals (401(k) Plans),* later).

Tax treatment of returned contributions or distributed elective deferrals. The return of employee after-tax contributions or the distribution of elective deferrals to correct excess annual additions is considered a corrective payment rather than a distribution of accrued benefits. The penalties for early distributions and excess distributions do not apply.

These disbursements **are not wages** reportable on Form W–2. You must report them on a separate Form 1099–R as follows.

- Report the total amount of the distribution, including employee contributions, in box 1. If the distribution includes any gain from the contribution, report the gain in box 2a. Report the return of employee contributions in box 5. Enter Code E in box 7.
- Report a distribution of an elective deferral in boxes 1 and 2a. Include any gain from the contribution. Leave box 5 blank and enter Code E in box 7.

Participants must report these amounts on the line for *Total pensions and annuities* on Form 1040 or Form 1040A.

Employee Contributions

Participants may be permitted to make nondeductible contributions to a plan in addition to your contributions. Even though these employee contributions are not deductible, the earnings on them are tax free until distributed in later years. Also, these contributions must satisfy the nondiscrimination test of section 401(m). See Notice 98–1 for further guidance and transition relief relating to recent statutory amendments to the nondiscrimination rules under sections 401(k) and 401(m). Notice 98–1 is in Internal Revenue Bulletin No. 1998–3.

Employer Deduction

You can usually deduct, subject to limits, contributions you make to a qualified plan, including those made for your own retirement. The contributions (and earnings and gains on them) are generally tax free until distributed by the plan.

Deduction Limits

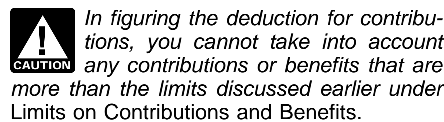
The deduction limit for your contributions to a qualified plan depends on the kind of plan you have.

Defined contribution plans. The deduction limit for a defined contribution plan depends on whether it is a profit-sharing plan or a money purchase pension plan.

Profit-sharing plan. Your deduction for contributions to a profit-sharing plan cannot be more than ***15%*** of the compensation paid (or accrued) during the year to your eligible employees participating in the plan. You must reduce this 15% limit in figuring the deduction for contributions you make for your own account. See *Deduction Limit for Self-Employed Individuals,* later.

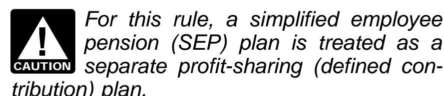
Money purchase pension plan. Your deduction for contributions to a money purchase pension plan is generally limited to ***25%*** of the compensation paid (or accrued) during the year to your eligible employees. You must reduce this 25% limit in figuring the deduction for contributions you make for yourself, as discussed later.

Defined benefit plans. The deduction for contributions to a defined benefit plan is based on actuarial assumptions and computations. Consequently, an actuary must figure your deduction limit.


In figuring the deduction for contributions, you cannot take into account any contributions or benefits that are more than the limits discussed earlier under Limits on Contributions and Benefits.

Deduction limit for multiple plans. If you contribute to both a defined contribution plan and a defined benefit plan and at least one employee is covered by both plans, your deduction for those contributions is limited. Your deduction cannot be more than the ***greater*** of the following amounts.

- 25% of the compensation paid (or accrued) during the year to your eligible employees participating in the plan. You must reduce this 25% limit in figuring the deduction for contributions you make for your own account.
- Your contributions to the defined benefit plans, but not more than the amount needed to meet the year's minimum funding standard for any of these plans.


For this rule, a simplified employee pension (SEP) plan is treated as a separate profit-sharing (defined contribution) plan.

Deduction Limit for Self-Employed Individuals

If you make contributions for yourself, you need to make a special computation to figure your maximum deduction for these contributions. Compensation is your net earnings from self-employment, defined earlier under *Definitions You Need To Know.* This definition takes into account both the following items.

- The deduction for one-half of your self-employment tax.
- The deduction for contributions on behalf of yourself to the plan.

The deduction for your own contributions and your net earnings depend on each other. For this reason, you determine the deduction for your own contributions indirectly by reducing the contribution rate called for in your plan. To do this, use either the *Rate Table for Self-Employed* or the *Rate Worksheet for Self-Employed* in the *Appendix.* Then figure your maximum deduction by using the *Deduction Worksheet for Self-Employed* in the *Appendix.*

Multiple plans. The deduction limit for multiple plans (discussed earlier) also applies to contributions you make as an employer on your own behalf.

Where To Deduct Contributions

Deduct the contributions you make for your common-law employees on Schedule C (Form 1040), on Schedule F (Form 1040), or on Form 1065, whichever applies.

You take the deduction for contributions for yourself on line 29 of Form 1040.

If you are a partner, the partnership passes its deduction to you for the contributions it made for you. The partnership will report these contributions on Schedule K–1 (Form 1065). You deduct them on line 29 of Form 1040.

Carryover of Excess Contributions

If you contribute more to the plans than you can deduct for the year, you can carry over and deduct the excess in later years, combined with your contributions for those years. Your combined deduction in a later year is limited to 25% of the participating employees' compensation for that year. The limit is 15% if you have only profit-sharing plans (including SEPs). Remember that these percentage limits must be reduced to figure your maximum deduction for contributions you make for yourself. See *Deduction Limit for Self-Employed Individuals,* earlier. The amount you carry over and deduct may be subject to the excise tax discussed next.

Table 2 illustrates the carryover of excess contributions to a profit-sharing plan.

Excise Tax for Nondeductible (Excess) Contributions

If you contribute more than your deduction limit to a retirement plan, you have made nondeductible contributions and you may be liable for an excise tax. In general, a 10% excise tax applies to nondeductible contributions made to qualified pension, profit-sharing, stock bonus, or annuity plans and to simplified employee pension plans (SEPs).

Special rule for self-employed individuals. The 10% excise tax does not apply to any contribution made to meet the minimum funding requirements in a money purchase pension plan or a defined benefit plan. Even if that contribution is more than your earned income from the trade or business for which the plan is set up, the difference is not subject

Table 2. **Carryover of Excess Contributions Illustrated—Profit-Sharing Plan (000's omitted)**

Year	Participants' compensation	Participants' share of required contribution (10 percent of annual profit)	Deductible limit for current year (15 percent of compensation)	Contribution	Excess contribution carryover used*	Total deduction including carryovers	Excess contribution carryover available at end of year
1996 . . .	$1,000	$100	$150	$100	$ 0	$100	$ 0
1997 . . .	400	125	60	125	0	60	65
1998 . . .	500	50	75	50	25	75	40
1999 . . .	600	100	90	100	0	90	50

* There were no carryovers from years before 1996.

to this excise tax. See *Minimum Funding Requirements* earlier.

Exception. The 10% excise tax does not apply to contributions to one or more defined contribution plans that are not deductible only because they are more than the combined plan deduction limit, and then only to the extent the excess is not more than the greater of the following amounts.

- 6% of the participants' compensation for the year.
- The sum of employer matching contributions and the elective deferrals to a 401(k) plan.

Reporting the tax. You must report the tax on your nondeductible contributions on **Form 5330.** Form 5330 includes a computation of the tax. See the separate instructions for completing the form.

Elective Deferrals (401(k) Plans)

Your qualified plan can include a cash or deferred arrangement (401(k) plan) under which participants can choose to have you contribute part of their before-tax compensation to the plan rather than receive the compensation in cash. (As a participant in the plan, you can contribute part of your before-tax net earnings from the business.) This contribution, called an ***elective deferral,*** and any earnings on it remain tax free until distributed by the plan.

In general, a qualified plan can include a 401(k) plan only if the qualified plan is one of the following plans.

- A profit-sharing plan.
- A money purchase pension plan in existence on June 27, 1974, that included a salary reduction arrangement on that date.

Partnership. A partnership can have a 401(k) plan.

Restriction on conditions of participation. The plan may not require, as a condition of participation, that an employee complete more than 1 year of service.

Matching contributions. If your plan permits, you can make matching contributions for an employee who makes an elective deferral to your 401(k) plan. For example, the plan might provide that you will contribute 50 cents for each dollar your participating employees choose to defer under your 401(k) plan.

Nonelective contributions. You can, under a qualified 401(k) plan, also make contributions (other than matching contributions) for your participating employees without giving them the choice to take cash instead.

Employee compensation limit. No more than $160,000 of the employee's compensation can be taken into account when figuring contributions.

Limit on Elective Deferrals

There is a limit on the amount that an employee can defer each year under these plans. This limit applies without regard to community property laws. Your plan must provide that your employees cannot defer more than the limit that applies for a particular year. For 1999, the basic limit on elective deferrals is ***$10,000.*** This limit is subject to annual increases to reflect inflation (as measured by the Consumer Price Index). If, in conjunction with other plans, the deferral limit is exceeded, the excess is included in the employee's gross income.

Self-employed individual's matching contributions. Matching contributions to a 401(k) plan on behalf of a self-employed individual are not subject to the limit on elective deferrals. These matching contributions receive the same treatment as the matching contributions for other employees.

Treatment of contributions. Your contributions to a 401(k) plan are generally deductible by you and tax free to participating employees until distributed from the plan. Participating employees have a nonforfeitable right to the accrued benefit resulting from these contributions. Deferrals are included in wages for social security, Medicare, and federal unemployment (FUTA) tax.

Reporting on Form W–2. You must report the total amount deferred in boxes 3, 5, and 13 of your employee's Form W–2. See the Form W–2 instructions.

Treatment of Excess Deferrals

If the total of an employee's deferrals is more than the limit for 1999, the employee can have the difference (called an excess deferral) paid out of any of the plans that permit these distributions. He or she must notify the plan by March 1, 2000, of the amount to be paid from each plan. The plan must then pay the employee that amount by April 17, 2000.

Excess withdrawn by April 17. If the employee takes out the excess deferral by April 17, 2000, it is not reported again by including it in the employee's gross income for 2000. However, any income earned on the excess deferral taken out is taxable in the tax year in which it is taken out. The distribution is not subject to the additional 10% tax on early distributions.

If the employee takes out ***part*** of the excess deferral and the income on it, the distribution is treated as made proportionately from the excess deferral and the income.

Even if the employee takes out the excess deferral by April 17, the amount is considered contributed for satisfying (or not satisfying) the nondiscrimination requirements of the plan. See *Contributions or benefits must not discriminate,* later, under *Qualification Rules.*

Excess not withdrawn by April 17. If the employee does not take out the excess deferral by April 17, 2000, the excess, though taxable in 1999, is not included in the employee's cost basis in figuring the taxable amount of any eventual benefits or distributions under the plan. In effect, an excess deferral left in the plan is taxed twice, once when contributed and again when distributed. Also, if the entire deferral is allowed to stay in the plan, the plan may not be a qualified plan.

Reporting corrective distributions on Form 1099–R. Report corrective distributions of excess deferrals (including any earnings) on Form 1099–R. For specific information about reporting corrective distributions, see the 1999 *Instructions for Forms 1099, 1098, 5498, and W–2G.*

Tax on excess contributions of highly compensated employees. The law provides tests to detect discrimination in a plan. If tests, such as the *actual deferral percentage test (ADP test)* (see section 401(k)(3)) and the *actual contribution percentage test (ACP test)* (see section 401(m)(2)), show that contributions for highly compensated employees are more than the test limits for these contributions, the employer may have to pay a ***10% excise tax.*** Report the tax on Form 5330.

The tax for the year is 10% of the excess contributions for the plan year ending in your tax year. Excess contributions are elective deferrals, employee contributions, or employer matching or nonelective contributions that are more than the amount permitted under the ADP or ACP test.

See Notice 98–1 for further guidance and transition relief relating to recent statutory amendments to the nondiscrimination rules under sections 401(k) and 401(m). Notice 98–1 is in Internal Revenue Bulletin No. 1998–3.

Distributions

Amounts paid to plan participants from a qualified plan are called distributions. Distributions may be nonperiodic, such as lump-sum distributions, or periodic, such as annuity payments. Also, certain loans may be treated as distributions. See *Loans Treated as Distributions* in Publication 575.

Required Distributions

A qualified plan must provide that each participant will either:

- Receive his or her entire interest (benefits) in the plan by the ***required beginning date*** (defined later), or
- Begin receiving regular periodic distributions by the required beginning date in annual amounts calculated to distribute the participant's entire interest (benefits) over his or her life expectancy or over the joint life expectancy of the participant and the designated beneficiary.

These distribution rules apply individually to each qualified plan. You cannot satisfy the requirement for one plan by taking a distribution from another. These rules may be incorporated in the plan by reference. The plan must provide that these rules override any inconsistent distribution options previously offered.

Minimum distribution. If the account balance of a qualified plan participant is to be distributed (other than as an annuity), the plan administrator must figure the minimum amount required to be distributed each distribution calendar year. This amount is figured by dividing the account balance by the applicable life expectancy. For details on figuring the minimum distribution, see *Tax on Excess Accumulation* in Publication 575.

Minimum distribution incidental benefit requirement. Minimum distributions must also meet the *minimum distribution incidental benefit* requirement. This requirement ensures that the plan is used primarily to provide retirement benefits to the employee. After the employee's death, only “incidental” benefits are expected to remain for distribution to the employee's beneficiary (or beneficiaries). For more information about this and other distribution requirements, see Publication 575.

Required beginning date. Generally, each participant must receive his or her entire benefits in the plan or begin to receive periodic distributions of benefits from the plan by the required beginning date.

A participant must begin to receive distributions from his or her qualified retirement plan by April 1 of the year that follows the **later of** the following years.

1) Calendar year in which he or she reaches age 70½.
2) Calendar year in which he or she retires.

Before 1997, the law did not take into account whether or not the participant had retired. A participant was required to begin receiving distributions by April 1 of the year following the calendar year in which the participant reached age 70½. This rule still applies if the participant is a 5% owner or the distribution is from a traditional IRA. For more information, see *Tax on Excess Accumulation* in Publication 575.

Distributions after the starting year. The distribution required to be made by April 1 is treated as a distribution for the starting year. (The starting year is the year in which the participant meets (1) or (2) above, whichever applies.) After the starting year, the participant must receive the required distribution for each year by December 31 of that year. If no distribution is made in the starting year, required distributions for 2 years must be made in the next year (one by April 1 and one by December 31).

Distributions after participant's death. See Publication 575 for the special rules covering distributions made after the death of a participant.

Distributions From 401(k) Plans

Generally, a distribution may not be made until one of the following occurs.

- The employee retires, dies, becomes disabled, or otherwise separates from service.
- The plan ends and no other defined contribution plan is established or continued.
- In the case of a 401(k) plan that is part of a profit-sharing plan, the employee reaches age 59½ or suffers financial hardship. For the rules on hardship distributions, including the limits on them, see section 1.401(k)–1(d)(2) of the regulations.

Some of the above distributions may be subject to the tax on early distributions discussed later.

Qualified domestic relations order (QDRO). These distribution restrictions do not apply if the distribution is to an alternate payee under the terms of a QDRO, which is defined in Publication 575.

Tax Treatment of Distributions

Distributions from a qualified plan minus a prorated part of any cost basis are subject to income tax in the year they are distributed. Since most recipients have no cost basis, a distribution is generally fully taxable. An exception is a distribution that is properly rolled over as discussed next under *Rollover.*

The tax treatment of distributions depends on whether they are made periodically over several years or life ***(periodic distributions)*** or are ***nonperiodic distributions.*** See *Taxation of Periodic Payments* and *Taxation of Nonperiodic Payments* in Publication 575 for a detailed description of how distributions are taxed, including the 5- or 10-year tax option or capital gain treatment of a ***lump-sum distribution.***

The 5-year tax option is repealed for tax years beginning after 1999.

Rollover. The recipient of an ***eligible rollover distribution*** from a qualified plan can defer the tax on it by rolling it over into an IRA or another eligible retirement plan. However, it may be subject to withholding as discussed under *Withholding requirements,* later.

Eligible rollover distribution. This is a distribution of all (such as a lump-sum distribution) or any part of an employee's balance in a qualified retirement plan that *is not* any of the following.

- A required minimum distribution. See *Required Distributions,* earlier.
- An annual (or more frequent) payment under a long-term (10 years or more) annuity contract or as part of a similar long-term series of substantially equal periodic distributions.
- A hardship distribution.
- The portion of a distribution that represents the return of an employee's nondeductible contributions to the plan. See *Employee Contributions,* earlier.
- A corrective distribution of excess contributions or deferrals under a 401(k) plan and any income allocable to the excess, or of excess annual additions and any allocable gains. See *Correcting excess annual additions,* earlier, under *Limits on Contributions and Benefits.*

Hardship distributions from a 401(k) plan that occur after 1998 cannot be rolled over into an IRA or other eligible retirement plan. They are subject to the 10% additional tax on early distributions. However, they are not subject to the 20% withholding tax that generally applies to eligible rollover distributions that are not transferred directly to another retirement plan or IRA.

The IRS has made application of this new rule optional for 1999. For more information, see Notice 99–5 in Internal Revenue Bulletin No. 1999–3.

More information. For more information about rollovers, see *Rollovers* in Publications 575 and 590.

Withholding requirements. If, during a year, a qualified plan pays to a participant one or more *eligible rollover distributions* (defined earlier) that are reasonably expected to total $200 or more, the payor must withhold 20% of each distribution for federal income tax.

Exceptions. If, instead of having the distribution paid to him or her, the participant chooses to have the plan pay it directly to an IRA or another eligible retirement plan (a *direct rollover*), no withholding is required.

If the distribution is not an eligible rollover distribution, defined earlier, the 20% withholding requirement does not apply. Other withholding rules apply to distributions such as long-term periodic distributions and required distributions (periodic or nonperiodic). However, the participant can still choose not to have tax withheld from these distributions. If the participant does not make this choice, the following withholding rules apply.

- For periodic distributions, withholding is based on their treatment as wages.
- For nonperiodic distributions, 10% of the taxable part is withheld.

Estimated tax payments. If no income tax is withheld or not enough tax is withheld, the recipient of a distribution may have to make estimated tax payments. For more information, see *Withholding Tax and Estimated Tax* in Publication 575.

Tax on Early Distributions

If a distribution is made to an employee under the plan before he or she reaches age 59½, the employee may have to pay a ***10%*** additional tax on the distribution. This tax applies to the amount received that the employee must include in income.

Exceptions. The 10% tax will not apply if distributions before age 59½ are made in any of the following circumstances.

- Made to a beneficiary (or to the estate of the employee) on or after the death of the employee.
- Due to the employee having a qualifying disability.
- Part of a series of substantially equal periodic payments beginning after separation from service and made at least annually for the life or life expectancy of the employee or the joint lives or life expectancies of the employee and his or her designated beneficiary. (The payments under this exception, except in the case of death or disability, must continue for at least 5 years or until the employee reaches age 59½, whichever is the longer period.)
- Made to an employee after separation from service if the separation occurred during or after the calendar year in which the employee reached age 55.
- Made to an alternate payee under a qualified domestic relations order (QDRO).
- Made to an employee for medical care up to the amount allowable as a medical expense deduction (determined without regard to whether the employee itemizes deductions).
- Timely made to reduce excess contributions under a 401(k) plan.
- Timely made to reduce excess employee or matching employer contributions (excess aggregate contributions).
- Timely made to reduce excess elective deferrals.

Reporting the tax. To report the tax on early distributions, file **Form 5329.** See the form instructions for additional information about this tax.

Tax on Excess Benefits

If you are or have been a ***5% owner*** of the business maintaining the plan, amounts you receive at any age that are more than the benefits provided for you under the plan formula are subject to an additional tax. This tax also applies to amounts received by your successor. The tax is 10% of the excess benefit that is includible in income.

5% owner. You are a 5% owner if you meet either of the following conditions.

- You own more than 5% of the capital or profits interest in the employer.
- You own or are considered to own more than 5% of the outstanding stock (or more than 5% of the total voting power of all stock) of the employer.

You are also a 5% owner if you were a 5% owner at any time during the 5 plan years immediately before the plan year that ends within the tax year in which you receive the distribution.

Reporting the tax. Include on Form 1040, line 56, any tax you owe for an excess benefit. On the dotted line next to the total, write "Sec. 72(m)(5)" and write in the amount.

Lump-sum distributions. The amount subject to the additional tax is not eligible for the optional methods of figuring income tax on a lump-sum distribution. The optional methods are discussed under *Lump-Sum Distributions* in Publication 575.

Excise Tax on Reversion of Plan Assets

A 20% or 50% excise tax generally is imposed on any direct or indirect reversion of qualified plan assets to an employer. If you owe this tax, report it in Part XIII of **Form 5330.** See Form 5330 instructions for more information.

Prohibited Transactions

Prohibited transactions are transactions between the plan and a ***disqualified person*** that are prohibited by law. (However, see *Exemptions,* later.) If you are a disqualified person who takes part in a prohibited transaction, you must pay a tax (discussed later).

Prohibited transactions generally include the following transactions.

1) A transfer of plan income or assets to, or use of them by or for the benefit of, a disqualified person.
2) Any act of a fiduciary by which he or she deals with plan income or assets in his or her own interest.
3) The receipt of consideration by a fiduciary for his or her own account from any party dealing with the plan in a transaction that involves plan income or assets.
4) Any of the following acts between the plan and a disqualified person.
    a) Selling, exchanging, or leasing property.
    b) Lending money or extending credit.
    c) Furnishing goods, services, or facilities.

Exemptions. Some transactions are exempt from being treated as prohibited transactions. For example, a prohibited transaction does not take place if you are a disqualified person and receive any benefit to which you are entitled as a plan participant or beneficiary. However, the benefit must be figured and paid under the same terms as for all other participants and beneficiaries. For other transactions that are exempt, see section 4975 and its regulations.

Disqualified person. You are a disqualified person if you are any of the following.

1) A fiduciary of the plan.
2) A person providing services to the plan.
3) An employer, any of whose employees are covered by the plan.
4) An employee organization, any of whose members are covered by the plan.
5) Any direct or indirect owner of 50% or more of any of the following.
    a) The combined voting power of all classes of stock entitled to vote, or the total value of shares of all classes of stock of a corporation.
    b) A capital interest or profits interest of a partnership.
    c) The beneficial interest of a trust or unincorporated enterprise that is an employer or an employee organization described in (3) or (4).
6) A member of the family of any individual described in (1), (2), (3), or (5). (A member of a family is the spouse, ancestor, lineal descendant, or any spouse of a lineal descendant.)
7) A corporation, partnership, trust, or estate of which (or in which) any direct or indirect owner holds 50% or more of the interest described in 5(a), (b), or (c). For (c), the beneficial interest of the trust or estate is directly or indirectly owned, or held by persons described in (1) through (5).
8) An officer, director (or an individual having powers or responsibilities similar to those of officers or directors), a 10% or more shareholder, or highly compensated employee (earning 10% or more of the yearly wages of an employer) of a person described in (3), (4), (5), or (7).
9) A 10% or more (in capital or profits) partner or joint venturer of a person described in (3), (4), (5), or (7).
10) Any disqualified person, as described in (1) through (9) above, who is a disqualified person with respect to any plan to which a section 501(c)(22) trust is permitted to make payments under section 4223 of ERISA.

Tax on Prohibited Transactions

The initial tax on a prohibited transaction is 15% of the amount involved for each year (or part of a year) in the taxable period. If the transaction is not corrected within the taxable period, an additional tax of 100% of the amount involved is imposed. For information on correcting the transaction, see *Correcting prohibited transactions,* later.

Both taxes are payable by any disqualified person who participated in the transaction (other than a fiduciary acting only as such). If more than one person takes part in the transaction, each person can be jointly and severally liable for the entire tax.

Amount involved. The amount involved in a prohibited transaction is the greater of the following amounts.

- The money and fair market value of any property given.
- The money and fair market value of any property received.

If services are performed, the amount involved is any excess compensation given or received.

Taxable period. The taxable period starts on the transaction date and ends on the ***earliest*** of the following days.

- The day the IRS mails a notice of deficiency for the tax.
- The day the IRS assesses the tax.
- The day the correction of the transaction is completed.

Payment of the 15% tax. Pay the 15% tax with Form 5330.

Correcting prohibited transactions. If you are a disqualified person who participated in a prohibited transaction, you can avoid the 100% tax by correcting the transaction as soon as possible. Correcting the transaction means undoing it as much as you can without putting the plan in a worse financial position than if you had acted under the highest fiduciary standards.

Correction period. If the prohibited transaction is not corrected during the taxable period, you usually have an additional 90 days after the day the IRS mails a notice of deficiency for the 100% tax to correct the transaction. This correction period (the taxable period plus the 90 days) can be extended if either of the following occurs.

- The IRS grants a reasonable time needed to correct the transaction.
- You petition the Tax Court.

If you correct the transaction within this period, the IRS will abate, credit, or refund the 100% tax.

Reporting Requirements

You may have to file an annual return/report form by the last day of the 7th month after the plan year ends. See the following list of forms to choose the right form for your plan.

Form 5500–EZ. You can use Form 5500–EZ if you meet ***ALL*** of the following conditions.

- The plan is a ***one-participant plan,*** defined below.
- The plan meets the minimum coverage requirements of section 410(b) without being combined with any other plan you may have that covers other employees of your business.
- The plan does not provide benefits for anyone except you, you and your spouse, or one or more partners and their spouses.
- The plan does not cover a business that is a member of an affiliated service group, a controlled group of corporations, or a group of businesses under common control.
- The plan does not cover a business that leases employees.

One-participant plan. Your plan is a one-participant plan if, as of the first day of the plan year for which the form is filed, either of the following is true.

- The plan covers only you (or you and your spouse) and you (or you and your spouse) own the entire business (whether incorporated or unincorporated).
- The plan covers only one or more partners (or partner(s) and spouse(s)) in a business partnership.

Example. You are a sole proprietor and your plan meets all the conditions for filing Form 5500–EZ. The total plan assets are more than $100,000. You should file Form 5500–EZ.

Form 5500–EZ not required. You do not have to file Form 5500–EZ (or Form 5500) if you meet the conditions mentioned above and either of the following conditions.

- You have a one-participant plan that had total plan assets of $100,000 or less at the end of every plan year beginning on or after January 1, 1994.
- You have two or more one-participant plans that together had total plan assets of $100,000 or less at the end of every plan year beginning on or after January 1, 1994.

All one-participant plans must file a Form 5500–EZ for their final plan year, even if the total plan assets have always been less than $100,000. The final plan year is the year in which distribution of all plan assets is completed.

Form 5500. If you do not meet the requirements for filing Form 5500–EZ, you must file Form 5500, *Annual Return/Report of Employee Benefit Plan.*

Schedule A (Form 5500). If any plan benefits are provided by an insurance company, insurance service, or similar organization, complete and attach Schedule A (Form 5500), *Insurance Information,* to Form 5500. Schedule A is not needed for a plan that covers only either of the following.

1) An individual or an individual and spouse who wholly own the trade or business, whether incorporated or unincorporated.
2) Partners in a partnership or the partners and their spouses.

Do not file a Schedule A (Form 5500) with a Form 5500–EZ.

Schedule B (Form 5500). For most defined benefit plans, complete and attach Schedule B (Form 5500), *Actuarial Information,* to Form 5500 or Form 5500–EZ.

Schedule P (Form 5500). This schedule is used by a fiduciary (trustee or custodian) of a trust described in section 401(a) or a custodial account described in section 401(f) to protect it under the statute of limitations provided in section 6501(a). The filing of a completed Schedule P (Form 5500), *Annual Return of Fiduciary of Employee Benefit Trust,* by the fiduciary satisfies the annual filing requirement under section 6033(a) for the trust or custodial account created as part of a qualified plan. This filing starts the running of the 3-year limitation period that applies to the trust or custodial account. For this protection, the trust or custodial account must qualify under section 401(a) and be exempt from tax under section 501(a). The fiduciary should file, under section 6033(a), a Schedule P as an attachment to Form 5500 or Form 5500–EZ for the plan year in which the trust year ends. The fiduciary cannot file Schedule P separately. See the Schedule P instructions for more information.

Form 5310. If you terminate your plan and are the plan sponsor or plan administrator, you can file Form 5310, *Application for Determination for Terminating Plan.* Your application must be accompanied by the appropriate user fee and **Form 8717,** *User Fee for Employee Plan Determination Letter Request.*

More information. For more information about reporting requirements, see the forms and their instructions.

Qualification Rules

To qualify for the tax benefits available to qualified plans, a plan must meet certain requirements (qualification rules) of the tax law. Generally, unless you write your own plan, the financial institution that provided your plan will take the continuing responsibility for meeting qualification rules that are later changed. The following is a brief overview of important qualification rules that generally have not yet been discussed. It is not intended to be all-inclusive. See *Setting Up a Qualified Plan,* earlier.

Generally, the following qualification rules also apply to a SIMPLE 401(k) retirement plan. A SIMPLE 401(k) plan is, however, not subject to the top-heavy rules and nondiscrimination rules of qualified plans if the plan satisfies the provisions discussed earlier under SIMPLE 401(k) Plan.

Plan assets must not be diverted. Your plan must make it impossible for its assets to be used for, or diverted to, purposes other than for the benefit of employees and their beneficiaries. As a general rule, the assets cannot be diverted to the employer.

Minimum coverage requirements must be met. To be a qualified plan, a defined benefit plan must benefit at least the lesser of the following.

1) 50 employees.
2) The greater of:
   a) 40% of all employees, or
   b) Two employees.

If there is only one employee, the plan must benefit that employee.

Contributions or benefits must not discriminate. Under the plan, contributions or benefits to be provided must not discriminate in favor of highly compensated employees.

Contribution and benefit limits must not be more than certain limits. Your plan must not provide for contributions or benefits that are more than certain limits. The limits apply to the annual contributions and other additions to the account of a participant in a defined contribution plan and to the annual benefit payable to a participant in a defined benefit plan. These limits were discussed earlier under *Contributions.*

Minimum vesting standards must be met. Your plan must satisfy certain requirements regarding when benefits vest. A benefit is ***vested*** (you have a fixed right to it) when it becomes nonforfeitable. A benefit is ***nonforfeitable*** if it cannot be lost upon the happening, or failure to happen, of any event.

Leased employees. A leased employee, defined earlier under *Definitions You Need To Know,* who performs services for you (recipient of the services) is treated as your employee for certain plan qualification rules. These rules include those in all the following areas.

- Nondiscrimination in coverage, contributions, and benefits.
- Minimum age and service requirements.
- Vesting.
- Limits on contributions and benefits.
- Top-heavy plan requirements.

However, contributions or benefits provided by the leasing organization for services performed for you are treated as provided by you.

Benefit payments must begin when required. Your plan must provide that, unless the participant chooses otherwise, the payment of benefits to the participant must begin within 60 days after the close of the ***latest*** of the following periods.

- The plan year in which the participant reaches the earlier of age 65 or the normal retirement age specified in the plan.
- The plan year in which the 10th anniversary of the year in which the participant began participating in the plan.
- The plan year in which the participant separates from service.

Early retirement. Your plan can provide for payment of retirement benefits before the normal retirement age. If your plan offers an early retirement benefit, a participant who separates from service before satisfying the early retirement age requirement becomes entitled to that benefit if he or she meets both the following requirements.

- Satisfies the ***service requirement*** for the early retirement benefit.
- Separates from service with a nonforfeitable right to an accrued benefit. The benefit, which may be actuarially reduced, is payable when the early retirement age requirement is met.

Survivor benefits. Defined benefit and certain money purchase pension plans must provide automatic survivor benefits in both the following forms.

- A qualified joint and survivor annuity for a vested participant who does not die before the annuity starting date.
- A qualified pre-retirement survivor annuity for a vested participant who dies before the annuity starting date and who has a surviving spouse.

The automatic survivor benefit also applies to any participant under a profit-sharing plan unless all the following conditions are met.

- The participant does not choose benefits in the form of a life annuity.
- The plan pays the full vested account balance to the participant's surviving spouse (or other beneficiary if the surviving spouse consents or if there is no surviving spouse) if the participant dies.
- The plan is not a direct or indirect transferee of a plan that must provide automatic survivor benefits.

Loan secured by benefits. If survivor benefits are required for a spouse under a plan, he or she must consent to a loan that uses as security the accrued benefits in the plan.

Waiver of survivor benefits. Each plan participant may be permitted to waive the joint and survivor annuity or the pre-retirement survivor annuity (or both), but only if the participant has the written consent of the spouse. The plan also must allow the participant to withdraw the waiver. The spouse's consent must be witnessed by a plan representative or notary public.

Waiver of 30-day waiting period before annuity starting date. A plan may permit a participant to waive (with spousal consent) the 30-day minimum waiting period after a written explanation of the terms and conditions of a joint and survivor annuity is provided to each participant.

The waiver is allowed only if the distribution begins more than 7 days after the written explanation is provided.

Involuntary cash-out of benefits not more than dollar limit. A plan may provide for the immediate distribution of the participant's benefit under the plan if the value of the benefit is not greater than $5,000.

However, the distribution cannot be made after the annuity starting date unless the participant and the spouse (or surviving spouse of a participant who died) consent in writing to the distribution. If the present value is greater than $5,000, the plan must have the written consent of the participant and the spouse (or surviving spouse) for any immediate distribution of the benefit.

Consolidation, merger, or transfer of assets or liabilities. Your plan must provide that, in the case of any merger or consolidation with, or transfer of assets or liabilities to, any other plan, each participant would (if the plan then terminated) receive a benefit equal to or more than the benefit he or she would have been entitled to just before the merger, etc. (if the plan had then terminated).

Benefits must not be assigned or alienated. Your plan must provide that its benefits cannot be assigned or alienated.

Exception for certain loans. A loan from the plan (not from a third party) to a participant or beneficiary is not treated as an assignment or alienation if the loan is secured by the participant's accrued nonforfeitable benefit and is exempt from the tax on prohibited transactions under section 4975(d)(1) or would be exempt if the participant were a disqualified person. A disqualified person is defined earlier under *Prohibited Transactions.*

Exception for qualified domestic relations order (QDRO). Compliance with a QDRO does not result in a prohibited assignment or alienation of benefits. QDRO is defined in Publication 575.

Payments to an alternate payee under a QDRO before the participant attains age 59½ are not subject to the 10% additional tax that would otherwise apply under certain circumstances. The interest of the alternate payee is not taken into account in determining whether a distribution to the participant is a lump-sum distribution. Benefits distributed to an alternate payee under a QDRO can be rolled over tax free to an individual retirement account or to an individual retirement annuity.

No benefit reduction for social security increases. Your plan must not permit a benefit reduction for a post-separation increase in the social security benefit level or wage base for any participant or beneficiary who is receiving benefits under your plan, or who is separated from service and has nonforfeitable rights to benefits. This rule also applies to plans supplementing the benefits provided by other federal or state laws.

Elective deferrals must be limited. If your plan provides for elective deferrals, it must limit those deferrals to the amount in effect for that particular year. See *Limit on Elective Deferrals,* earlier.

Top-heavy plan requirements. A top-heavy plan is one that mainly favors partners, sole proprietors, and other key employees.

A plan is top heavy for any plan year for which the total value of accrued benefits or account balances of key employees is more than 60% of the total value of accrued benefits or account balances of all employees. Additional requirements apply to a top-heavy plan primarily to provide minimum benefits or contributions for non-key employees covered by the plan.

Most qualified plans, whether or not top heavy, must contain provisions that meet the top-heavy requirements and that will take effect in plan years in which the plans are top heavy. These qualification requirements for top-heavy plans are explained in section 416 and its regulations.

SIMPLE exception. The top-heavy plan requirements do not apply to SIMPLE plans.

Appendix— Rate Table, Rate Worksheet, and Deduction Worksheet for Self-Employed Individuals With Qualified or SEP Plans

As discussed earlier under *Simplified Employee Pension (SEP)* and *Qualified Plans (Keogh Plans),* if you are self-employed, you must use the following rate table or rate worksheet and deduction worksheet to figure your deduction for contributions you made for yourself to a SEP-IRA or qualified plan.

First, use either the rate table or rate worksheet to find your reduced contribution rate. Then complete the deduction worksheet to figure your deduction for contributions.

The table and the worksheets that follow apply only to unincorporated employers who have only one defined contribution plan, such as a profit-sharing plan. A SEP plan is treated as a profit-sharing plan.

Rate table for self-employed. If your plan's contribution rate is a whole number (for example, 12% rather than 12½%), you can use the following table to find your reduced contribution rate. Otherwise, use the rate worksheet provided later.

First, find your plan contribution rate (the contributions rate stated in your plan) in *Column A* of the table. Then read across to the rate under *Column B.* Enter the rate from *Column B* in step 1 of the *Deduction Worksheet for Self-Employed.*

Rate Table for Self-Employed

Column A If the Plan Contribution Rate Is: (shown as %)	Column B Your Rate Is: (shown as decimal)
1	.009901
2	.019608
3	.029126
4	.038462
5	.047619
6	.056604
7	.065421
8	.074074
9	.082569
10	.090909
11	.099099
12	.107143
13	.115044
14	.122807
15*	.130435*
16	.137931
17	.145299
18	.152542
19	.159664
20	.166667
21	.173554
22	.180328
23	.186992
24	.193548
25*	.200000*

*The deduction for annual employer contributions to a SEP plan or a profit-sharing plan cannot be more than 13.0435% of your net earnings (figured without deducting contributions for yourself) from the business that has the plan. If the plan is a money purchase plan, the deduction is limited to 20% of your net earnings.

Example. You are a sole proprietor and have employees. If your plan's contribution rate is 10% of a participant's compensation, your rate is 0.090909. Enter this rate in step 1 of the *Deduction Worksheet for Self-Employed.*

Rate worksheet for self-employed. If your plan's contribution rate is not a whole number (for example, 10½%), you cannot use the *Rate Table for Self-Employed.* Use the following worksheet instead.

Rate Worksheet for Self-Employed

1) Plan contribution rate as a decimal (10½% = 0.105) .... ______
2) Rate in line 1 plus 1 (0.105 + 1 = 1.105) .... ______
3) Self-employed rate as a decimal rounded to at least 3 decimal places (line 1 ÷ line 2) .... ______

Figuring your deduction. Now that you have your self-employed rate from either the rate table or rate worksheet, you can figure your maximum deduction for contributions for yourself by completing the following worksheet.

Deduction Worksheet for Self-Employed

Step 1
Enter your rate from the *Rate Table for Self-Employed* or *Rate Worksheet for Self-Employed* .... ______

Step 2
Enter your net earnings (net profit) from line 31, Schedule C (Form 1040); line 3, Schedule C–EZ (Form 1040); line 36, Schedule F (Form 1040); or line 15a, Schedule K–1 (Form 1065) .... ______

Step 3
Enter your deduction for self-employment tax from line 27, Form 1040 .... ______

Step 4
Subtract step 3 from step 2 and enter the result .... ______

Step 5
Multiply step 4 by step 1 and enter the result .... ______

Step 6
Multiply $160,000 by your plan contribution rate. Enter the result, but not more than $30,000 .... ______

Step 7
Enter the smaller of step 5 or step 6. This is your ***maximum deductible contribution.*** Enter your deduction on line 29, Form 1040 .... ______

Example. You are a sole proprietor and have employees. The terms of your plan provide that you contribute 10½% (.105) of your compensation and 10½% of your participants' compensation. Your net profit from line 31, Schedule C (Form 1040) is $200,000. In figuring this amount, you deducted your common-law employees' compensation of $100,000 and contributions for them of $10,500 (10½% x $100,000). Your self-employment tax deduction on line 27 of Form 1040 is $7,180. See the filled-in portions of both Schedule SE (Form 1040) and Form 1040, later.

You figure your self-employed rate and maximum deduction for employer contributions you made for yourself as follows.

Rate Worksheet for Self-Employed

1) Plan contribution rate as a decimal (10½% = 0.105) 0.105
2) Rate in line 1 plus 1 (0.105 + 1 = 1.105) 1.105
3) Self-employed rate as a decimal rounded to at least 3 decimal places (line 1 ÷ line 2) 0.0950

Deduction Worksheet for Self-Employed

Step 1
Enter your rate from the *Rate Table for Self-Employed* or *Rate Worksheet for Self-Employed* 0.0950

Step 2
Enter your net earnings (net profit) from line 31, Schedule C (Form 1040); line 3, Schedule C–EZ (Form 1040); line 36, Schedule F (Form 1040); or line 15a, Schedule K–1 (Form 1065) $200,000

Step 3
Enter your deduction for self-employment tax from line 27, Form 1040 7,180

Step 4
Subtract step 3 from step 2 and enter the result 192,820

Step 5
Multiply step 4 by step 1 and enter the result 18,318

Step 6
Multiply $160,000 by your plan contribution rate. Enter the result but not more than $30,000 16,800

Step 7
Enter the smaller of step 5 or step 6. This is your ***maximum deductible contribution.*** Enter your deduction on line 29, Form 1040 .... $ 16,800

Portion of Schedule SE (Form 1040)

Section A—Short Schedule SE. Caution: *Read above to see if you can use Short Schedule SE.*

1	Net farm profit or (loss) from Schedule F, line 36, and farm partnerships, Schedule K-1 (Form 1065), line 15a	1	
2	Net profit or (loss) from Schedule C, line 31; Schedule C-EZ, line 3; Schedule K-1 (Form 1065), line 15a (other than farming); and Schedule K-1 (Form 1065-B), box 9. Ministers and members of religious orders, see page SE-1 for amounts to report on this line. See page SE-2 for other income to report	2	200,000
3	Combine lines 1 and 2	3	200,000
4	**Net earnings from self-employment.** Multiply line 3 by 92.35% (.9235). If less than $400, **do not** file this schedule; you do not owe self-employment tax ▶	4	184,700
5	**Self-employment tax.** If the amount on line 4 is: • $72,600 or less, multiply line 4 by 15.3% (.153). Enter the result here and on **Form 1040, line 50.** • More than $72,600, multiply line 4 by 2.9% (.029). Then, add $9,002.40 to the result. Enter the total here and on **Form 1040, line 50.**	5	14,359
6	**Deduction for one-half of self-employment tax.** Multiply line 5 by 50% (.5). Enter the result here and on **Form 1040, line 27** — 6: 7,180		

For Paperwork Reduction Act Notice, see Form 1040 instructions. Cat. No. 11358Z **Schedule SE (Form 1040) 1999**

Portion of Form 1040

Adjusted Gross Income

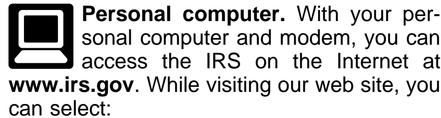
Line	Description				
23	IRA deduction (see page 26)	23			
24	Student loan interest deduction (see page 26)	24			
25	Medical savings account deduction. Attach Form 8853	25			
26	Moving expenses. Attach Form 3903	26			
27	One-half of self-employment tax. Attach Schedule SE	27	7,180		
28	Self-employed health insurance deduction (see page 28)	28			
29	Keogh and self-employed SEP and SIMPLE plans	29	16,800		
30	Penalty on early withdrawal of savings	30			
31a	Alimony paid **b** Recipient's SSN ▶	31a			
32	Add lines 23 through 31a			32	23,980
33	Subtract line 32 from line 22. This is your **adjusted gross income** ▶			33	

For Disclosure, Privacy Act, and Paperwork Reduction Act Notice, see page 54. Cat. No. 11320B Form **1040** (1999)

How To Get More Information

You can order free publications and forms, ask tax questions, and get more information from the IRS in several ways. By selecting the method that is best for you, you will have quick and easy access to tax help.

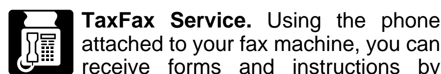
Free tax services. To find out what services are available, get Publication 910, *Guide to Free Tax Services.* It contains a list of free tax publications and an index of tax topics. It also describes other free tax information services, including tax education and assistance programs and a list of TeleTax topics.



Personal computer. With your personal computer and modem, you can access the IRS on the Internet at **www.irs.gov**. While visiting our web site, you can select:

- *Frequently Asked Tax Questions* (located under *Taxpayer Help & Ed)* to find answers to questions you may have.
- *Forms & Pubs* to download forms and publications or search for forms and publications by topic or keyword.
- *Fill-in Forms* (located under *Forms & Pubs)* to enter information while the form is displayed and then print the completed form.
- *Tax Info For You* to view Internal Revenue Bulletins published in the last few years.
- *Tax Regs in English* to search regulations and the Internal Revenue Code (under *United States Code (USC)).*
- *Digital Dispatch* and *IRS Local News Net* (both located under *Tax Info For Business)* to receive our electronic newsletters on hot tax issues and news.
- *Small Business Corner* (located under *Tax Info For Business)* to get information on starting and operating a small business.

You can also reach us with your computer using File Transfer Protocol at **ftp.irs.gov.**



TaxFax Service. Using the phone attached to your fax machine, you can receive forms and instructions by calling **703–368–9694.** Follow the directions from the prompts. When you order forms, enter the catalog number for the form you need. The items you request will be faxed to you.

Phone. Many services are available by phone.

- *Ordering forms, instructions, and publications.* Call **1–800–829–3676** to order current and prior year forms, instructions, and publications.
- *Asking tax questions.* Call the IRS with your tax questions at **1–800–829–1040.**
- *TTY/TDD equipment.* If you have access to TTY/TDD equipment, call **1–800–829–4059** to ask tax questions or to order forms and publications.
- *TeleTax topics.* Call **1–800–829–4477** to listen to pre-recorded messages covering various tax topics.

Evaluating the quality of our telephone services. To ensure that IRS representatives give accurate, courteous, and professional answers, we evaluate the quality of our telephone services in several ways.

- A second IRS representative sometimes monitors live telephone calls. That person only evaluates the IRS assistor and does not keep a record of any taxpayer's name or tax identification number.
- We sometimes record telephone calls to evaluate IRS assistors objectively. We hold these recordings no longer than one week and use them only to measure the quality of assistance.
- We value our customers' opinions. Throughout this year, we will be surveying our customers for their opinions on our service.

Walk-in. You can walk in to many post offices, libraries, and IRS offices to pick up certain forms, instructions, and publications. Also, some libraries and IRS offices have:

- An extensive collection of products available to print from a CD-ROM or photocopy from reproducible proofs.
- The Internal Revenue Code, regulations, Internal Revenue Bulletins, and Cumulative Bulletins available for research purposes.

Mail. You can send your order for forms, instructions, and publications to the Distribution Center nearest to you and receive a response within 10 workdays after your request is received. Find the address that applies to your part of the country.

- **Western part of U.S.:**
  Western Area Distribution Center
  Rancho Cordova, CA 95743–0001
- **Central part of U.S.:**
  Central Area Distribution Center
  P.O. Box 8903
  Bloomington, IL 61702–8903
- **Eastern part of U.S. and foreign addresses:**
  Eastern Area Distribution Center
  P.O. Box 85074
  Richmond, VA 23261–5074

CD-ROM. You can order IRS Publication 1796, *Federal Tax Products on CD-ROM,* and obtain:

- Current tax forms, instructions, and publications.
- Prior-year tax forms, instructions, and publications.
- Popular tax forms which may be filled in electronically, printed out for submission, and saved for recordkeeping.
- Internal Revenue Bulletins.

The CD-ROM can be purchased from National Technical Information Service (NTIS) by calling **1–877–233–6767** or on the Internet at **www.irs.gov/cdorders.** The first release is available in mid-December and the final release is available in late January.

IRS Publication 3207, *Small Business Resource Guide,* is an interactive CD-ROM that contains information important to small businesses. It is available in mid-February. You can get one free copy by calling **1–800–829–3676.**

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Tax Publications for Business Taxpayers

See *How To Get More Information* for a variety of ways to get publications, including by computer, phone, and mail.

General Guides

1 Your Rights as a Taxpayer
17 Your Federal Income Tax (For Individuals)
225 Farmer's Tax Guide
334 Tax Guide for Small Business
509 Tax Calendars for 2000
553 Highlights of 1999 Tax Changes
595 Tax Highlights for Commercial Fishermen
910 Guide to Free Tax Services

Employer's Guides

15 Circular E, Employer's Tax Guide
15-A Employer's Supplemental Tax Guide
51 Circular A, Agricultural Employer's Tax Guide
80 Federal Tax Guide For Employers in the U.S. Virgin Islands, Guam, American Samoa, and the Commonwealth of the Northern Mariana Islands (Circular SS)
179 Circular PR Guía Contributiva Federal Para Patronos Puertorriqueños
926 Household Employer's Tax Guide

Specialized Publications

378 Fuel Tax Credits and Refunds
463 Travel, Entertainment, Gift, and Car Expenses
505 Tax Withholding and Estimated Tax
510 Excise Taxes for 2000
515 Withholding of Tax on Nonresident Aliens and Foreign Corporations
517 Social Security and Other Information for Members of the Clergy and Religious Workers
527 Residential Rental Property
533 Self-Employment Tax
534 Depreciating Property Placed in Service Before 1987
535 Business Expenses
536 Net Operating Losses
537 Installment Sales
538 Accounting Periods and Methods
541 Partnerships
542 Corporations
544 Sales and Other Dispositions of Assets
551 Basis of Assets
556 Examination of Returns, Appeal Rights, and Claims for Refund
560 Retirement Plans for Small Business (SEP, SIMPLE, and Keogh Plans)
561 Determining the Value of Donated Property
583 Starting a Business and Keeping Records
587 Business Use of Your Home (Including Use by Day-Care Providers)
594 Understanding the Collection Process
597 Information on the United States-Canada Income Tax Treaty
598 Tax on Unrelated Business Income of Exempt Organizations
686 Certification for Reduced Tax Rates in Tax Treaty Countries
901 U.S. Tax Treaties
908 Bankruptcy Tax Guide
911 Direct Sellers
925 Passive Activity and At-Risk Rules
946 How To Depreciate Property
947 Practice Before the IRS and Power of Attorney
954 Tax Incentives for Empowerment Zones and Other Distressed Communities
1544 Reporting Cash Payments of Over $10,000
1546 The Taxpayer Advocate Service of the IRS

Spanish Language Publications

1SP Derechos del Contribuyente
579SP Cómo Preparar la Declaración de Impuesto Federal
594SP Comprendiendo el Proceso de Cobro
850 English-Spanish Glossary of Words and Phrases Used in Publications Issued by the Internal Revenue Service
1544SP Informe de Pagos en Efectivo en Exceso de $10,000 (Recibidos en una Ocupación o Negocio)

Commonly Used Tax Forms

See *How To Get More Information* for a variety of ways to get forms, including by computer, fax, phone, and mail. Items with an asterisk are available by fax. For these orders only, use the catalog numbers when ordering.

Form Number and Title	Catalog Number
W-2 Wage and Tax Statement	10134
W-4 Employee's Withholding Allowance Certificate*	10220
940 Employer's Annual Federal Unemployment (FUTA) Tax Return*	11234
940EZ Employer's Annual Federal Unemployment (FUTA) Tax Return*	10983
941 Employer's Quarterly Federal Tax Return	17001
1040 U.S. Individual Income Tax Return*	11320
Sch A & B Itemized Deductions & Interest and Ordinary Dividends*	11330
Sch C Profit or Loss From Business*	11334
Sch C-EZ Net Profit From Business*	14374
Sch D Capital Gains and Losses*	11338
Sch D-1 Continuation Sheet for Schedule D	10424
Sch E Supplemental Income and Loss*	11344
Sch F Profit or Loss From Farming*	11346
Sch H Household Employment Taxes*	12187
Sch J Farm Income Averaging*	25513
Sch R Credit for the Elderly or the Disabled*	11359
Sch SE Self-Employment Tax*	11358
1040-ES Estimated Tax for Individuals*	11340
1040X Amended U.S. Individual Income Tax Return*	11360
1065 U.S. Partnership Return of Income	11390
Sch D Capital Gains and Losses	11393
Sch K-1 Partner's Share of Income, Credits, Deductions, etc.	11394
1120 U.S. Corporation Income Tax Return	11450
1120-A U.S. Corporation Short-Form Income Tax Return	11456
1120S U.S. Income Tax Return for an S Corporation	11510
Sch D Capital Gains and Losses and Built-In Gains	11516
Sch K-1 Shareholder's Share of Income, Credits, Deductions, etc.	11520
2106 Employee Business Expenses*	11700
2106-EZ Unreimbursed Employee Business Expenses*	20604
2210 Underpayment of Estimated Tax by Individuals, Estates, and Trusts*	11744
2441 Child and Dependent Care Expenses*	11862
2848 Power of Attorney and Declaration of Representative*	11980
3800 General Business Credit	12392
3903 Moving Expenses*	12490
4562 Depreciation and Amortization*	12906
4797 Sales of Business Property*	13086
4868 Application for Automatic Extension of Time To File U.S. Individual Income Tax Return*	13141
5329 Additional Taxes Attributable to IRAs, Other Qualified Retirement Plans, Annuities, Modified Endowment Contracts, and MSAs*	13329
6252 Installment Sale Income*	13601
8283 Noncash Charitable Contributions*	62299
8300 Report of Cash Payments Over $10,000 Received in a Trade or Business*	62133
8582 Passive Activity Loss Limitations*	63704
8606 Nondeductible IRAs*	63966
8822 Change of Address*	12081
8829 Expenses for Business Use of Your Home*	13232