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Retirement Plans for the Self-Employed

For use in preparing

1995 Returns

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Important Change

Caution. As this publication was being prepared for printing, the Congress was considering changes to the tax law on retirement plans for the self-employed that could affect your 1996 tax return for next year. See Publication 553, *Highlights of 1995 Tax Changes,* for further developments. Information about these changes also will be available electronically through our bulletin board or via the Internet (see page 34 of the Form 1040 Instructions).

Important Reminder

Plan amendments required by changes in the law. If your Keogh plan needs to be revised to conform to recent legislation, you may choose to get a determination letter from your IRS key district office approving the revision. Generally, master and prototype plans (but not the elections in their related adoption agreements) 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 and that you maintain. Your request should be made on the appropriate form (generally Form 5300 or 5307 for a master or prototype plan) and should be filed with Form 8717 and the appropriate user fee (see Publication 1380, *User Fees).*

You may have to amend your plan to comply with law changes made by the Uruguay Round Agreement, Public Law 103–465. Generally, you need not make any amendment until a later date to be provided by IRS. In the meantime, IRS has issued guidance in the form of questions and answers for complying with these changes. The questions and answers are in Revenue Ruling 95–29, published on page 10 of Internal Revenue Bulletin 95–15.

For further information, contact employee plans taxpayer assistance telephone service between the hours of 1:30 p.m. and 4 p.m. Eastern Time, Monday through Thursday, at (202) 622–6074/6075. (These are not toll-free numbers.)

Introduction

This publication discusses retirement plans that can be used by self-employed persons and partnerships. These plans are called Simplified Employee Pension (SEP) plans and H.R. 10 (Keogh) plans. ***For purposes of these plans, a self-employed individual is both an employer and employee.*** Under a SEP plan, contributions are made to individual retirement arrangements (SEP-IRAs) set up for all employees who qualify. A SEP can also be set up by a corporation.

Only a sole proprietor or a partnership can set up a Keogh plan. The plan must meet certain legal requirements to qualify for tax benefits. See *Setting Up a Keogh Plan,* later, for a discussion of a standard form of plan that generally meets these requirements, and that you can adopt through a sponsoring organization.

Certain fishermen are considered to be self-employed for purposes of setting up a Keogh plan. (See *Fishermen treated as self-employed* in the glossary near the end of this publication.)

There is an example near the end of this publication showing you how to complete and file the Form 5500–EZ, *Annual Return of One-Participant (Owners and Their Spouses) Retirement Plan.* See *Reporting Requirements,* later, to determine if you must file this annual return.

Useful Items

You may want to see:

Publications

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

Forms (and Instructions)

- ☐ **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
- ☐ **5329** Additional Taxes Attributable to Qualified Retirement Plans (Including IRAs), Annuities, and Modified Endowment Contracts
- ☐ **5330** Return of Excise Taxes Related to Employee Benefit Plans
- ☐ **5500** Annual Return/Report of Employee Benefit Plan (With 100 or more participants)
- ☐ **5500–C/R** Return/Report of Employee Benefit Plan (With fewer than 100 participants)
- ☐ **5500–EZ** Annual Return of One-Participant (Owners and Their Spouses) Retirement Plan

Free publications and forms. If you need information about a subject not covered in this publication, you may check our other free publications. To order publications and forms, call 1–800–TAX–FORM (1–800–829–3676) or write the Internal Revenue Service (IRS) Forms Distribution Center for your area as shown in the income tax package.

If you have access to a personal computer and a modem, you also can get many forms and publications electronically. See *How To Get Forms and Publications,* in your tax package for details.

Telephone help for hearing-impaired persons. If you have access to TDD equipment, you can call **1–800–829–4050** with your tax questions or to order forms and publications. See your tax package for the hours of operation.

Note: All references to ''section'' in the following discussions are to sections of the Internal Revenue Code (IRC), unless otherwise indicated.

Tax Benefits of SEP and Keogh Plans

Terms you may need to know (see Glossary):

Common-law employee
Contribution
Deduction
Employee
Self-employed individual
Sole proprietor

A *deduction* for *contributions* to a retirement plan and deferral of tax on income of the plan are benefits that apply to each *self-employed individual* (see *Glossary*) who has a SEP or Keogh plan.

If you are self-employed, you can take an income tax deduction for certain contributions you make for yourself to the plan. You can also deduct trustee's fees if contributions to the plan do not cover them. Deductible contributions plus the plan's earnings on them stay tax free until you receive distributions from the plan in later years. If you are a *sole proprietor,* you can deduct contributions you make for your *common-law employees* (see *Glossary*) as well as contributions you make for yourself. A common-law employee cannot deduct contributions you make.

Simplified Employee Pension (SEP)

Terms you may need to know (see Glossary):

Annual addition
Annual benefit
Business
Common-law employee
Compensation
Contribution
Deduction
Earned income
Employee
Employer
Partner
Self-employed individual
Sole proprietor

A simplified employee pension (SEP) is a written plan that allows you to make contributions toward your own (if you are a self-employed individual) and your employees' retirement without getting involved in the more complex Keogh plan. *But some advantages available to Keogh plans, such as the special treatment*

Form **5305-SEP**
(Rev. March 1994)
Department of the Treasury
Internal Revenue Service

Simplified Employee Pension-Individual Retirement Accounts Contribution Agreement

(Under section 408(k) of the Internal Revenue Code)

OMB No. 1545-0499
Expires 2-28-97

DO NOT File with the Internal Revenue Service

______________________________ makes the following agreement under section 408(k) of the
(Name of employer)
Internal Revenue Code and the instructions to this form.

Article I—Eligibility Requirements (Check appropriate boxes—see **Specific Instructions.**)

The employer agrees to provide for discretionary contributions in each calendar year to the individual retirement account or individual retirement annuity (IRA) of all employees who are at least ______ years old (not to exceed 21 years old) and have performed services for the employer in at least ______ years (not to exceed 3 years) of the immediately preceding 5 years. This simplified employee pension (SEP) ☐ includes ☐ does not include employees covered under a collective bargaining agreement, ☐ includes ☐ does not include certain nonresident aliens, and ☐ includes ☐ does not include employees whose total compensation during the year is less than $396*.

Article II—SEP Requirements (See **Specific Instructions.**)

The employer agrees that contributions made on behalf of each eligible employee will be:

A. Based only on the first $150,000 of compensation.
B. Made in an amount that is the same percentage of total compensation for every employee.
C. Limited annually to the smaller of $30,000* or 15% of compensation.
D. Paid to the employee's IRA trustee, custodian, or insurance company (for an annuity contract).

______________________________ ______________________________
Employer's signature and date | Name and title

that may apply to Keogh plan lump-sum distributions, do not apply to SEPs.

Under a SEP, you make the contributions to an individual retirement arrangement (called a SEP-IRA in this publication), which is owned by you or one of your common-law employees.

SEP-IRAs are set up for, at a minimum, each *qualifying employee* (defined below). A SEP-IRA may have to be set up for a *leased employee* (defined below), but need not be set up for *excludable employees* (defined below). If the employee cannot be located or is unwilling to execute the necessary set-up documents (SEP agreement and IRA trust), you can execute them for him or her.

You may be able to use **Form 5305–SEP** in setting up your SEP.

This form may ***not*** be used by an employer who:

- Currently maintains any other qualified retirement plan. This does not prevent you from also maintaining a Model Elective SEP (Form 5305A–SEP) or other SEP to which either elective or nonelective contributions are made.
- Has maintained in the past a defined benefit plan, even if now terminated.
- Has any eligible employees for whom IRAs have not been established.
- Uses the services of *leased employees* (as described later).
- Is a member of an affiliated service group (as described in section 414(m) of the Internal Revenue Code), 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 such groups, trades, or businesses participate under the SEP.
- Does not pay the cost of the SEP contributions. Do not use Form 5305–SEP for a SEP that provides for employee-elected contributions even if the contributions are made under a salary reduction agreement. Use Form 5305A–SEP, or a nonmodel SEP if you want to permit elective deferrals to a SEP.

Many financial institutions will assist you in setting up a SEP.

You can set up and contribute to a SEP-IRA for a year as late as the due date (plus extensions) of your income tax return for that year. Contributions must be in the form of money (cash, check, or money order). You cannot contribute property. However, you 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 below). When you contribute, you must contribute to the SEP-IRAs of all qualifying employees who actually performed personal services during the year for which the contributions are made, even if the employee dies or terminates 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. Contributions generally are not subject to federal income, social security, Medicare, or unemployment taxes.

Partnership. A partnership can have a SEP.

Definitions

The term *self-employed individual* is defined in the glossary. For SEP purposes, he or she is an employee as well as the employer. The self-employed individual can have a SEP-IRA.

A qualifying employee is an individual who:

1) Reached the age of 21 years,
2) Worked for you in at least 3 of the immediately preceding 5 years, and
3) Received at least $400 in compensation from you for 1995.

Note. You can establish less restrictive participation requirements for employees than those listed, but not more restrictive ones.

Leased employees. If you have leased employees who are treated as your employees and meet the above participation requirements, you must include these employees in your SEP. You have a leased employee if a person who is not your employee is hired by a leasing organization and provides employee services to you of the type historically performed by employees in your business field. These services must be provided by that person on a substantially full-time basis for at least a year under an agreement between you and the leasing organization.

To determine whether any leased employee must be treated as your employee, see *Keogh Plan Qualification Rules,* later.

Excludable employees. The following employees need not be covered under a SEP:

1) Employees who are covered by a union agreement and whose retirement benefits were bargained for in good faith by their union and you, and
2) Nonresident alien employees who have no U.S.-source earned income from you.

A highly compensated employee is an employee who during the current or preceding year:

- Owned more than 5% of the capital or profits interest in your business; or
- Received annual compensation from you of more than $100,000; or
- Received annual compensation from you of more than $66,000 and was among the top 20% most highly paid employees during the year, or
- An individual who was at any time an officer and received compensation of more than $60,000.

Contribution Limits

Contributions you make for a year to a common-law employee's SEP-IRA cannot exceed the smaller of 15% of the employee's ***compensation*** (see *Glossary*) or $30,000. Compensation, for this purpose, does not include employer contributions to the SEP.

Annual compensation limit. You generally cannot consider the part of compensation of an employee that is over $150,000 when figuring your contributions limit for that employee. The maximum contribution amount for you or for employees for which the $150,000 limit applies is $22,500.

Note. For employees in a collective bargaining unit covered by a SEP for which the $150,000 limit is not effective, the compensation limit is $245,000.

More than one plan. If you also contribute to a defined contribution retirement plan, annual additions to an account are limited to the lesser of (1) $30,000 or (2) 25% of the participant's compensation. When you figure these limits, your contributions to more than one such plan must be added. Since a SEP is considered a defined contribution plan for purposes of these limits, your contributions to a SEP must be added to your contributions to defined contribution plans.

Reporting on Form W–2. Do not include SEP contributions on Form W–2, Wage and Tax Statement, unless there are contributions over the limit that applies or there are contributions under a salary reduction arrangement as discussed later.

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. Also see *Deduction of Contributions for Yourself,* later.

Tax treatment of excess contributions. If the amount you contribute to an employee's SEP-IRA (or to your own SEP-IRA) for a year exceeds the smaller of 15% (or, for you, 13.0435% of your net earnings from self-employment) of the employee's compensation or $30,000, the excess is included in the employee's income for the year and is treated as a contribution by the employee to his or her SEP-IRA. As a result, the annual limit on contributions the employee can make to an IRA (generally, the smaller of $2,000 or the employee's compensation), which also applies to the employee's own contributions to a SEP-IRA, may have been exceeded. In that case, the employee would be subject to a 6% excise tax on the excess unless the employee withdraws it (and any net income earned on the excess) by the due date (including extensions) for filing his or her income tax return for that year and did not take a deduction for the excess.

The employee's IRA deduction may be limited because of coverage by an employer plan (including the SEP).

When To Make Contributions

To take a deduction for contributions for a particular year, you must make the contributions by the due date (plus extensions) of your income tax return for that year.

Deduction Limits

The most you can deduct for employer contributions for common-law employees is 15% of the *compensation* (see *Glossary*) paid to them during the year from the business that has the plan.

Deduction of Contributions for Yourself

When figuring the deduction for employer contributions made to your own SEP-IRA, *compensation* is your *net earnings from self-employment* (see *Glossary*), which takes into account:

1) The deduction allowed to you for one-half of the self-employment tax, and
2) The deduction for contributions on behalf of yourself to the plan.

The deduction amount for (2) and your compensation (net earnings) are each dependent on the other. For this reason, the deduction amount for (2) is determined indirectly by reducing the contribution rate called for in your plan. This is done by using the *Rate Table for Self-Employed* that follows or by using the *Rate Worksheet for Self-Employed,* later.

Rate table for self-employed. If your plan's contribution rate for allocating employer contributions to employees is a whole number (for example, 12% rather than 12½%), you can use the following table to find the rate that applies to you. Otherwise, you can figure your rate using the 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. This is the rate to be applied for you as shown in *Example 1,* later.

Rate Table for Self-Employed

Column A If the Plan Contribution Allocation Rate is: (shown as a %)	Column B Your Rate is: (shown as a 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 or profit-sharing plan cannot exceed 13.0435% of your compensation (figured without deducting contributions for yourself) from the business that has the plan.

Note. The rates in the above 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 is treated as a profit-sharing plan.

Example 1. You are a sole proprietor and have employees. If your plan's contribution rate for allocating contributions is 10% of a participant's compensation, your rate is 0.090909. Enter this rate in step 1 under *Figuring your deduction,* later.

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 *Rate Worksheet for Self-Employed* that follows.

Rate Worksheet for Self-Employed

1) Plan contribution rate as a decimal (for example, 10½% would be 0.105)	
2) Rate in line 1 plus one (for example, 0.105 plus one would be 1.105)	
3) Self-employed rate as a decimal (divide line 1 by line 2)	

Figuring your deduction. Now that you have your self-employed rate, you can figure your maximum deduction for contributions for yourself by completing the following steps:

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 from line 3, Schedule C–EZ (Form 1040), line 31, Schedule C (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 25, 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 $150,000 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 27, Form 1040	$

Example 2. 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 common-law employees' compensation. Your net earnings from line 31, Schedule C (Form 1040) are $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). This net earnings amount is now reduced to $193,527 by subtracting your self-employment tax deduction of $6,473 (see Table 2). You figure your self-employed rate and maximum deduction for employer contributions on behalf of yourself as follows:

Rate Worksheet for Self-Employed

1) Plan contribution rate as a decimal (for example, 10½% would be 0.105)	0.105
2) Rate in line 1 plus one (for example, 0.105 plus one would be 1.105)	1.105
3) Self-employed rate as a decimal (divide line 1 by 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 from line 3, Schedule C–EZ (Form 1040), line 31, Schedule C (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 25, Form 1040	$ 6,473
Step 4 Subtract step 3 from step 2 and enter the result	$ 193,527
Step 5 Multiply step 4 by step 1 and enter the result	$ 18,385
Step 6 Multiply $150,000 by your plan contribution rate. Enter the result but not more than $30,000	$ 15,750
Step 7 Enter the smaller of step 5 or step 6. This is your ***maximum deductible contribution.*** Enter your deduction on line 27, Form 1040.	$ 15,750

Multiple Plan Limits

For purposes of the deduction limits, treat all of your qualified ***defined contribution plans*** (defined later) as a single plan, and treat all of your qualified ***defined benefit plans*** (defined later) as a single plan. If you have both kinds of plans, a SEP is treated as a separate profit-sharing (defined contribution) plan. See the definitions for defined contribution and defined benefit plans in *Kinds of Plans* under *Keogh Plans,* later. A ''qualified'' plan is a plan that meets certain requirements. See *Keogh Plan Qualification Rules,* later.

SEP and profit-sharing plans. If you also contributed 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.

SEP, defined contribution, and defined benefit plans. If you contribute to one or more defined contribution plans (including a SEP) and one or more defined benefit plans, special deduction limits may apply. For more information about the special deduction limits, see *Deducting contributions to combination of plans* under *Keogh Plans,* later.

Carryover of excess contributions. If you made 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 exceed the deduction limit for that year.

Excise tax. If you made nondeductible (excess) contributions to a SEP, you may be subject to a 10% excise tax. To figure and report the excise tax, see *Excise Tax for Nondeductible (Excess) Contributions* and *Carryover of Excess Contributions* under *Keogh Plans,* later.

Where to Deduct on Form 1040

Deduct contributions for yourself on line 27 of Form 1040. You deduct contributions for your common-law employees on Schedule C (Form 1040), on Schedule F (Form 1040), 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 them by entering the amount on line 27 of Form 1040.

Salary Reduction Arrangement

A SEP can include a salary reduction arrangement. Under this arrangement, your employees can elect 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 may be able to use Form 5305A–SEP to set up this

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; and Schedule K-1 (Form 1065), line 15a (other than farming). 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: • $61,200 or less, multiply line 4 by 15.3% (.153). Enter the result here and on **Form 1040, line 47.** • More than $61,200, multiply line 4 by 2.9% (.029). Then, add $7,588.80 to the result. Enter the total here and on **Form 1040, line 47.**	5	12,945
6	**Deduction for one-half of self-employment tax.** Multiply line 5 by 50% (.5). Enter the result here and on **Form 1040, line 25** . . . 6	6,473		

For Paperwork Reduction Act Notice, see Form 1040 instructions. Cat. No. 11358Z Schedule SE (Form 1040) 1995

Portion of Form 1040

Adjustments to Income

23a	Your IRA deduction (see page 19)	23a			
b	Spouse's IRA deduction (see page 19)	23b			
24	Moving expenses. Attach Form 3903 or 3903-F	24			
25	One-half of self-employment tax	25	6,473		
26	Self-employed health insurance deduction (see page 21)	26			
27	Keogh & self-employed SEP plans. If SEP, check ▶ ☐	27	15,750		
28	Penalty on early withdrawal of savings	28			
29	Alimony paid. Recipient's SSN ▶	29			
30	Add lines 23a through 29. These are your **total adjustments** ▶			30	22,223

type of SEP. Many qualified financial institutions can assist you in setting up such an arrangement.

Restrictions. This arrangement is available only if:

1) At least 50% of your employees eligible to participate choose the salary reduction arrangement,
2) You have no more than 25 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, and
3) The amount deferred each year by each ***highly compensated employee*** as a percentage of pay (the deferral percentage) is no more than 125% of the average deferral percentage (ADP) of all nonhighly compensated employees eligible to participate ***(the ADP test).***

A salary reduction arrangement is not available for a SEP maintained by a state or local government, or any of their political subdivisions, agencies, or instrumentalities, or to a tax-exempt organization.

Limits on elective deferrals. The most compensation a participant can elect to defer for the calendar year 1995 is the smaller of:

- 15% of the participant's compensation; or
- $9,240

If the employee also participates in a tax-sheltered annuity plan (section 403(b) plan), total deferrals cannot exceed $9,500.

Employee compensation defined. Generally, for a plan participant other than a self-employed individual, compensation is his or her pay from the employer.

Self-employed individuals. If you are self-employed (a sole proprietor or a partner), ***compensation*** is your net earnings from your trade or business (provided your personal services are a material income-producing factor), taking into account your deduction for contributions on your behalf to employer retirement plans and the deduction allowed for one-half of your self-employment tax.

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

Disabled participants. You may be able to elect to use special rules to determine compensation for a participant who is permanently and totally disabled. See Internal Revenue Code section 415(c)(3)(C), which provides that the participant's compensation means the compensation the participant would have received if paid at the rate of compensation paid before becoming permanently and totally disabled.

Tax treatment of deferrals. You can deduct your deferrals that when added to your other SEP contributions are not more than the limits under *Deduction Limits,* earlier. Deferrals not more then the average deferral percentage (ADP) test limit (see item 3 under *Restrictions* above) under an elective deferral arrangement are excluded from the employee's 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 purposes.

Reporting on Form W–2. Any SEP contributions relating to your employee's wages under a salary reduction arrangement are included in the Form W–2 wages for social security and Medicare tax purposes only.

Example. In 1995 Jim chose to have his pay reduced by $4,500 and to have that amount contributed by his employer to a SEP-IRA under a salary reduction arrangement. His salary for the year is $30,000. On Jim's Form W–2, the employer will show total wages of $25,500 ($30,000 minus $4,500), social security wages of $30,000, and Medicare wages of $30,000. Jim will report $25,500 as wages on his individual income tax return.

Excess deferrals. The treatment of excess deferrals made under a SEP plan is similar to the treatment of excess deferrals made under a Keogh plan. See *Treatment of Excess Deferrals* under *Keogh Plans,* later.

Overall Limits on SEP Contributions

Contributions you make to a common-law employee's SEP-IRA, *including elective deferrals,* are subject to the SEP limits discussed earlier. These limits also apply to contributions you make to your own SEP-IRA. See *Contribution Limits,* earlier.

Distributions (Withdrawals)

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

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

Additional Taxes

Additional taxes may apply to SEP-IRA premature distributions, excess accumulations, or excess distributions. For information about these taxes, see chapter 7, *What Acts Result in Penalties?,* in Publication 590. Also, a SEP-IRA account may be disqualified, or an excise tax may apply, if the account is involved in a prohibited transaction, discussed next.

Prohibited transaction. If an owner improperly uses his or her SEP-IRA, such as by borrowing money from it, the owner 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 *Keogh Plans,* later.

Effect on owner. 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 owner of that SEP-IRA on the first day of the year in which the transaction occurred. The owner must include in income the excess of the assets' fair market value (on the first day of the year) over any cost basis in the account. Also, the owner may have to pay the additional tax on premature distributions.

Reporting and Disclosure Requirements

If you set up a SEP using **Form 5305–SEP,** or **Form 5305A–SEP,** you can satisfy the Internal Revenue Code reporting and disclosure requirements by giving each employee a copy of the completed agreement form (including its questions and answers) and a statement each year showing any contributions to the employee's SEP-IRA. If you set up a salary reduction SEP, you must also provide a notice of any excess contributions.

If you do not use Form 5305–SEP (or Form 5305A–SEP if it applies) to set up your SEP, you must give your employees general information about a SEP. The information must satisfy the Internal Revenue Code reporting and disclosure requirements. For guidance, see the preceding paragraph.

Keogh Plans

Terms you may need to know (see Glossary):

Annual addition
Annual benefit
Business
Common-law employee
Compensation
Contribution
Deduction
Earned income
Employee
Employer
Master plan
Net earnings from self-employment
Partner
Self-employed individual
Sole proprietor

A qualified employer plan set up by a self-employed person is generally referred to as a Keogh or HR–10 plan. Only a sole proprietor or a partnership can establish a Keogh plan. A common-law employee or a partner cannot. See the glossary definitions for more information.

The plan must be for the exclusive benefit of employees or their beneficiaries. A Keogh plan ***includes coverage for a self-employed individual.*** For Keogh plan purposes, a self-employed individual is both an employer and an employee.

As an employer, you can usually deduct, subject to limits, contributions you make to a Keogh 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.

Figure 1. **Setting Up A Keogh Plan**

To set up a Keogh plan, you can:

Adopt an IRS-approved prototype or master plan offered by a sponsoring organization

or

Prepare and adopt a written plan that satisfies the qualification requirements of the Internal Revenue Code

Then you must:

Establish a trust or custodial account for investment of funds

or

Buy an annuity contract or face amount certificates from an insurance company

Setting Up a Keogh Plan

If you are self-employed, it is not necessary to have employees besides yourself to sponsor and set up a Keogh plan. If you have employees, you must allow them to participate in the plan if they meet the ***minimum participation requirements*** (or the requirements of your plan, if more lenient).

You, the employer, are responsible for establishing and maintaining the plan.

Minimum participation requirements. An employee must be allowed to participate in your plan if he or she:

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

Note. A plan cannot exclude an employee because he or she has reached a specified age older than age 21.

Written plan requirement. To qualify, the plan you establish 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 Keogh plans follow a standard form of plan (a master or prototype plan) approved by the IRS. You can adopt an approved master or prototype plan offered by an organization that provides such plans.

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, and
- Mutual funds.

Nonstandard 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 assistance for this. A reading of Revenue Procedure 95–6 may help you decide whether to apply for approval of your plan. It is available at most IRS offices and at some libraries.

Investing plan assets. In setting up a Keogh 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 establish a trust by a legal instrument (written document). You may need professional assistance to do this.

You can establish 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.

Other plan requirements. For information on other important plan requirements, see *Keogh Plan Qualification Rules,* 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).

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

Kinds of Plans

There are two basic kinds of Keogh plans, ***defined contribution plans*** and ***defined benefit plans***, and different rules apply to each. You can have more than one Keogh plan, but your contributions to all the plans must not exceed 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 and losses, and any forfeitures of other accounts that may be allocated to an account. A defined contribution plan can be either a profit-sharing or a money purchase pension plan.

Profit-sharing plan. A profit-sharing plan is a plan for sharing employer profits with the firm's employees. However, an employer does not have to make contributions for common-law employees out of net profits to have a profit-sharing plan.

The plan need not 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 prior 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 employer contributions.

Stock bonus plan. This plan is similar to a profit-sharing plan, but it can only be set up by a corporation. Benefits are payable in the form of the company's stock.

Money purchase pension plan. A money purchase pension plan has contributions that are fixed and are not based on the employer's profits. For example, if the plan requires that contributions be 10% of the participants' compensation, without regard to whether the self-employed person has earned income (or the amount of earned income), the plan is a money purchase pension plan. This applies even though the compensation of the 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 a computation of what contributions are needed to provide definitely determinable benefits to plan participants. Actuarial assumptions and computations are required to figure these contributions. You may 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.

Minimum Funding Requirements

In general, if your Keogh 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 determination is based on what should be contributed under the plan formula using actuarial assumptions and formulas. For information on this funding requirement, see Internal Revenue Code Section 412 and the regulations under that section. (Most libraries have the Internal Revenue Code.) The minimum funding requirements ***do not apply to profit-sharing plans.***

Quarterly installments of required contributions. If your Keogh 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 eight and one-half months after the end of that year.

Contributions

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

Self-employed individual. You can make contributions for yourself ***only if*** you have net earnings (compensation) from self-employment in the trade or business for which the plan was established. Consequently, 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. Also, your net earnings must be from your personal services, not merely from your investment.

Table 4. **Key Retirement Plan Rules**

Type of Plan	Last Date for Contribution	Maximum Contribution	When To Begin Distributions[1]
IRA	Due date of IRA owner's income tax return (NOT including extensions)	Smaller of $2,000 or taxable compensation	April 1 of year after year IRA owner reaches age 70½
SEP-–IRA	Due date of employer's return (Plus extensions)	Smaller of $30,000 or 15%[2] of participant's taxable compensation[3]	April 1 of year after year participant reaches age 70½
Keogh	Due date of employer's return (plus extensions).[4]	**Defined Contribution Plans** **Employee** ***Money Purchase***–Smaller of $30,000 or 25% of employee's taxable compensation ***Profit-Sharing***–Smaller of $30,000 or 15% of employee's taxable compensation **Self-Employed Individual** ***Money Purchase***–Smaller of $30,000 or 20% of self-employed participant's taxable compensation[5] ***Profit-Sharing***–Smaller of $30,000 or 13.0435% of self-employed participant's taxable compensation[5] **Defined Benefit Plans** Amount needed to provide an annual retirement benefit no larger than the smaller of $120,000 or 100% of the participant's average taxable compensation for his or her highest 3 consecutive years	Generally April 1 of year after year participant reaches age 70½[6]

[1] Distributions of at least the required minimum amount must be made each year if the entire balance is not distributed.
[2] 13.0435% of the self-employed participant's taxable compensation before adjustment for this contribution.
[3] Contributions are made to each participant's IRA (SEP-IRA) including that of any self-employed participant.
[4] To make contributions for a year to a new plan, the employer must set up the plan by the end of the employer's tax year.
[5] Compensation is before adjustment for this contribution.
[6] If the participant reached age 70½ before 1988, distributions must begin by the year he or she retires.

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 Keogh plan is a defined contribution plan or a defined benefit plan.

Defined benefit plan. For 1995 the annual ***benefit*** for a participant under a defined benefit plan may not be more than the **smaller** of:

1) $120,000, or
2) 100% of the participant's average compensation for his or her highest 3 consecutive calendar years.

Defined contribution plan. A defined contribution plan's annual ***contributions*** and other additions (excluding earnings) to the account of a participant cannot exceed the **smaller** of:

1) $30,000, or
2) 25% of the participant's compensation.

The maximum compensation that can be taken into account for this limit is generally $150,000.

Note. For employees in a collective bargaining unit covered by a plan for which the $150,000 limit is not effective for the plan year beginning in 1995, the compensation limit is $245,000.

Amounts contributed in excess of these limits (excess annual additions). A plan can correct excess annual additions because of:

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

Correcting excess annual additions. A plan can provide for the correction of excess contributions 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; or, if these limits are exceeded,
2) Hold the excess in a separate account and allocate (and reallocate) it to participants' accounts in the subsequent year (or years) before making any contributions for that subsequent year (see also *Carryover of Excess Contributions,* later); or
3) 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 premature (early) distributions and excess distributions do not apply.

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

- Report a return of employee contributions in boxes 1 and 5. If the disbursement includes any gain from the contribution, report it in box 2a. 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 the employer contributions. Even though these employee contributions are not deductible, the earnings on them are tax free until distributed in later years. But see *Excise Tax for Nondeductible (Excess) Contributions,* later. Also, these contributions must satisfy the nondiscrimination test of section 401(m) of the Internal Revenue Code.

When Contributions Are Considered Made

You generally apply your Keogh plan contributions to the year in which you make them. But you can apply them to the previous year if:

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; and
4) Either—
   - You specify in writing to the plan administrator or trustee that the contributions apply to the previous year; or
   - 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 for purposes of the Keogh deduction. Also, issuing this note is a prohibited transaction subject to tax. See *Prohibited Transactions,* later.

Employer Deduction

Only self-employed persons can deduct contributions to a Keogh plan.

Contributions that must be capitalized. You cannot deduct employer contributions to Keogh plans (or any other expense) that you must capitalize (include in the basis of certain property or in the costs of inventory). For more information, see section 263A of the Internal Revenue Code and the related regulations.

Deduction Limits

The limit on your deduction for your contributions to a Keogh 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 from the business paid (or accrued) during the year to the common-law employees participating in the plan. You must reduce this 15% limit in figuring the deduction for contributions you make for your own account. See *Deducting Contributions for Yourself,* later.

Money purchase pension plan. Your deduction for contributions to a money purchase pension plan is limited to ***25%*** of the compensation from the business paid (or accrued) during the year to participating common-law 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.

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

Deducting contributions to combination of plans. If you contribute to both defined contribution plans and defined benefit plans and at least one employee is covered by both plans, your deduction for those contributions is limited. Your deduction cannot exceed the ***greater*** of:

- 25% of the participating employees' compensation for the year, or
- Your contributions to the defined benefit plans, but not more than the amount needed to meet the year's minimum funding standard for any such plans.

For purposes of this rule, a Simplified Employee Pension (SEP) plan is treated as a separate profit-sharing (defined contribution) plan.

Deducting Contributions for Yourself

When figuring the deduction for contributions made for yourself, compensation is your net earnings from self-employment which takes into account:

1) The deduction allowed to you for one-half of the self-employment tax, and
2) The deduction for contributions on behalf of yourself to the plan.

The deduction amount for (2) above is determined indirectly by using a *self-employed person's contribution rate.* See *Deduction of Contributions for Yourself,* earlier, in the Simplified Employee Pension (SEP) section.

Combination of plans. The combined deduction of contributions to a combination of plans also applies to contributions you make as an employer on your own behalf. See *Deducting contributions to combination of plans,* earlier.

Where to Deduct on Form 1040

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

Take the deduction for contributions for yourself on line 27 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 by entering the amount on line 27 of Form 1040.

Carryover of Excess Contributions

If you contribute more into the plans than you can deduct for the year, you can carry over and deduct the excess in later years, combined with your deduction 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. Remember that these percentage limits must be reduced to figure your maximum deduction for contributions you make for yourself. See *Deducting Contributions for Yourself,* earlier. The excess you carry over and deduct may be subject to the excise tax discussed next.

Excise Tax for Nondeductible (Excess) Contributions

If you made contributions 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 can apply to nondeductible contributions made to qualified pension, profit-sharing, stock bonus, or annuity plans, and to simplified employee pension plans (SEPs).

Exception. The 10% excise tax does not apply to any contribution 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 excess is treated as a deductible contribution, which is not subject to this excise tax. See *Minimum Funding Requirements* earlier in this section.

Reporting the tax. You must report the tax on your nondeductible contributions on Form 5330. Form 5330 includes a computation of

Table 5. **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 deductible including carryovers	Excess contribution carryover available at end of year
1992........	$1,000	$100	$150	$100	$ 0	$100	$ 0
1993........	400	125	60	125	0	60	65
1994........	500	50	75	50	25	75	40
1995........	600	100	90	100	0	90	50

* There were no carryovers from years before 1992.

the tax. See the separate instructions for completing the form.

Elective Deferrals (401(k) Plans)

Your Keogh plan can include a cash or deferred arrangement (401(k) plan) under which eligible employees can elect to have you contribute part of their before-tax pay to the plan rather than receive the pay in cash. (As a participant in the plan, you can contribute part of your before-tax net earnings from the business.) This amount, called an ***elective deferral*** (and any earnings on it), remains tax free until it is distributed by the plan.

In general, a Keogh plan can include a 401(k) plan only if the Keogh is:

A profit-sharing plan, or

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

As discussed earlier, you can also include a similar arrangement under a SEP plan. See *Salary Reduction Arrangement* in the SEP section.

Restriction on conditions of participation. The plan may not require, as a condition of participation, that an employee complete a period of service beyond the later of age 21 or the completion of one year of service.

Matching contributions. If your plan permits, you can make additional (matching) contributions for an employee on account of the contributions on behalf of the employee under the deferral election just discussed. For example, the plan might provide that you will contribute 50 cents for each dollar your participating employees elect 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.

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

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 may not defer more than the limit that applies for a particular year. For 1995 the basic limit on elective deferrals is ***$9,240.*** 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. If contributions are also made to a tax-sheltered annuity (403(b) plan), the limit is increased to $9,500.

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 purposes.

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, *Wage and Tax Statement.* See the Form W–2 instructions.

Treatment of Excess Deferrals

If the total of an employee's deferrals exceeds the limit for 1995, the employee can have the excess deferral paid out of any of the plans that permit these distributions. He or she must tell each plan by March 1, 1996, the amount to be paid from that particular plan. The plan must then pay the employee that amount by April 15, 1996.

Excess withdrawn by April 15. If the employee takes out the excess deferral by April 15, 1996, it is not reported again by including it in the employee's gross income for 1996. 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 premature (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.

Excess not withdrawn by April 15. If the employee does not take out the excess deferral by April 15, the excess, though taxable in 1995, 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 to your plan and you allow the excess deferral to stay in the plan, the plan may not be a qualified plan.

Even if the employee takes out the excess deferral by April 15, the amount is considered contributed for purposes of satisfying (or not satisfying) the nondiscrimination requirements of your plan. See *Contributions or benefits must not discriminate* later, under *Keogh Plan Qualification Rules.*

Tax on certain excess deferrals. The law provides tests to detect discrimination in a plan. If tests, such as the *deferral percentage test* (see section 401(k)(8)(B) (or 408(k)(6)(C) in the case of salary reduction SEPs)) and the *contribution percentage test* (see section 401(m)(6)(B)) show that contributions for highly compensated employees exceed the test limits for such contributions, you may have to pay a ***10% excise tax.*** Report the tax on Form 5330.

The tax for the year is equal to 10% of the sum of the following for the plan year ending in your tax year:

1) Any *excess contributions* (matching contributions, employee contributions, and any qualified nonelective or elective contributions) determined under the deferral percentage test that applies, and

2) Any *excess total contributions* (matching contributions, employee contributions, and any qualified nonelective or elective contributions taken into account) determined under the contribution percentage test.

Distributions

Amounts paid to you or other plan participants from your Keogh plan are distributions. Distributions may be nonperiodic, such as a lump-sum distribution, or periodic, such as annuity payments. Also, certain loans may be treated as distributions. See *Loans Treated as Distributions* in Publication 575, *Pension and Annuity Income (Including Simplified General Rule).*

Required Distributions

Your Keogh plan must provide that each participant will either:

1) Receive his or her entire interest in the plan by the ***required beginning date*** (defined below), ***or***

2) Begin receiving regular periodic distributions by the required beginning date in annual amounts calculated to distribute the participant's entire interest over his or her life expectancy or over the joint life expectancy of the participant and the designated beneficiary. This is your required ***minimum distribution.*** Regular periodic distributions can be paid out over a shorter period and in larger amounts, but they cannot be paid out over a longer period in smaller amounts. Minimum distributions must meet the ***minimum distribution incidental benefit*** requirement. For more information about this and other distribution requirements, get Publication 575.

The minimum distribution rules apply individually to each Keogh 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.

Required beginning date. Generally, each participant must begin to receive distributions of benefits from the plan by April 1 of the year following the calendar year in which the participant reaches age 70½. However, if the participant reached that age before 1988, generally he or she need not begin receiving distributions until April 1 following the calendar year in which he or she retires.

Distributions From 401(k) Plans

Generally, a distribution may not be made until the employee:

Retires

Dies,

Becomes disabled, or

Otherwise separates from service.

Also, a distribution may be made if the plan ends without establishing a successor plan. In the case of a 401(k) plan that is part of a profit-sharing plan, a distribution may be made if the employee reaches age 59½ or suffers financial hardship.

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

Hardship distribution. For the rules on hardship distributions, including the limits on them, see Treasury Regulation 1.401(k)–1(d)(2).

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. QDRO is defined in Publication 575.

Tax Treatment of Distributions

Distributions from your Keogh 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 the distributions depends on whether they are made periodically over several years or life (***periodic payments***), or are ***nonperiodic distributions.*** See *Taxation of Periodic Payments* or *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 gains treatment of a ***lump-sum distribution***.

Rollover

The recipient of an *eligible rollover distribution* from a Keogh 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. For more information about rollovers, see *Rollovers* in Publications 575 and 590.

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 (such as a Keogh plan) that *is not:*

- A required 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.
- The portion of a distribution that represents the return of an employee's nondeductible contributions to the plan. See *Employee Contributions,* earlier.
- A distribution such as a return of excess contributions or deferrals under a 401(k) plan. See *Correcting excess annual additions,* earlier, under *Limits on Contributions and Benefits.*

Withholding Requirements

If, during a year, your Keogh plan pays to a participant one or more *eligible rollover distributions* (defined in the preceding discussion) that are reasonably expected to total more than $200, 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.

Or, if the participant receives a *distribution that is not eligible for rollover treatment* (see the list of these distributions excluded from the definition of an *eligible rollover distribution,* earlier), the 20% withholding requirement does not apply. Other withholding rules apply to these excluded distributions, such as long-term ***periodic*** distributions and required distributions (periodic or ***nonperiodic***). However, you can still choose not to have tax withheld from these distributions. If you do not make this choice, the following withholding rules apply:

For these distributions that are ***periodic,*** withholding is based on their treatment as wages, and

For these distributions that are ***nonperiodic,*** 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 Premature (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 premature 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 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).*** (QDRO is defined in Publication 575.)

- 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 this 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 exceed 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.

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.

5% owner. For purposes of this tax, you are a 5% owner if you own more than 5% of the capital or profits interest in 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 54, any tax you owe for an excess benefit. On the dotted line next to the total, write ''Section 72(m)(5)'' and write in the amount.

Other Taxes

In addition to the taxes just discussed, other taxes may be imposed on the participant for receiving ***excess distributions*** or for not having the required minimum amount distributed to him or her (***Excess accumulation***). For information about these, see *Tax on Excess Distributions,* and *Tax on Excess Accumulation* 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 the Form 5330 instructions for more information.

Prohibited Transactions

Certain transactions (listed below) between the plan and a ***disqualified person*** generally are prohibited. (However, see *Exemptions,* later.) An excise tax is charged on these transactions. If you are a disqualified person who takes part in a prohibited transaction, you must pay the tax.

Disqualified person. You are a disqualified person if you are:

1) The employer of participants in the plan,
2) A 10% (or more) partner in a partnership having the plan, or
3) A fiduciary of the plan.

Disqualified persons also include:

1) Highly compensated employees (earning 10% or more of the employer's yearly wages),
2) Employee organizations, any of whose members are covered by the plan, and
3) Persons providing services to the plan.

Related disqualified persons. If you are a disqualified person, the following are also disqualified persons:

1) Members of your family (spouse, ancestors, direct descendants, and any spouse of a direct descendant),
2) Corporations, partnerships, trusts, or estates in which you own, directly or indirectly, at least half the:
   - Total voting stock or the value of all stock of the corporation,
   - Capital interest or profit interest of the partnership, or
   - Beneficial interest of the trust or estate,

Prohibited transactions generally include:

1) A transfer of plan income or assets to, or use of them by or for the benefit of, a disqualified person;
2) Dealing with plan income or assets by a fiduciary in his or her own interest;
3) The receiving of consideration by a fiduciary for his or her own account from a party that is dealing with the plan in a transaction that involves plan income or assets; or
4) Any of the following acts between the plan and a disqualified person:
   - Selling, exchanging, or leasing property,
   - Lending money, extending credit, or
   - Furnishing goods, services, or facilities.

Loans to owner-employee. A loan from a Keogh plan to a self-employed individual also may be a ***prohibited transaction***.

Exemptions. 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.

Other transactions also are exempt from being treated as prohibited transactions. See section 4975 of the Internal Revenue Code and its underlying regulations.

Tax on Prohibited Transactions

The tax on a prohibited transaction is *5%* 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. 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 money and fair market value of any property given, or
- The money and fair market value of any property received.

Services. 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:

- The day IRS mails a notice of deficiency for the tax,
- The day IRS assesses the tax, or
- The day you finish correcting the transaction.

Payment of the 5% tax. Pay the 5% tax with Form 5330.

Correcting prohibited transactions. If you are a disqualified person who participated in a prohibited transaction, you can minimize the tax by correcting it as soon as possible. Correcting it 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.

100% tax for failure to correct. The 100% tax is charged if you do not correct the transaction during the taxable period. It is based on the amount involved that is figured by using the highest fair market value during the taxable period of any property given or received in the transaction.

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:

- IRS grants a reasonable time needed to correct the transaction, or

• You petition the Tax Court.

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

Reporting Requirements

As the Keogh plan administrator or the employer, you may have to file an annual return/report form by the last day of the 7th month following the end of the plan year. See the following list of forms to choose the right form for your plan.

1) ***Form 5500–EZ.*** If your plan is a one-participant pension benefit plan and meets the other four conditions listed under *Who May File Form 5500–EZ* in the form instructions, you can file Form 5500–EZ.

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

   a) The plan covers only you (or you and your spouse) and you (or you and your spouse) own the entire business. (The business may be incorporated or unincorporated.), or

   b) The plan covers only one or more partners (or partner(s) and spouse(s)) in a business partnership.

See the filled-in copy of Form 5500–EZ near the end of this publication.

You do not have to file Form 5500–EZ (or Forms 5500 or 5500–C/R), ***if*** you meet the five conditions mentioned in (1) above, ***and***

   a) You have a one-participant plan with total plan assets of $100,000 or less at the end of the plan year, ***or***

   b) You have two or more one-participant plans that together have total plan assets of $100,000 or less at the end of the plan year.

However, 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.

2) ***Form 5500–C/R.*** Unless otherwise exempted, file Form 5500–C/R if your plan has fewer than 100 participants at the start of the plan year, or if your one-participant plan does not meet the conditions outlined in the instructions for Form 5500–EZ.

3) ***Form 5500.*** If your plan has 100 or more participants at the start of the plan year, you must file Form 5500.

4) ***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 or Form 5500–C/R. Schedule A is not needed for a plan that covers only:

   • An individual or an individual and spouse who wholly own the trade or business, whether incorporated or unincorporated, or

   • Partners in a partnership or the partners and their spouses.

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

6) ***Schedule P (Form 5500),*** *Annual Return of Fiduciary of Employee Benefit Trust,* is used by a fiduciary (trustee or custodian) of a trust described in section 401(a) of the Internal Revenue Code 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 by the fiduciary satisfies the annual filing requirement, under section 6033(a), for the trust or custodial account created as part of a Keogh 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, 5500–C/R, or Form 5500–EZ for the plan year in which the trust year ends. The fiduciary cannot file Schedule P separately. Refer to the Schedule P instructions for more information.

7) ***Schedule SSA (Form 5500).*** For certain separated participants, attach Schedule SSA (Form 5500), *Annual Registration Statement Identifying Separated Participants with Deferred Vested Benefits,* to Form 5500 or Form 5500–C/R. See the instructions for Schedule SSA.

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

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

Keogh Plan Qualification Rules

To qualify for the tax benefits available to qualified plans, a Keogh 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 requirements that are subsequently 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 Keogh Plan,* earlier.

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. A qualified plan must benefit at least the fewer of 50 employees or 40% of all employees.

Contributions or benefits must not discriminate. Under the plan, contributions or benefits to be provided must not discriminate in favor of highly compensated employees. See also *Top-heavy plan requirements,* later, under *Additional Rules for Plans Covering Owner-Employees.*

Contribution and benefit limits must not be exceeded. Your plan must not provide for contributions or benefits that exceed 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 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 below, who performs services for any person (recipient of the services) is treated as an employee of the recipient of the services for certain plan qualification requirements. These requirements include:

• Nondiscrimination in coverage, contributions, and benefits,

• Minimum age and service requirements,

• Vesting,

• Limits on contributions and benefits, and

• Top-heavy plan requirements.

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

Leased employee defined. A leased employee is a person who is ***not*** the common-law employee of a recipient and who:

1) Provides services to the recipient under an agreement between the recipient and a leasing organization,

2) Has performed services for the recipient (or for the recipient and related persons) substantially full time for at least 1 year, and

3) Provides services of a type historically performed in the business field of the recipient by employees.

Safe harbor exception. A leased employee is not treated as the employee of the recipient of the services if the employee is covered by the leasing organization under its qualified pension plan and leased employees are not more than 20% of the recipient's nonhighly compensated work force. The leasing organization's plan must be a money purchase pension plan providing:

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

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

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:

1) The plan year in which the participant reaches the earlier of age 65 or the normal retirement age,
2) The plan year in which the 10th anniversary of the year in which the participant came under the plan occurs, or
3) The plan year in which the participant separated 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:

- Satisfied the ***service requirement*** for the early retirement benefit, and
- Separated 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 the form of:

1) A qualified joint and survivor annuity for a vested participant who does not die before the annuity starting date.
2) 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:

1) The participant does not choose benefits in the form of a life annuity,
2) 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, and
3) 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 preretirement 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.

Benefits not more than $3,500. A plan may provide for the immediate distribution of the present value of a qualified joint and survivor annuity or a qualified preretirement survivor annuity if the present value of the annuity is not greater than $3,500. 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 $3,500, the plan must have the written consent of the participant and spouse (or surviving spouse) for any immediate distribution of the present value of a qualified joint and survivor or preretirement survivor annuity.

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 or would have been exempt if the participant were a disqualified person.

Exception for domestic relations orders. Compliance with a judgment, decree, or order relating to child support, alimony payments, or marital property rights under a state domestic relations law that meets certain requirements (a qualified domestic relations order) does not result in a prohibited assignment or alienation of benefits.

Payments to an alternate payee under a qualified domestic relations order before the participant attains age $59\frac{1}{2}$ 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 qualified domestic relations order can be rolled over tax free to an individual retirement account or to an individual retirement annuity.

There must be 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.

Additional Rules for Plans Covering Owner-Employees

Plans that cover an owner-employee (self-employed individual, including a more than 10% partner), must meet certain additional requirements.

Plans must be combined. If an owner-employee controls, or a group of owner-employees together control, more than one trade or business, all of the plans of the controlled trades or businesses must be considered together as a single plan to determine whether they qualify. The qualification requirements include the special requirements that apply to plans benefiting owner-employees.

Control. An owner-employee, or a group of owner-employees, is considered to control a trade or business if the owner-employee, or the group together:

1) Owns the entire interest in the trade or business, or
2) For a partnership, owns more than 50% of either the capital interest or the profits interest in the partnership.

Top-heavy plan requirements. A top-heavy plan is one that mainly favors partners, self-employed persons, 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 nonkey 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 set forth in Internal Revenue Code section 416 and its underlying regulations.

Form 5500–EZ Example

John Jones is in business for himself as the J & J Repair Service. He provides radio and television repair service. His wife, Beth, also works in the business. He has no other employees. The business has a Keogh money purchase pension plan adopted in 1985 with an effective date of January 1, 1985. This is John's only pension plan.

Contributions to the pension plan for 1995 were $10,000. The income earned by the plan for 1995 was $10,500. The bank charged John's plan a $10 maintenance fee for 1995. The total assets of the plan at the end of 1995 were $162,200.

John completes and files Form 5500–EZ for 1995 as shown in the following example of a filled-in Form 5500–EZ.

Form **5500-EZ**

Department of the Treasury
Internal Revenue Service

Annual Return of One-Participant (Owners and Their Spouses) Retirement Plan

This form is required to be filed under section 6058(a) of the Internal Revenue Code.

▶ See separate instructions.

OMB No. 1545-0956

1995

This Form is Open to Public Inspection

Please type or print

For the calendar plan year 1995 or fiscal plan year beginning , 1995, and ending , 19

This return is: (i) ☐ the first return filed (ii) ☐ an amended return (iii) ☐ the final return (iv) ☐ a short plan year (less than 12 mos.)

Check here if you filed an extension of time to file and attach a copy of the approved extension ▶ ☐

Use IRS label. Otherwise, please type or print.

1a Name of employer: John Jones DBA J&J Repair Service

Number, street, and room or suite no. (If a P.O. box, see instructions for line 1a.): 1234 Second Street

City or town, state, and ZIP code: Anytown, VA 22000

1b Employer identification number: 00 1234567

1c Telephone number of employer: (518) 999-1234

1d Business activity code: 7622

1e If plan year has changed since last return, check here ▶ ☐

2a Is the employer also the plan administrator? ☐ Yes ☐ No (If "No," see instructions.)

2b (i) Name of plan ▶ J&J Repair Service Pension Plan

(ii) ☐ Check if name of plan has changed since last return

2c Date plan first became effective Month 1 Day 1 Year 85

2d Enter three-digit plan number ▶ 001

3 Type of plan: a ☐ Defined benefit pension plan (attach Schedule B (Form 5500)) b ☑ Money purchase plan (see instructions) c ☐ Profit-sharing plan d ☐ Stock bonus plan e ☐ ESOP plan (attach Schedule E (Form 5500))

4a If this is a master/prototype, or regional prototype plan, enter the opinion/notification letter number

b Check if this plan covers: (i) ☑ Self-employed individuals, (ii) ☐ Partner(s) in a partnership, or (iii) ☐ 100% owner of corporation

5a Enter the number of qualified pension benefit plans maintained by the employer (including this plan) ▶ 1

b Check here if you have more than one plan and the total assets of all plans are more than $100,000 (see instructions) ▶ ☐

6 Enter the number of participants in each category listed below:

		Number
a Under age 59½ at the end of the plan year	6a	2
b Age 59½ or older at the end of the plan year, but under age 70½ at the beginning of the plan year	6b	0
c Age 70½ or older at the beginning of the plan year	6c	0

7a (i) Is this a fully insured pension plan which is funded entirely by insurance or annuity contracts? ▶ ☐ Yes ☑ No

If "Yes," complete lines 7a(ii) through 7f and skip lines 7g through 9d.

(ii) If 7a(i) is "Yes," are the insurance contracts held: ▶ ☐ under a trust ☐ with no trust

b Cash contributions received by the plan for this plan year	7b	10,000
c Noncash contributions received by the plan for this plan year	7c	0
d Total plan distributions to participants or beneficiaries	7d	0
e Total nontaxable plan distributions to participants or beneficiaries	7e	0
f Transfers to other plans	7f	0
g Amounts received by the plan other than from contributions	7g	10,500
h Plan expenses other than distributions	7h	10
8a Total plan assets at the end of the year	8a	162,200
b Total plan liabilities at the end of the year	8b	0

9 Check "Yes" and enter amount involved if any of the following transactions took place between the plan and a disqualified person during this plan year. Otherwise, check "No."

		Yes	No	Amount
a Sale, exchange, or lease of property	9a		✓	
b Payment by the plan for services	9b		✓	
c Acquisition or holding of employer securities	9c		✓	
d Loan or extension of credit	9d		✓	

If 10a is "No," do not complete line 10b and line 10c. See the specific instructions for line 10b and line 10c.

		Yes	No
10a Does your business have any employees other than you and your spouse (and your partners and their spouses)? ▶	10a		✓
b Total number of employees (including you and your spouse and your partners and their spouses) ▶			
c Does this plan meet the coverage requirements of Code section 410(b)? ▶	10c		
11a Did the plan distribute any annuity contracts this plan year? ▶	11a		✓
b During this plan year, did the plan make distributions to a married participant in a form other than a qualified joint and survivor annuity or were any distributions on account of the death of a married participant made to beneficiaries other than the spouse of that participant? ▶	11b		✓
c During this plan year, did the plan make loans to married participants? ▶	11c		✓

Under penalties of perjury and other penalties set forth in the instructions, I declare that I have examined this return, including accompanying schedules and statements, and to the best of my knowledge and belief, it is true, correct, and complete.

Signature of employer (owner) or plan administrator ▶ John Jones Date ▶ 7/20/96

For Paperwork Reduction Act Notice, see page 1 of the instructions. Cat. No. 63263R Form **5500-EZ** (1995)

Glossary

The definitions in this glossary are the meanings of the terms as used in this publication. The same term used in another publication may have a slightly different meaning.

Annual addition. Annual addition is the total in a year of all employer contributions, employee contributions (not including rollovers), and forfeitures allocated to a participant's account.

Annual benefit. Annual benefit means a benefit to be paid yearly in the form of a straight-life annuity (with no extra benefits) under a plan but excluding the benefit attributable to employee contributions or rollover contributions.

Business. A business is an activity in which 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 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.

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

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 Keogh plan purposes.

Compensation. Compensation means the pay a participant received from an employer for personal services for a year. An employer can generally define compensation as including:

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

The definition of compensation generally cannot include:

- Reimbursements or other expense allowances (unless paid under a nonaccountable plan), or
- Deferred compensation (either amounts going in or amounts coming out).

Other options. In figuring the compensation of a common-law employee, you may treat one of the following as the employee's compensation.

1) The employee's wages as defined for income tax withholding purposes, or
2) The employee's wages that you report in box 1 of Form W–2, *Wage and Tax Statement.*

Self-employed person. For the self-employed person, compensation means the ***earned income***, as discussed later, of the person.

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

Deduction. A deduction is the amount of plan contributions an employer takes on an income tax return as a subtraction from gross income. Limits apply to the amount deductible.

Earned income. Earned income for Keogh plan purposes is net earnings from self-employment (defined below) from a business in which your services materially helped to produce the income.

You can 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.

Earned income does not include interest income.

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.

Employee. For retirement plan purposes, the term ''employee'' generally includes a self-employed person as well as a common-law employee. It also may include a leased employee.

Employer. A sole proprietor is his or her own employer for Keogh plan purposes, and a partnership employs each partner. A partner is not an employer for Keogh plan purposes.

Fishermen treated as self-employed. A fisherman (other than a child under age 18 working for his or her father or mother) may be considered self-employed for purposes of setting up a Keogh plan. A fisherman qualifies if he or she serves on a fishing boat under an arrangement providing pay in the form of a share of the boat's catch, or a share of the proceeds from the sale of the catch. The share must depend on the amount of the boat's catch. The fisherman receiving the share must not receive any remuneration in cash other than the proceeds from the sale of his or her share. Also, the operating crew of the boat (or each boat if the operation involves more than one boat) must normally be made up of fewer than 10 persons.

Master plan. A master plan has a single trust or custodial account. If you adopt a master plan, you use the single trust or custodial account along with the other employers adopting the plan.

Net earnings from self-employment. For SEP and Keogh plan purposes, these earnings are a self-employed person's gross income from a business, taking into account allowable deductions for that business. Allowable deductions include contributions to SEP and Keogh plans for common-law employees. 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 allowed for one-half of the self-employment tax and the deduction for contributions to a qualified 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). ***Guaranteed payments to limited partners*** qualify as 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 do not qualify.

Partner. An individual who shares ownership of an unincorporated trade or business with one or more persons.

Prototype plan. This is a plan with separate trusts or custodial accounts for each employer who adopts the plan.

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 Keogh plan purposes. See *Common-law employee,* earlier. Also see *Net earnings from self-employment.*

Sole proprietor. An individual in business for himself or herself and who is the only owner of the unincorporated trade or business.

Tax Publications for Business Taxpayers

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 1996
- 553 Highlights of 1995 Tax Changes
- 595 Tax Guide for Commercial Fishermen
- 910 Guide to Free Tax Services

Employer's Guides

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

Specialized Publications

- 349 Federal Highway Use Tax on Heavy Vehicles
- 378 Fuel Tax Credits and Refunds
- 463 Travel, Entertainment, and Gift Expenses
- 505 Tax Withholding and Estimated Tax
- 510 Excise Taxes for 1996
- 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 Tax Information on Partnerships
- 542 Tax Information on 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 the Self-Employed
- 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)
- 589 Tax Information on S Corporations
- 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 Tax Information on Bankruptcy
- 911 Tax Information for Direct Sellers
- 917 Business Use of a Car
- 924 Reporting of Real Estate Transactions to IRS
- 925 Passive Activity and At-Risk Rules
- 938 Real Estate Mortgage Investment Conduits (REMICs) Reporting Information
- 946 How To Depreciate Property
- 947 Practice Before the IRS and Power of Attorney
- 952 Sick Pay Reporting
- 953 International Tax Information for Businesses
- 1544 Reporting Cash Payments of Over $10,000
- 1546 How to Use the Problem Resolution Program 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

Commonly Used Tax Forms

- W-2 Wage and Tax Statement
- W-4 Employee's Withholding Allowance Certificate
- 940 Employer's Annual Federal Unemployment (FUTA) Tax Return
- 940EZ Employer's Annual Federal Unemployment (FUTA) Tax Return
- 1040 U.S. Individual Income Tax Return
  - Sch A Itemized Deductions
  - Sch B Interest and Dividend Income
  - Sch C Profit or Loss From Business
  - Sch C-EZ Net Profit From Business
  - Sch D Capital Gains and Losses
  - Sch E Supplemental Income and Loss
  - Sch F Profit or Loss From Farming
  - Sch R Credit for the Elderly or the Disabled
  - Sch SE Self-Employment Tax
- 1040-ES Estimated Tax for Individuals
- 1040X Amended U.S. Individual Income Tax Return
- 1065 U.S. Partnership Return of Income
  - Sch D Capital Gains and Losses
  - Sch K-1 Partner's Share of Income, Credits, Deductions, etc.
- 1120 U.S. Corporation Income Tax Return
- 1120S U.S. Income Tax Return for an S Corporation
  - Sch D Capital Gains and Losses and Built-in Gains
  - Sch K-1 Shareholder's Share of Income, Credits, Deductions, etc.
- 2106 Employee Business Expenses
- 2106-EZ Unreimbursed Employee Business Expenses
- 2210 Underpayment of Estimated Tax by Individuals, Estates, and Trusts
- 2441 Child and Dependent Care Expenses
- 2848 Power of Attorney and Declaration of Representative
- 3903 Moving Expenses
- 4562 Depreciation and Amortization
- 4797 Sales of Business Property
- 4868 Application for Automatic Extension of Time To File U.S. Individual Income Tax Return
- 5329 Additional Taxes Attributable to Qualified Retirement Plans (Including IRAs), Annuities, and Modified Endowment Contracts
- 6252 Installment Sale Income
- 8283 Noncash Charitable Contributions
- 8300 Report of Cash Payments Over $10,000 Received in a Trade or Business
- 8582 Passive Activity Loss Limitations
- 8606 Nondeductible IRAs (Contributions, Distributions, and Basis)
- 8822 Change of Address
- 8829 Expenses for Business Use of Your Home

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