Department of the Treasury

Internal Revenue Service

Publication 560

Cat. No. 46574N

Retirement Plans for Small Business

(SEP, SIMPLE, and Qualified Plans)

For use in preparing

2002 Returns

Get forms and other information faster and easier by:

Computer • www.irs.gov or **FTP** • ftp.irs.gov

FAX • 703-368-9694 (from your FAX machine)

Contents

Important Changes for 2002

Plan amendments to conform to the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA). Generally, master and prototype plans are amended by sponsoring organizations. However, you may need to request a determination letter regarding a master or prototype plan you maintain that is a non-standardized plan if you make changes to adopt some provisions of EGTRRA. Your request should be made on the appropriate form (generally Form 5300 or Form 5307). The request should be filed with Form 8717, *User Fee for Employee Plan Determination Letter Request,* and the applicable user fee. See *User fee,* later.

Earned income of members of recognized religious sects. For years beginning after 2001, earned income for retirement plans includes amounts received for services by self-employed members of recognized religious sects opposed to social security benefits who are exempt from self-employment tax.

Credit for startup costs. For costs paid or incurred in tax years beginning after December 31, 2001, for retirement plans that first become effective after that date, you may be able to claim a tax credit for part of the ordinary and necessary costs of starting a SEP, SIMPLE, or qualified plan. The credit equals 50% of the cost to set up and administer the plan and educate employees about the plan, up to a maximum of $500 per year for each of the first 3 years of the plan. For plans that become effective after 2002, you can choose to start claiming the credit in the tax year before the tax year in which the plan becomes effective.

You must have had 100 or fewer employees who received at least $5,000 in compensation from you for the preceding year. At least one participant must be a non-highly compensated employee. The employees generally cannot be substantially the same employees for whom contributions were made or benefits accrued under a plan of any of the following employers in the 3-tax-year period immediately before the first year to which the credit applies.

1) You.
2) A member of a controlled group that includes you.
3) A predecessor of (1) or (2).

The credit is part of the general business credit, which can be carried back or forward to other tax years if it cannot be used in the current year. However, the part of the general business credit attributable to the small employer pension plan startup cost credit cannot be carried back to a tax year beginning before January 1, 2002. You cannot deduct the part of the startup costs equal to the credit claimed for a tax year, but you can choose not to claim the allowable credit for a tax year.

To take the credit, get Form 8881, *Credit for Small Employer Pension Plan Startup Costs,* and the instructions.

Compensation limit. For years beginning after 2001, the maximum compensation used for figuring contributions and benefits increases to $200,000. This amount is subject to cost-of-living increases after 2002.

Deduction limits. After 2001, certain deduction limits change as explained next.

Elective deferrals. For years beginning after 2001, elective deferrals are not subject to the deduction limit that applies to SARSEPs and profit-sharing plans (discussed next). Also, elective deferrals are not taken into account when figuring the amount you can deduct for employer contributions that are not elective deferrals.

SEP and profit-sharing plans. For years beginning after 2001, your maximum deduction for contributions to a SEP or a profit-sharing plan increases to 25% of the compensation paid or accrued during the year to your eligible employees participating in the plan. Compensation for figuring the deduction for contributions includes elective deferrals.

However, a lower limit may apply to SARSEPs. For more information, see *Limit on Elective Deferrals* in chapter 2.

Defined benefit plans. For plan years beginning after 2001, your deduction for contributions to a defined benefit plan can be as much as the plan's unfunded current liability.

Elective deferrals. The limit on elective deferrals increases to $11,000 for tax years beginning in 2002 and then increases $1,000 each tax year thereafter until it reaches $15,000 in 2006. These new limits will apply for participants in SARSEPs, 401(k) plans (excluding SIMPLE plans), and deferred compensation plans of state or local governments and tax-exempt organizations. The $15,000 figure is subject to cost-of-living increases after 2006.

Catch-up contributions. For tax years beginning after 2001, a plan can permit participants who are age 50 or over at the end of the calendar year to also make catch-up contributions. The catch-up contribution limit for 2002 is $1,000. This limit increases by $1,000 each year thereafter until it reaches $5,000 in 2006. The limit is subject to cost-of-living increases after 2006. The catch-up contribution a participant can make for a year cannot exceed the lesser of the following amounts.

- The catch-up contribution limit.
- The excess of the participant's compensation over the elective deferrals that are not catch-up contributions.

SIMPLE plan salary reduction contributions. The limit on salary reduction contributions to a SIMPLE plan increases to $7,000 beginning in 2002 and then increases $1,000 each tax year thereafter until it reaches $10,000 in 2005. The $10,000 figure is subject to adjustment after 2005 for cost-of-living increases.

Catch-up contributions. For tax years beginning after 2001, a SIMPLE plan can permit participants who are age 50 or over at the end of the calendar year to make catch-up contributions. The catch-up contribution limit for 2002 is $500. This limit increases by $500 each year thereafter until it reaches $2,500 in 2006. The limit is subject to cost-of-living increases after 2006. The catch-up contributions a participant can make for a year cannot exceed the lesser of the following amounts.

- The catch-up contribution limit.
- The excess of the participant's compensation over the salary reduction contributions that are not catch-up contributions.

User fee. The user fee for requesting a determination letter does not apply to certain requests made after 2001, by employers who have 100 or fewer employees, at least one of whom is a non-highly compensated employee participating in the plan. See *User fee* under *Setting Up a Qualified Plan* in chapter 4.

Limits on contributions and benefits. For years ending after 2001, the maximum annual benefit for a participant under a defined benefit plan increases to the lesser of the following amounts.

- 100% of the participant's average compensation for his or her highest 3 consecutive calendar years.
- $160,000 (subject to cost-of-living increases after 2002).

For years beginning after 2001, a defined contribution plan's maximum annual contributions and other additions (excluding earnings) to the account of a participant increases to the lesser of the following amounts.

- 100% of the participant's compensation.
- $40,000 (subject to cost-of-living increases after 2002).

For years beginning after 2001, the annual limit on the amount of employer contributions to a SEP increases to the lesser of the following amounts.

- 25% of an eligible employee's compensation.
- $40,000 (subject to cost-of-living adjustments after 2002).

Excise tax for nondeductible (excess) contributions. For years beginning after 2001, you can choose to exclude certain nondeductible (excess) contributions when figuring the 10% excise tax. For more information, see *Defined benefit plan exception* under *Excise Tax for Nondeductible (Excess) Contributions* in chapter 4.

Rollover distributions. A hardship distribution made after 2001 will not qualify as an eligible rollover distribution.

Involuntary payment of benefits. If a participant's employment is terminated, a plan may provide for immediate distribution of the participant's benefit under the plan if the present value of the benefit is not greater than $5,000. For distributions after 2001, benefits attributable to rollover contributions and earnings on the contributions can be ignored in determining the value of these benefits.

For distributions made after the Department of Labor adopts final regulations implementing rules on fiduciary responsibilities relating to this provision, a plan must provide for the automatic rollover of any distribution of more than $1,000 to an IRA under this provision, unless the participant chooses otherwise. The plan administrator must notify the participant in writing that the distribution can be transferred to another IRA.

Retirement savings contributions credit. Beginning in 2002, retirement plan participants (including self-employed individuals) who make contributions to their plan may qualify for the retirement savings contributions credit. The amount of the credit is based on the contributions participants make and their credit rate. The maximum contribution eligible for the credit is $2,000. The credit rate can be as low as 10% or as high as 50%, depending on the participant's adjusted gross income. The credit also depends on the participant's filing status. Form 8880, *Credit for Qualified Retirement Savings Contributions,* and the instructions explain how to claim the credit.

Important Change for 2003

Deemed IRA under a qualified plan. For plan years beginning after 2002, a qualified plan (discussed in chapter 4) can maintain a separate account or annuity under the plan to receive voluntary employee contributions. If the separate account or annuity otherwise meets the requirements of a traditional IRA or Roth IRA, it is deemed a traditional IRA or Roth IRA. A deemed IRA is subject to IRA rules and not to qualified plan rules. Also, the deemed IRA and contributions to it are not taken into account in applying qualified plan rules to any other contributions under the plan. Voluntary employee contributions must be designated as such by employees covered under the plan. They are includible in income.

If you want to provide for a deemed IRA, you will have to amend your plan. For information on amending the plan, see Revenue Procedure 2003–13 in Internal Revenue Bulletin 2003–4.

Important Reminders

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

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

- Uniformed Services Employment and Reemployment Rights Act of 1994, Public Law 103–353.
- Uruguay Round Agreements Act, Public Law 103–465.
- Small Business Job Protection Act of 1996, Public Law 104–188.
- Taxpayer Relief Act of 1997, Public Law 105–34.
- Internal Revenue Service Restructuring and Reform Act of 1998, Public Law 105–206.
- Community Renewal Tax Relief Act of 2000, Public Law 106–554.

You generally were required to make these amendments by February 28, 2002. Plans directly affected by the September 11, 2001, terrorist attacks on the United States had until June 30, 2002, to make these amendments. In cases of substantial hardship resulting from the terrorist attacks, the IRS could have granted additional extensions of time up to December 31, 2002, to make the amendments.

For more information about these extensions, see Revenue Procedure 2001–55 in Internal Revenue Bulletin 2001–49.

The time for amending a pre-approved plan (master or prototype or volume submitter plan) is extended to the later of September 30, 2003, or the end of the 12th month beginning after the date on which the IRS issues a GUST opinion or advisory letter for the pre-approved plan. For more information, see Revenue Procedure 2002–73 in Internal Revenue Bulletin 2002–49.

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

Introduction

This publication discusses retirement plans you can set up and maintain for yourself and your employees. In this publication, "you" refers to the employer. See chapter 1 for the definition of the term employer and the definitions of other terms used in this publication. This publication covers the following types of retirement plans.

- SEP (simplified employee pension) plans.
- SIMPLE (savings incentive match plan for employees) plans.
- Qualified plans (also called H.R. 10 plans or Keogh plans when covering self-employed individuals).

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

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

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

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

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

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

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

Qualified plans. The qualified plan rules are more complex than the SEP plan and SIMPLE plan rules. However, there are advantages to qualified plans, such as increased flexibility in designing plans and increased contribution and deduction limits in some cases.

Table 1. **Key Retirement Plan Rules for 2002**

Type of Plan	Last Date for Contribution	Maximum Contribution	Maximum Deduction	When to Set Up Plan
SEP	Due date of employer's return (including extensions).	Smaller of $40,000 or 25%[1] of participant's compensation.[2]	25%[1] of all participants' compensation.[2]	Any time up to due date of employer's return (including extensions).
SIMPLE IRA and SIMPLE 401(k)	**Salary reduction contributions:** 30 days after the end of the month for which the contributions are to be made.[3]	**Employee:** Salary reduction contribution, up to $7,000.	Same as maximum contribution.	Any time between 1/1 and 10/1 of the calendar year. For a new employer coming into existence after 10/1, as soon as administratively feasible.
	Matching contributions or nonelective contributions: Due date of employer's return (including extensions).	**Employer contribution:** *Either* dollar-for-dollar matching contributions, up to 3% of employee's compensation,[4] *or* fixed nonelective contributions of 2% of compensation.[2]	Same as maximum contribution.	
Qualified	Due date of employer's return (including extensions).	<u>Defined Contribution Plans</u>	<u>Defined Contribution Plans</u>	By the end of the tax year.
	Note: For a defined benefit plan subject to minimum funding requirements, contributions are due in quarterly installments. See *Minimum Funding Requirements* in chapter 4.	**Money Purchase:** Smaller of $40,000 or 100%[1] of participant's compensation.[2] **Profit-Sharing:** Smaller of $40,000 or 100%[1] of participant's compensation.[2]	**Money Purchase:** 25%[1] of all participants' compensation.[2] **Profit-Sharing:** 25%[1] of all participants' compensation.[2]	
		<u>Defined Benefit Plans</u> Amount needed to provide an annual benefit no larger than the smaller of $160,000 or 100% of the participant's average compensation for his or her highest 3 consecutive calendar years.	<u>Defined Benefit Plans</u> Based on actuarial assumptions and computations.	

[1]Net earnings from self-employment must take the contribution into account.
[2]Compensation is generally limited to $200,000.
[3]Does not apply to SIMPLE 401(k) plans. The deadline for qualified plans applies instead.
[4]Under a SIMPLE 401(k) plan, compensation is generally limited to $200,000.

What this publication does not cover. Although the purpose of this publication is to provide general information about retirement plans you can set up for your employees, it does not contain all the rules and exceptions that apply to these plans. You may also need professional help and guidance.

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

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

Comments and suggestions. We welcome your comments about this publication and your suggestions for future editions.

You can e-mail us while visiting our web site at **www.irs.gov**.

You can write to us at the following address:

Internal Revenue Service
Tax Forms and Publications
W:CAR:MP:FP
1111 Constitution Ave. NW
Washington, DC 20224

We respond to many letters by telephone. Therefore, it would be helpful if you would include your daytime phone number, including the area code, in your correspondence.

Help from the Internal Revenue Service (IRS). See chapter 6 for information about getting publications and forms.

If you own a business and have questions about starting a pension plan, an existing plan, or filing **Form 5500**, call our **Tax Exempt/Government Entities Customer Account Services** at **1–877–829–5500**. Assistance is available Monday through Friday from 8:00 a.m. to 6:30 p.m. EST. **If you have questions about a traditional or Roth IRA or any individual income tax issues, you should call 1–800–829–1040**.

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

1.

Definitions You Need To Know

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

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

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

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

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

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

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

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

However, an individual may be a common-law employee and a self-employed person 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), *Profit or Loss From Business,* for performing marriages, baptisms, and other personal services are self-employment earnings for qualified plan purposes.

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

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

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

Compensation generally includes amounts deferred in the following employee benefit plans. These amounts are elective deferrals.

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

However, an employer can choose to exclude elective deferrals under the above plans from the definition of compensation. The limit on elective deferrals is discussed in chapter 2 under *Salary Reduction Simplified Employee Pension (SARSEP)* and in chapter 4.

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

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

Compensation generally cannot include either of the following items.

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

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

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

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

You can also have earned income from property your personal efforts helped create, such as royalties from your books or inventions. 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 includes amounts received for services by self-employed members of recognized religious sects opposed to social security benefits who are exempt from self-employment tax.

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

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

Highly compensated employee. A highly compensated employee is an individual who:

- Owned more than 5% of the capital or profits in your business at any time during the year or the preceding year, or
- For the preceding year, received compensation from you of more than $90,000 and, if you so choose, was in the top 20% of employees when ranked by compensation.

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

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

Exception. A leased employee is not treated as your employee if all the following conditions are met.

1) Leased employees are not more than 20% of your non-highly compensated work force.
2) The employee is covered under the leasing organization's qualified pension plan.

3) The leasing organization's plan is a money purchase pension plan that has all the following provisions.

   a) Immediate participation. (This requirement does not apply to any individual whose compensation from the leasing organization in each plan year during the 4-year period ending with the plan year is less than $1,000.)

   b) Full and immediate vesting.

   c) A nonintegrated employer contribution rate of at least 10% of compensation for each participant.

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

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

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

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

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

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

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

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

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

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

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

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

2. Simplified Employee Pension (SEP)

Topics

This chapter discusses:

- Setting up a SEP
- How much to contribute
- Deducting contributions
- Salary reduction simplified employee pensions (SARSEPs)
- Distributions (withdrawals)
- Additional taxes
- Reporting and disclosure requirements

Useful Items

You may want to see:

Publication

❑ **590** Individual Retirement Arrangements (IRAs)

Forms (and Instructions)

❑ **W–2** Wage and Tax Statement

❑ **1040** U.S. Individual Income Tax Return

❑ **5305–SEP** Simplified Employee Pension—Individual Retirement Accounts Contribution Agreement

❑ **5305A–SEP** Salary Reduction Simplified Employee Pension—Individual Retirement Accounts Contribution Agreement

A simplified employee pension (SEP) is a written plan that allows you to make contributions toward your own retirement (if you are self-employed) and your employees' retirement without getting involved in a more complex qualified plan.

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

SEP-IRAs are set up for, at a minimum, each eligible employee (defined later). A SEP-IRA may have to be set up for a leased employee (defined in chapter 1), but does not need to be set up for excludable employees (defined later).

Eligible employee. An eligible employee is an individual who meets all the following requirements.

- Has reached age 21.
- Has worked for you in at least 3 of the last 5 years.
- Has received at least $450 in compensation from you for 2002 (subject to cost-of-living adjustments for 2003 and later years).

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

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

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

Setting Up a SEP

There are three basic steps in setting up a SEP.

1) You must execute a formal written agreement to provide benefits to all eligible employees.

2) You must give each eligible employee certain information about the SEP.

3) A SEP-IRA must be set up by or for each eligible employee.

TIP *Many financial institutions will help you set up a SEP.*

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

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

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

1) You currently maintain any other qualified retirement plan. This does not prevent you from maintaining another SEP.
2) You have any eligible employees for whom IRAs have not been set up.
3) You use the services of leased employees (as described in chapter 1).
4) You are a member of any of the following unless all eligible employees of all the members of these groups, trades, or businesses participate under the SEP.
   a) An affiliated service group described in section 414(m).
   b) A controlled group of corporations described in section 414(b).
   c) Trades or businesses under common control described in section 414(c).
5) You do not pay the cost of the SEP contributions.

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

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

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

Credit for startup costs. You may be able to claim a tax credit for part of the ordinary and necessary costs of starting a SEP that first became effective in 2002. For more information, see *Credit for startup costs* under *Important Changes for 2002*, earlier.

How Much Can I Contribute?

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

You do not have to make contributions every year. But if you make contributions, they must be based on a written allocation formula and must not discriminate in favor of highly compensated employees (defined in chapter 1). When you contribute, you must contribute to the SEP-IRAs of all participants who actually performed personal services during the year for which the contributions are made, even employees who die or terminate employment before the contributions are made.

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

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

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

Contribution Limits

Contributions you make for 2002 to a common-law employee's SEP-IRA cannot exceed the lesser of 25% of the employee's compensation or $40,000 (subject to cost-of-living adjustments for 2003 and later years). Compensation generally does not include your contributions to the SEP.

Example. Your employee, Mary Plant, earned $21,000 for 2002. The maximum contribution you can make to her SEP-IRA is $5,250 (25% x $21,000).

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

Annual compensation limit. You cannot consider the part of an employee's compensation over $200,000 when figuring your contribution limit for that employee. However, $40,000 is the maximum contribution for an eligible employee. (The annual compensation limit of $200,000 is subject to cost-of-living adjustments for 2003 and later years.)

More than one plan. If you contribute to a defined contribution plan (defined in chapter 4), annual additions to an account are limited to the lesser of $40,000 or 100% of the participant's compensation. When you figure this limit, you must add your contributions to all defined contribution plans. Because a SEP is considered a defined contribution plan for this limit, your contributions to a SEP must be added to your contributions to other defined contribution plans.

Tax treatment of excess contributions. Excess contributions are your contributions to an employee's SEP-IRA (or to your own SEP-IRA) for 2002 that exceed the lesser of the following amounts.

- 25% of the employee's compensation (or, for you, 20% of your net earnings from self-employment).
- $40,000.

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

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

Deducting Contributions

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

Deduction Limit for Contributions for Participants

The most you can deduct for your contributions (other than elective deferrals) for participants is the lesser of the following amounts.

1) Your contributions (including any excess contributions carryover).
2) 25% of the compensation (limited to $200,000 per participant) paid to the participants during 2002 from the business that has the plan, not to exceed $40,000 per participant.

For 2003 and later years, the $200,000 and $40,000 amounts in (2) above are subject to cost-of-living increases.

CAUTION

Compensation in (2) above includes elective deferrals (explained, later, under Salary Reduction Simplified Employee Pension (SARSEP)). *Beginning in 2002, elective deferrals are no longer subject to this deduction limit. However, the combined deduction for a participant's elective deferrals and other SEP contributions cannot exceed $40,000.*

Your SEP document may limit contributions to lower amounts because of elective deferrals.

Deduction Limit for Self-Employed Individuals

If you contribute to your own SEP-IRA, you must make a special computation to figure your maximum deduction for these contributions. When figuring the deduction for contributions made to your own SEP-IRA, compensation is your net earnings from self-employment (defined in chapter 1), which takes into account both the following deductions.

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

The deduction for contributions to your own SEP-IRA and your net earnings depend on each other. For this reason, you determine the deduction for contributions to your own SEP-IRA indirectly by reducing the contribution rate called for in your plan. To do this, use the *Rate Table for Self-Employed* or the *Rate Worksheet for Self-Employed,* whichever is appropriate for your plan's contribution rate, in chapter 5. Then figure your maximum deduction by using the *Deduction Worksheet for Self-Employed* in chapter 5.

Deduction Limits for Multiple Plans

For the deduction limits, treat all your qualified defined contribution plans as a single plan and all your qualified defined benefit plans as a single plan. See *Kinds of Plans* in chapter 4 for the definitions of defined contribution plans and defined benefit plans. If you have both kinds of plans, a SEP is treated as a separate profit-sharing (defined contribution) plan. A qualified plan is a plan that meets the requirements discussed under *Qualification Rules* in chapter 4. For information about the special deduction limits, see *Deduction limit for multiple plans* under *Employer Deduction* in chapter 4.

SEP and defined contribution plan. If you also contribute to a qualified defined contribution plan, you must reduce the 25% deduction limit for that plan by the allowable deduction for contributions to the SEP-IRAs of those participating in both the SEP plan and the defined contribution plan.

Carryover of Excess SEP Contributions

If you made SEP contributions that are more than the deduction limit (nondeductible contributions), you can carry over and deduct the difference in later years. However, the carryover, when combined with the contribution for the later year, is subject to the deduction limit for that year. If you also contributed to a defined benefit plan or defined contribution plan, see *Carryover of Excess Contributions* under *Employer Deduction* in chapter 4 for the carryover limit.

Excise tax. If you made nondeductible (excess) contributions to a SEP, you may be subject to a 10% excise tax. For information about the excise tax, see *Excise Tax for Nondeductible (Excess) Contributions* under *Employer Deduction* in chapter 4.

When To Deduct Contributions

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

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

Example. You are a fiscal year taxpayer whose tax year ends June 30. You maintain a SEP on a calendar year basis. You deduct SEP contributions made for calendar year 2002 on your tax return for your tax year ending June 30, 2003.

Where To Deduct Contributions

Deduct the contributions you make for your common-law employees on your tax return. For example, sole proprietors deduct them on Schedule C (Form 1040), *Profit or Loss From Business,* or Schedule F (Form 1040), *Profit or Loss From Farming,* partnerships deduct them on Form 1065, *U.S. Return of Partnership Income,* and corporations deduct them on Form 1120, *U.S. Corporation Income Tax Return,* Form 1120–A, *U.S. Corporation Short-Form Income Tax Return,* or Form 1120S, *U.S. Income Tax Return for an S Corporation.*

Sole proprietors and partners deduct contributions for themselves on line 31 of Form 1040, *U.S. Individual Income Tax Return.* (If you are a partner, contributions for yourself are shown on the Schedule K-1 (Form 1065), *Partner's Share of Income, Credits, Deductions, etc.,* you get from the partnership.)

Salary Reduction Simplified Employee Pension (SARSEP)

A SARSEP is a SEP set up before 1997 that includes a salary reduction arrangement. (See the *Caution,* next.) Under a SARSEP, your employees can choose to have you contribute part of their pay to their SEP-IRAs rather than receive it in cash. This contribution is called an "elective deferral" because employees choose (elect) to set aside the money, and they defer the tax on the money until it is distributed to them.

CAUTION *You are not allowed to set up a SARSEP after 1996. However, participants (including employees hired after 1996) in a SARSEP set up before 1997 can continue to have you contribute part of their pay to the plan. If you are interested in setting up a retirement plan that includes a salary reduction arrangement, see chapter 3.*

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

- At least 50% of your employees eligible to participate choose to make elective deferrals.
- You have 25 or fewer employees who were eligible to participate in the SEP at any time during the preceding year.
- The elective deferrals of your highly compensated employees meet the SARSEP ADP test.

SARSEP ADP test. Under the SARSEP ADP test, the amount deferred each year by each eligible highly compensated employee as a percentage of pay (the deferral percentage) cannot be more than 125% of the average deferral percentage (ADP) of all non-highly compensated employees eligible to participate. A highly compensated employee is defined in chapter 1.

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

$$\frac{\text{The elective employer contributions (excluding certain catch-up contributions) paid to the SEP for the employee for the year}}{\text{The employee's compensation (limited to \$200,000)}}$$

TIP *The instructions for Form 5305A–SEP have a worksheet you can use to determine whether the elective deferrals of your highly compensated employees meet the SARSEP ADP test.*

Employee compensation. For figuring the deferral percentage, compensation is generally the amount you pay to the employee for the year. Compensation includes the elective deferral and other amounts deferred in certain employee benefit plans. See *Compensation* in chapter 1. Elective deferrals under the SARSEP are included in figuring your employees' deferral percentage even though they are not included in the income of your employees for income tax purposes.

Compensation of self-employed individuals. If you are self-employed, compensation is your net earnings from self-employment as defined in chapter 1.

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

Choice not to treat deferrals as compensation. You can choose not to treat elective deferrals (and other amounts deferred in certain employee benefit plans) for a year as compensation under your SARSEP.

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

Limit on Elective Deferrals

The most a participant can choose to defer for calendar year 2002 is the lesser of the following amounts.

1) 25% of the participant's compensation (limited to $200,000 of the participant's compensation).
2) $11,000.

In 2003, the compensation limit in (1) of $200,000 is subject to cost-of-living adjustments. The amount in (2) increases to $12,000.

The $11,000 limit applies to the total elective deferrals the employee makes for the year to a SEP and any of the following.

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

Catch-up contributions. Beginning in 2002, a SEP can permit participants who are age 50 or over at the end of the calendar year to also make catch-up contributions. The catch-up contribution limit for 2002 is $1,000 ($2,000 for 2003). Elective deferrals are not treated as catch-up contributions for 2002 until they exceed the elective deferral limit (the lesser of 25% of compensation or $11,000), the SARSEP ADP test limit discussed earlier, or the plan limit (if any). However, the catch-up contribution a participant can make for a year cannot exceed the lesser of the following amounts.

- The catch-up contribution limit.
- The excess of the participant's compensation over the elective deferrals that are not catch-up contributions.

Catch-up contributions are not subject to the elective deferral limit (the lesser of 25% of compensation or $11,000).

Overall limit on SEP contributions. If you also make nonelective contributions to a SEP-IRA, the total of the nonelective and elective contributions to that SEP-IRA cannot exceed the lesser of 25% of the employee's compensation or $40,000 (subject to cost-of-living adjustments after 2002). The same rule applies to contributions you make to your own SEP-IRA. See *Contribution Limits,* earlier.

Figuring the elective deferral. For figuring the 25% limit on elective deferrals, compensation does not include SEP contributions, including elective deferrals or other amounts deferred in certain employee benefit plans.

Tax Treatment of Deferrals

Beginning in 2002, elective deferrals are no longer subject to the deduction limits discussed earlier under *Deducting Contributions.* However, the combined deduction for a participant's elective deferrals and other SEP contributions cannot exceed $40,000.

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

Excess deferrals. For 2002, excess deferrals are the elective deferrals for the year that are more than the $11,000 limit discussed earlier. For a participant who is eligible to make catch-up contributions, excess deferrals are the elective deferrals that are more than $12,000. The treatment of excess deferrals made under a SARSEP is similar to the treatment of excess deferrals made under a qualified plan. See *Treatment of Excess Deferrals* under *Elective Deferrals (401(k) Plans)* in chapter 4.

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

Reporting on Form W–2. Do not include elective deferrals in the "Wages, tips, other compensation" box of Form W–2. You must, however, include them in the "Social security wages" and "Medicare wages and tips" boxes. You must also include them in box 12. Mark the "Retirement plan" checkbox in box 13. For more information, see the Form W–2 instructions.

Distributions (Withdrawals)

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

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

Additional Taxes

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

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

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

Prohibited transaction. If an employee improperly uses his or her SEP-IRA, such as by borrowing money from it, the employee has engaged in a prohibited transaction. In that case, the SEP-IRA will no longer qualify as an IRA. For a list of prohibited transactions, see *Prohibited Transactions* in chapter 4.

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

Reporting and Disclosure Requirements

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

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

3. SIMPLE Plans

Topics

This chapter discusses:

- SIMPLE IRA plan
- SIMPLE 401(k) plan

Useful Items

You may want to see:

Forms (and instructions)

- ❏ **W–2** Wage and Tax Statement
- ❏ **5304–SIMPLE** Savings Incentive Match Plan for Employees of Small Employers (SIMPLE)—Not for use with a Designated Financial Institution
- ❏ **5305–SIMPLE** Savings Incentive Match Plan for Employees of Small

Employers (SIMPLE)—for Use With a Designated Financial Institution

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

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

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

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

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

SIMPLE IRA Plan

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

Who Can Set Up a SIMPLE IRA Plan?

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

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

Employee limit. You can set up a SIMPLE IRA plan only if you had 100 or fewer employees who received $5,000 or more in compensation from you for the preceding year. Under this rule, you must take into account ***all*** employees employed at any time during the calendar year regardless of whether they are eligible to participate. Employees include self-employed individuals who received earned income and leased employees (defined in chapter 1).

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

Grace period for employers who cease to meet the 100-employee limit. If you maintain the SIMPLE IRA plan for at least 1 year and you cease to meet the 100-employee limit in a later year, you will be treated as meeting it for the 2 calendar years immediately following the calendar year for which you last met it.

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

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

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

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

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

Who Can Participate in a SIMPLE IRA Plan?

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

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

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

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

Compensation. Compensation for employees is the total wages required to be reported on Form W–2. Compensation also includes the salary reduction contributions made under this plan, compensation deferred under a section 457 plan, and the employees' elective deferrals under a section 401(k) plan, a SARSEP, or a section 403(b) annuity contract. If you are self-employed, compensation is your net earnings from self-employment (line 4 of Short Schedule SE (Form 1040)) before subtracting any contributions made to the SIMPLE IRA plan for yourself.

How To Set Up a SIMPLE IRA Plan

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

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

The SIMPLE IRA plan is adopted when you have completed all appropriate boxes and blanks on the form and you (and the designated financial institution, if any) have signed it. Keep the original form. Do not file it with the IRS.

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

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

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

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

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

Deadline for setting up a SIMPLE IRA. A SIMPLE IRA must be set up for an employee before the first date by which a contribution is required to be deposited into the employee's IRA. See *Time limits for contributing funds,* later, under *Contribution Limits.*

Credit for startup costs. You may be able to claim a tax credit for part of the ordinary and necessary costs of starting a SIMPLE IRA plan that first became effective in 2002. For more information, see *Credit for startup costs* under *Important Changes for 2002*, earlier.

Notification Requirement

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

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

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

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

Contribution Limits

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

Salary reduction contributions. The amount the employee chooses to have you contribute to a SIMPLE IRA on his or her behalf cannot be more than $7,000 for 2002 ($8,000 for 2003). These contributions must be expressed as a percentage of the employee's compensation unless you permit the employee to express them as a specific dollar amount. You cannot place restrictions on the contribution amount (such as limiting the contribution percentage), except to comply with the $7,000 limit.

If an employee is a participant in any other employer plan during the year and has elective salary reductions or deferred compensation under those plans, the salary reduction contributions under a SIMPLE IRA plan also are elective deferrals that count toward the overall annual limit ($11,000 for 2002) on exclusion of salary reductions and other elective deferrals.

Catch-up contributions. Beginning in 2002, a SIMPLE IRA plan can permit participants who are age 50 or over at the end of the calendar year to also make catch-up contributions. The catch-up contribution limit for 2002 is $500 ($1,000 for 2003). Salary reduction contributions are not treated as catch-up contributions for 2002 until they exceed $7,000. However, the catch-up contribution a participant can make for a year cannot exceed the lesser of the following amounts.

- The catch-up contribution limit.
- The excess of the participant's compensation over the salary reduction contributions that are not catch-up contributions.

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

Example. In 2002, your employee, John Rose, earned $25,000 and chose to defer 5% of his salary. Your net earnings from self-employment are $40,000, and you choose to contribute 10% of your earnings to your SIMPLE IRA. You make 3% matching contributions. The total contribution you can make for John is $2,000, figured as follows.

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

The total contribution you can make for yourself is $5,200, figured as follows.

Salary reduction contributions ($40,000 × .10)	$4,000
Employer matching contribution ($40,000 × .03)	1,200
Total contributions	**$5,200**

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

Nonelective contributions. Instead of matching contributions, you can choose to make nonelective contributions of 2% of compensation on behalf of each eligible employee who has at least $5,000 (or some lower amount you select) of compensation from you for the year. If you make this choice, you must make nonelective contributions whether or not the employee chooses to make salary reduction contributions. Only $200,000 of the employee's compensation can be taken into account to figure the contribution limit.

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

Example 1. In 2002, your employee, Jane Wood, earned $36,000 and chose to have you contribute 10% of her salary. Your net earnings from self-employment are $50,000, and you choose to contribute 10% of your earnings to your SIMPLE IRA. You make a 2% nonelective contribution. Both of you are under age 50. The total contribution you can make for Jane is $4,320, figured as follows.

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

The total contribution you can make for yourself is $6,000, figured as follows.

Salary reduction contributions ($50,000 × .10)	$5,000
Employer matching contribution ($50,000 × .02)	1,000
Total contributions	**$6,000**

Example 2. Using the same facts as in Example 1, above, the maximum contribution you can make for Jane or for yourself if you each earned $75,000 is $8,500, figured as follows.

Salary reduction contributions (maximum amount)	$7,000
2% nonelective contributions ($75,000 × .02)	1,500
Total contributions	**$8,500**

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

When To Deduct Contributions

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

Example 1. Your tax year is the fiscal year ending June 30. Contributions under a SIMPLE IRA plan for the calendar year 2002 (including contributions made in 2002 before July 1, 2002) are deductible in the tax year ending June 30, 2003.

Example 2. You are a sole proprietor whose tax year is the calendar year. Contributions under a SIMPLE IRA plan for the calendar year 2002 (including contributions made in 2003 by April 15, 2003) are deductible in the 2002 tax year.

Where To Deduct Contributions

Deduct the contributions you make for your common-law employees on your tax return. For example, sole proprietors deduct them on Schedule C (Form 1040), *Profit or Loss From Business,* or Schedule F (Form 1040), *Profit or Loss From Farming,* partnerships deduct them on Form 1065, *U.S. Return of Partnership Income,* and corporations deduct them on Form 1120, *U.S. Corporation Income Tax Return,* Form 1120–A, *U.S. Corporation Short-Form Income Tax Return,* or Form 1120S, *U.S. Income Tax Return for an S Corporation.*

Sole proprietors and partners deduct contributions for themselves on line 31 of Form 1040, *U.S. Individual Income Tax Return.* (If you are a partner, contributions for yourself are shown on the Schedule K-1 (Form 1065), *Partner's Share of Income, Credits, Deductions, etc.,* you get from the partnership.)

Tax Treatment of Contributions

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

Reporting on Form W–2. Do not include SIMPLE IRA contributions in the "Wages, tips, other compensation box" of Form W–2. However, salary reduction contributions must be included in the boxes for social security and Medicare wages. Also include the proper code in box 12. For more information, see the instructions for Forms W–2 and W–3.

Distributions (Withdrawals)

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

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

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

More Information on SIMPLE IRA Plans

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

Notice 98–4. This notice contains questions and answers about the implementation and operation of SIMPLE IRA plans, including the election and notice requirements for these plans. Notice 98–4 is in Cumulative Bulletin 1998–1.

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

SIMPLE 401(k) Plan

You can adopt a SIMPLE plan as part of a 401(k) plan if you meet the 100-employee limit as discussed earlier under *SIMPLE IRA Plan.* A SIMPLE 401(k) plan is a qualified retirement plan and generally must satisfy the rules discussed under *Qualification Rules* in chapter 4. However, a SIMPLE 401(k) plan is not subject to the nondiscrimination and top-heavy rules in that discussion if the plan meets the conditions listed below.

1) Under the plan, an employee can choose to have you make salary reduction contributions for the year to a trust in an amount expressed as a percentage of the employee's compensation, but not more than $7,000 for 2002 ($8,000 for 2003). If permitted under the plan, an employee who is age 50 or over can also make a catch-up contribution of up to $500 for 2002 ($1,000 for 2003). See *Catch-up contributions* earlier under *Contribution Limits.*
2) You must make either:
   a) Matching contributions up to 3% of compensation for the year, or
   b) Nonelective contributions of 2% of compensation on behalf of each eligible employee who has at least $5,000 of compensation from you for the year.
3) No other contributions can be made to the trust.
4) No contributions are made, and no benefits accrue, for services during the year under any other qualified retirement plan of the employer on behalf of any employee eligible to participate in the SIMPLE 401(k) plan.
5) The employee's rights to any contributions are nonforfeitable.

No more than $200,000 of the employee's compensation can be taken into account in figuring salary reduction contributions, matching contributions, and nonelective contributions.

Employee notification. The notification requirement that applies to SIMPLE IRA plans also applies to SIMPLE 401(k) plans. See *Notification Requirement* in this chapter.

Credit for startup costs. You may be able to claim a tax credit for part of the ordinary and necessary costs of starting a SIMPLE 401(k) plan that first became effective in 2002. For more information, see *Credit for startup costs* under *Important Changes for 2002*, earlier.

More Information on SIMPLE 401(k) Plans

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

4. Qualified Plans

Topics

This chapter discusses:

- Kinds of plans
- Setting up a qualified plan
- Minimum funding requirement
- Contributions
- Employer deduction
- Elective deferrals (401(k) plans)
- Distributions
- Prohibited transactions
- Reporting requirements
- Qualification rules

Useful Items

You may want to see:

Publication

❏ **575** Pension and Annuity Income

Forms (and Instructions)

❏ **Schedule C (Form 1040)** Profit or Loss From Business

❏ **Schedule F (Form 1040)** Profit or Loss From Farming

❏ **Schedule K-1 (Form 1065)** Partner's Share of Income, Credits, Deductions, etc.

❏ **W–2** Wage and Tax Statement

❏ **1040** U.S. Individual Income Tax Return

❏ **1099–R** Distributions From Pensions, Annuities, Retirement or

Profit-Sharing Plans, IRAs, Insurance Contracts, etc.

- ❏ **5330** Return of Excise Taxes Related to Employee Benefit Plans
- ❏ **5500** Annual Return/Report of Employee Benefit Plan
- ❏ **5500–EZ** Annual Return of One-Participant (Owners and Their Spouses) Retirement Plan
- ❏ **Schedule A (Form 5500)** Insurance Information

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

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

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

Kinds of Plans

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

Defined Contribution Plan

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

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

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

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

In general, you can be more flexible in making contributions to a profit-sharing plan than to a money purchase pension plan (discussed next) or a defined benefit plan (discussed later).

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

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

Defined Benefit Plan

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

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

Setting Up a Qualified Plan

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

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

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

Credit for startup costs. You may be able to claim a tax credit for part of the ordinary and necessary costs of starting a qualified plan that first became effective in 2002. For more information, see *Credit for startup costs* under *Important Changes for 2002*, earlier.

Adopting a Written Plan

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

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

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

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

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

Individually designed plan. If you prefer, you can set up an individually designed plan to meet specific needs. Although advance IRS approval is not required, you can apply for approval by paying a fee and requesting a determination letter. You may need professional help for this. Revenue Procedure 2003–6 in Internal Revenue Bulletin 2003–1 may help you decide whether to apply for approval.

Internal Revenue Bulletins are available on the IRS web site at **www.irs.gov.** They are also available at most IRS offices and at certain libraries.

User fee. The fee mentioned earlier for requesting a determination letter does not apply to certain requests made in 2002 and later years, by employers who have 100 or fewer employees who received at least $5,000 of compensation from the employer for the preceding year. At least one of them must be a non-highly compensated employee participating in the plan. The fee does not apply to requests made by the later of the following dates.

- The end of the 5th plan year the plan is in effect.
- The end of any remedial amendment period for the plan that begins within the first 5 plan years.

The request cannot be made by the sponsor of a prototype or similar plan the sponsor intends to market to participating employers.

For more information about whether the user fee applies, see Notice 2002–1 in Internal Revenue Bulletin 2002–2.

Investing Plan Assets

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

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

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

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

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

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

Minimum Funding Requirement

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

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

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

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

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

Contributions

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

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

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

When Contributions Are Considered Made

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

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

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

Employer Contributions

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

Limits on Contributions and Benefits

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

Defined benefit plan. For 2002, the annual benefit for a participant under a defined benefit plan cannot exceed the lesser of the following amounts.

1) 100% of the participant's average compensation for his or her highest 3 consecutive calendar years.
2) $160,000.

For 2003 and later years, the amount in (2) is subject to cost-of-living adjustments.

Defined contribution plan. For 2002, a defined contribution plan's annual contributions and other additions (excluding earnings) to the account of a participant cannot exceed the lesser of the following amounts.

1) 100% of the participant's compensation.
2) $40,000.

Catch-up contributions (discussed later under *Limit on Elective Deferrals*) are not subject to the above limit.

For 2003, and later years, the amount in (2) is subject to cost-of-living adjustments.

Excess annual additions. Excess annual additions are the amounts contributed to a defined contribution plan that are more than the limits discussed previously. A plan can correct excess annual additions caused by any of the following actions.

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

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

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

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

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

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

Participants must report these amounts on the line for *Pensions and annuities* on Form 1040 or Form 1040A, *U.S. Individual Income Tax Return.*

Employee Contributions

Participants may be permitted to make nondeductible contributions to a plan in addition to your contributions. Even though these employee contributions are not deductible, the earnings on them are tax free until distributed in later years. Also, these contributions must satisfy the nondiscrimination test of section 401(m). See Notice 98–1 for further guidance and transition relief relating to recent statutory amendments to the nondiscrimination rules under sections 401(k) and 401(m). Notice 98–1 is in Cumulative Bulletin 1998–1.

Employer Deduction

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

Deduction Limits

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

Defined contribution plans. The deduction for contributions to a defined contribution plan (profit-sharing plan or money purchase pension plan) cannot be more than 25% of the compensation paid (or accrued) during the year to your eligible employees participating in the plan. If you are self-employed, you must reduce this limit in figuring the deduction for contributions you make for your own account. See *Deduction Limit for Self-Employed Individuals,* later..

When figuring the deduction limit, the following rules apply.

- Elective deferrals (discussed later) are not subject to the limit.
- Compensation includes elective deferrals.
- The maximum compensation that can be taken into account for each employee is $200,000.

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.

CAUTION *In figuring the deduction for contributions, you cannot take into account any contributions or benefits that are more than the limits discussed earlier under* Limits on Contributions and Benefits. *However, for plan years beginning in 2002 and later years, your deduction for contributions to a defined benefit plan can be as much as the plan's unfunded current liability.*

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

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

This limit does not apply if contributions to the defined contribution plan consist only of elective deferrals.

CAUTION *For this rule, a SEP is treated as a separate profit-sharing (defined contribution) plan.*

Deduction Limit for Self-Employed Individuals

If you make contributions for yourself, you need to make a special computation to figure your maximum deduction for these contributions. Compensation is your net earnings from self-employment, defined in chapter 1. This definition takes into account both the following items.

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

The deduction for your own contributions and your net earnings depend on each other. For this reason, you determine the deduction for your own contributions indirectly by reducing the contribution rate called for in your plan. To do this, use either the *Rate Table for Self-Employed* or the *Rate Worksheet for Self-Employed* in chapter 5. Then figure your maximum deduction by using the *Deduction Worksheet for Self-Employed* in chapter 5.

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

Where To Deduct Contributions

Deduct the contributions you make for your common-law employees on your tax return. For example, sole proprietors deduct them on Schedule C (Form 1040), *Profit or Loss From Business,* or Schedule F (Form 1040), *Profit or Loss From Farming,* partnerships deduct them on Form 1065, *U.S. Return of Partnership Income,* and corporations deduct them on Form 1120, *U.S. Corporation Income Tax Return,* Form 1120–A, *U.S. Corporation Short-Form Income Tax Return,* or Form 1120S, *U.S. Income Tax Return for an S Corporation.*

Sole proprietors and partners deduct contributions for themselves on line 31 of Form 1040, *U.S. Individual Income Tax Return.* (If you are a partner, contributions for yourself are shown on the Schedule K-1 (Form 1065), *Partner's Share of Income, Credits, Deductions, etc.,* you get from the partnership.)

Table 4–1. **Carryover of Excess Contributions Illustrated—Profit-Sharing Plan (000's omitted)**

Year	Participants' Compensation	Participants' share of required contribution (10% of annual profit)	Deductible limit for current year (15% of compensation)[1]	Contribution	Excess contribution carryover used[2]	Total deduction including carryovers	Excess contribution carryover available at end of year
1999	$1,000	$100	$150	$100	$ 0	$100	$ 0
2000	400	125	60	125	0	60	65
2001	500	50	75	50	25	75	40
2002	600	100	150	100	40	140	0

[1]25% for 2002 and later years.
[2]There were no carryovers from years before 1999.

Carryover of Excess Contributions

If you contribute more to the plans than you can deduct for the year, you can carry over and deduct the difference in later years, combined with your contributions for those years. Your combined deduction in a later year is limited to 25% of the participating employees' compensation for that year. For purposes of this limit, a SEP is treated as a profit-sharing (defined contribution) plan. However, this percentage limit must be reduced to figure your maximum deduction for contributions you make for yourself. See *Deduction Limit for Self-Employed Individuals,* earlier. The amount you carry over and deduct may be subject to the excise tax discussed next.

Table 4–1 illustrates the carryover of excess contributions to a profit-sharing plan.

Excise Tax for Nondeductible (Excess) Contributions

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

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

Exceptions. The following exceptions may enable you to choose not to take certain nondeductible contributions into account when figuring the 10% excise tax.

Contributions to one or more defined contribution plans. If contributions to one or more defined contribution plans are not deductible only because they are more than the combined plan deduction limit, the 10% excise tax does not apply to the extent the difference is not more than the greater of the following amounts.

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

Defined benefit plan exception. For years beginning after 2001, in figuring the 10% excise tax, you can choose not to take into account as nondeductible contributions for any year contributions to a defined benefit plan that are not more than the full funding limit figured without considering the current liability limit. Apply the overall limits on deductible contributions first to contributions to defined contribution plans and then to contributions to defined benefit plans. If you use this new exception, you cannot also use the exception discussed above under *Contributions to one or more defined contribution plans.*

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

Elective Deferrals (401(k) Plans)

Your qualified plan can include a cash or deferred arrangement under which participants can choose to have you contribute part of their before-tax compensation to the plan rather than receive the compensation in cash. A plan with this type of arrangement is popularly known as a "401(k) plan." (As a self-employed individual participating in the plan, you can contribute part of your before-tax net earnings from the business.) This contribution is called an "elective deferral" because participants choose (elect) to set aside the money, and they defer the tax on the money until it is distributed to them.

In general, a qualified plan can include a cash or deferred arrangement only if the qualified plan is one of the following plans.

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

Automatic enrollment in a 401(k) plan. Your 401(k) plan can have an automatic enrollment feature. Under this feature, you can automatically reduce an employee's pay by a fixed percentage and contribute that amount to the 401(k) plan on his or her behalf unless the employee affirmatively chooses not to have his or her pay reduced or chooses to have it reduced by a different percentage. These contributions qualify as elective deferrals. For more information about 401(k) plans with an automatic enrollment feature, see Revenue Ruling 2000–8 in Cumulative Bulletin 2000–1.

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

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

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

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

Employee compensation limit. No more than $200,000 of the employee's compensation can be taken into account when figuring contributions.

SIMPLE 401(k) plan. If you had 100 or fewer employees who earned $5,000 or more in compensation during the preceding year, you may be able to set up a SIMPLE 401(k) plan. A SIMPLE 401(k) plan is not subject to the nondiscrimination and top-heavy plan requirements discussed later under *Qualification Rules.* For details about SIMPLE 401(k) plans, see *SIMPLE 401(k) Plan* in chapter 3.

Limit on Elective Deferrals

There is a limit on the amount an employee can defer each year under these plans. This limit applies without regard to community property laws. Your plan must provide that your employees cannot defer more than the limit that applies for a particular year. For 2002, the basic limit on elective deferrals is $11,000. (For 2003, this limit increases to $12,000.) If, in conjunction with other plans, the deferral limit is exceeded, the difference is included in the employee's gross income.

Catch-up contributions. Beginning in 2002, a 401(k) plan can permit participants who are age 50 or over at the end of the calendar year to also make catch-up contributions. The catch-up contribution limit for 2002 is $1,000 ($2,000 for 2003). Elective deferrals are not treated as catch-up contributions for 2002 until they exceed the $11,000 limit, the ADP test limit of Internal Revenue Code section 401(k)(3), or the plan limit (if any). However, the catch-up contribution a participant can make for a year cannot exceed the lesser of the following amounts.

- The catch-up contribution limit.
- The excess of the participant's compensation over the elective deferrals that are not catch-up contributions.

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

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

Reporting on Form W–2. You must report the total amount deferred in boxes 3, 5, and 12 of your employee's Form W–2. See the Form W–2 instructions.

Treatment of Excess Deferrals

If the total of an employee's deferrals is more than the limit for 2002, the employee can have the difference (called an excess deferral) paid out of any of the plans that permit these distributions. He or she must notify the plan by April 15, 2003 (or an earlier date specified in the plan), of the amount to be paid from each plan. The plan must then pay the employee that amount by April 15, 2003.

Excess withdrawn by April 15. If the employee takes out the excess deferral by April 15, 2003, it is not reported again by including it in the employee's gross income for 2003. However, any income earned on the excess deferral taken out is taxable in the tax year in which it is taken out. The distribution is not subject to the additional 10% tax on early distributions.

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

Even if the employee takes out the excess deferral by April 15, the amount is considered contributed for satisfying (or not satisfying) the nondiscrimination requirements of the plan, unless the distributed amount is for a non-highly compensated employee who participates in only one employer's 401(k) plan or plans. See *Contributions or benefits must not discriminate,* later, under *Qualification Rules.*

Excess not withdrawn by April 15. If the employee does not take out the excess deferral by April 15, 2003, the excess, though taxable in 2002, is not included in the employee's cost basis in figuring the taxable amount of any eventual benefits or distributions under the plan. In effect, an excess deferral left in the plan is taxed twice, once when contributed and again when distributed. Also, if the entire deferral is allowed to stay in the plan, the plan may not be a qualified plan.

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

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

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

See Notice 98–1 for further guidance and transition relief relating to recent statutory amendments to the nondiscrimination rules under sections 401(k) and 401(m). Notice 98–1 is in Cumulative Bulletin 1998–1.

Distributions

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

Required Distributions

A qualified plan must provide that each participant will either:

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

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

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

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

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

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

1) Calendar year in which he or she reaches age $70^1/_2$.
2) Calendar year in which he or she retires.

However, the plan may require the participant to begin receiving distributions by April 1 of the year after the participant reaches age $70^1/_2$ even if the participant has not retired.

If the participant is a 5% owner of the employer maintaining the plan or if the distribution is from a traditional or SIMPLE IRA, the participant must begin receiving distributions by April 1 of the first year after the calendar year in which the participant reached age $70^1/_2$. For more information, see *Tax on Excess Accumulation* in Publication 575.

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

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

Distributions From 401(k) Plans

Generally, distributions cannot be made until one of the following occurs.

- The employee retires, dies, becomes disabled, or otherwise severs employment.
- The plan ends and no other defined contribution plan is established or continued.
- In the case of a 401(k) plan that is part of a profit-sharing plan, the employee reaches age $59^1/_2$ or suffers financial hardship. For the rules on hardship distributions, including the limits on them, see section 1.401(k)–1(d)(2) of the regulations.

CAUTION *Certain distributions listed above may be subject to the tax on early distributions discussed later.*

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

Tax Treatment of Distributions

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

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

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

Eligible rollover distribution. This is a distribution of all or any part of an employee's balance in a qualified retirement plan that is not any of the following.

1) A required minimum distribution. See *Required Distributions,* earlier.

2) Any of a series of substantially equal payments made at least once a year over any of the following periods.
   a) The employee's life or life expectancy.
   b) The joint lives or life expectancies of the employee and beneficiary.
   c) A period of 10 years or longer.
3) A hardship distribution.
4) The portion of a distribution that represents the return of an employee's nondeductible contributions to the plan. See *Employee Contributions,* earlier. Also, see the *Tip* below.
5) A corrective distribution of excess contributions or deferrals under a 401(k) plan and any income allocable to the excess, or of excess annual additions and any allocable gains. See *Correcting excess annual additions,* earlier, under *Limits on Contributions and Benefits.*
6) Loans treated as distributions.
7) Dividends on employer securities.
8) The cost of life insurance coverage.

TIP *A distribution of the employee's nondeductible contributions may qualify as a rollover distribution. The transfer must be made either (1) through a direct rollover to a defined contribution plan that separately accounts for the taxable and nontaxable parts of the rollover or (2) through a rollover to a traditional IRA.*

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

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

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

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

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

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

Tax on Early Distributions

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

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

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

Reporting the tax. To report the tax on early distributions, file ***Form 5329,*** *Additional Taxes on Qualified Plans (Including IRAs) and Other Tax-Favored Accounts.* See the form instructions for additional information about this tax.

Tax on Excess Benefits

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

5% owner. You are a 5% owner if you meet either of the following conditions at any time during the 5 plan years immediately before the plan year that ends within the tax year you receive the distribution.

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

Reporting the tax. Include on Form 1040, line 61, any tax you owe for an excess benefit. On the dotted line next to the total, write "Sec. 72(m)(5)" and write in the amount.

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

Excise Tax on Reversion of Plan Assets

A 20% or 50% excise tax is generally imposed on the cash and fair market value of other property an employer receives directly or indirectly from a qualified plan. If you owe this tax, report it in Part XIII of ***Form 5330.*** See the form instructions for more information.

Notification of Significant Benefit Accrual Reduction

For plan amendments taking effect after June 6, 2001, the employer or the plan will have to pay an excise tax if both the following occur.

- A defined benefit plan or money purchase pension plan is amended to provide for a significant reduction in the rate of future benefit accrual.
- The plan administrator fails to notify the affected individuals and the employee organizations representing them of the reduction in writing. Affected individuals are the participants and alternate payees whose rate of benefit accrual under the plan may reasonably be expected to be significantly reduced by the amendment.

A plan amendment that eliminates or reduces any early retirement benefit or retirement-type subsidy reduces the rate of future benefit accrual.

The notice must be written in a manner calculated to be understood by the average plan participant and must provide enough information to allow each individual to understand the effect of the plan amendment. It must be provided within a reasonable time before the amendment takes effect or September 7, 2001, whichever is later.

The tax is $100 per participant or alternate payee for each day the notice is late. It is imposed on the employer, or, in the case of a multi-employer plan, on the plan.

There are certain exceptions to, and limitations on, the tax. The tax does not apply in any of the following situations.

- The amendment takes effect after June 6, 2001, and notice was provided before April 25, 2001, to participants and beneficiaries adversely affected by the amendment (or their representatives) to notify them of the nature and effective date of the amendment.
- The person liable for the tax was unaware of the failure and exercised reasonable diligence to meet the notice requirements.
- The person liable for the tax exercised reasonable diligence to meet the notice requirements and provided the notice within 30 days starting on the first date the person knew or should have known that the failure to provide notice existed.

If the person liable for the tax exercised reasonable diligence to meet the notice requirement, the tax cannot be more than $500,000 during the tax year. The tax can also be waived to the extent it would be excessive or unfair if the failure is due to reasonable cause and not to willful neglect.

Prohibited Transactions

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

Prohibited transactions generally include the following transactions.

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

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

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

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

Tax on Prohibited Transactions

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

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

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

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

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

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

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

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

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

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

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

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

Reporting Requirements

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

Form 5500–EZ. You can use Form 5500–EZ if the plan meets all the following conditions.

- The plan is a one-participant plan, defined below.

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

One-participant plan. Your plan is a one-participant plan if either of the following is true.

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

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

- You have a one-participant plan that had total plan assets of $100,000 or less at the end of every plan year beginning after December 31, 1993.
- You have two or more one-participant plans that together had total plan assets of $100,000 or less at the end of every plan year beginning after December 31, 1993.

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

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

Form 5500. If you do not meet the requirements for filing Form 5500–EZ, you must file Form 5500.

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) to Form 5500. Schedule A is not needed for a plan that covers only one of the following.

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

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

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

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

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

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

Qualification Rules

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

TIP *Generally, the following qualification rules also apply to a SIMPLE 401(k) retirement plan. A SIMPLE 401(k) plan is, however, not subject to the top-heavy plan rules and nondiscrimination rules if the plan satisfies the provisions discussed in chapter 3 under* SIMPLE 401(k) Plan.

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

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

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

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

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

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

Minimum vesting standard 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.

Participation. In general, an employee must be allowed to participate in your plan if he or she meets both the following requirements.

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

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

Leased employee. A leased employee, defined in chapter 1, who performs services for you (recipient of the services) is treated as your employee for certain plan qualification rules. These rules include those in all the following areas.

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

Contributions or benefits provided by the leasing organization for services performed for you are treated as provided by you.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

For distributions in 2002 and later years, benefits attributable to rollover contributions and earnings on them can be ignored in determining the present value of these benefits.

For distributions made after the Department of Labor adopts final regulations implementing rules on fiduciary responsibilities relating to this provision, a plan must provide for the automatic rollover of any distribution of more than $1,000 to an IRA under this provision, unless the participant chooses otherwise. The plan administrator must notify the participant in writing that the distribution can be transferred to another IRA.

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

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

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

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

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

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

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

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

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

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

SIMPLE 401(k) plan exception. The top-heavy plan requirements do not apply to SIMPLE 401(k) plans.

5.

Table and Worksheets for the Self-Employed

As discussed in chapters 2 and 4, if you are self-employed, you must use the following rate table or rate worksheet and deduction worksheet to figure your deduction for contributions you made for yourself to a SEP-IRA or qualified plan.

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

The table and the worksheets that follow apply only to self-employed individuals who have only one defined contribution plan, such as a profit-sharing plan. A SEP plan is treated as a profit-sharing plan. However, do not use this worksheet for SARSEPs.

Deduction Worksheet for Self-Employed

Step 1

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

*General partners should reduce this amount by the same additional expenses subtracted from line 15a to determine the amount on line 1 or 2 of Schedule SE

Step 2

Enter your deduction for self-employment tax from line 29, Form 1040 . . . . ______

Step 3

Net earnings from self-employment. Subtract step 2 from step 1 . . . . ______

Step 4

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

Step 5

Multiply step 3 by step 4 . . . . ______

Step 6

Multiply $200,000 by your plan contribution rate (not the reduced rate) . . . . ______

Step 7

Enter the **smaller** of step 5 or step 6 . . . . ______

Step 8

Contribution dollar limit $40,000

- **If you made any elective deferrals, go to step 9.**
- **Otherwise, skip steps 9 through 18 and enter the smaller of step 7 or step 8 on step 19.**

Step 9

Enter your allowable elective deferrals made during 2002. Do not enter more than $11,000 . . . . ______

Step 10

Subtract step 9 from step 8 . . . . ______

Step 11

Subtract step 9 from step 3 . . . . ______

Step 12

Enter one-half of step 11 . . . . ______

Step 13

Enter the **smallest** of step 7, 10, or 12 . . . . ______

Step 14

Subtract step 13 from step 3 . . . . ______

Step 15

Enter the **smaller** of step 9 or step 14 . . . . ______

- **If you made catch-up contributions, go to step 16.**
- **Otherwise, skip steps 16 through 18 and go to step 19.**

Step 16

Subtract step 15 from step 14 . . . . ______

Step 17

Enter your catch-up contributions, if any. Do not enter more than $1,000 . . . . . . ______

Step 18

Enter the **smaller** of step 16 or step 17 . . . . ______

Step 19

Add steps 13, 15, and 18. This is your ***maximum deductible contribution*** . . . . ______

Next: Enter your deduction on line 31, Form 1040.

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

First, find your plan contribution rate (the contribution rate stated in your plan) in *Column A* of the table. Then read across to the rate under *Column B.* Enter the rate from *Column B* in step 4 of the *Deduction Worksheet for Self-Employed.*

Rate Table for Self-Employed

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

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

Example. You are a sole proprietor with no employees. If your plan's contribution rate is 10% of a participant's compensation, your rate is 0.090909. Enter this rate in step 4 of the *Deduction Worksheet for Self-Employed.*

Deduction Worksheet for Self-Employed

Step 1

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

*General partners should reduce this amount by the same additional expenses subtracted from line 15a to determine the amount on line 1 or 2 of Schedule SE

Step 2

Enter your deduction for self-employment tax from line 29, Form 1040 7,942

Step 3

Net earnings from self-employment. Subtract step 2 from step 1 192,058

Step 4

Enter your rate from the *Rate Table for Self-Employed* or *Rate Worksheet for Self-Employed* 0.078

Step 5

Multiply step 3 by step 4 14,981

Step 6

Multiply $200,000 by your plan contribution rate (not the reduced rate) 17,000

Step 7

Enter the **smaller** of step 5 or step 6 14,981

Step 8

Contribution dollar limit $40,000

- **If you made any elective deferrals, go to step 9.**
- **Otherwise, skip steps 9 through 18 and enter the smaller of step 7 or step 8 on step 19.**

Step 9

Enter your allowable elective deferrals made during 2002. Do not enter more than $11,000 . . . . ______

Step 10

Subtract step 9 from step 8 . . . . ______

Step 11

Subtract step 9 from step 3 . . . . ______

Step 12

Enter one-half of step 11 . . . . ______

Step 13

Enter the **smallest** of step 7, 10, or 12 . . . . ______

Step 14

Subtract step 13 from step 3 . . . . ______

Step 15

Enter the **smaller** of step 9 or step 14 . . . . ______

- **If you made catch-up contributions, go to step 16.**
- **Otherwise, skip steps 16 through 18 and go to step 19.**

Step 16

Subtract step 15 from step 14 . . . . ______

Step 17

Enter your catch-up contributions, if any. Do not enter more than $1,000 . . . . ______

Step 18

Enter the **smaller** of step 16 or step 17 . . . . ______

Step 19

Add steps 13, 15, and 18. This is your ***maximum deductible contribution*** $14,981

Next: Enter your deduction on line 31, Form 1040.

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

Rate Worksheet for Self-Employed

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

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

Community property laws. If you reside in a community property state and you are married and filing a separate return, disregard community property laws for step 1 of the *Deduction Worksheet for Self-Employed.* Enter on step 1 the total net profit you actually earned.

Example. You are a sole proprietor with no employees. The terms of your plan provide that you contribute 8½% (.085) of your compensation to your plan. Your net profit from line 31, Schedule C (Form 1040) is $200,000. You have no elective deferrals or catch-up contributions. Your self-employment tax deduction on line 29 of Form 1040 is $7,942. See the filled-in portions of both Schedule SE (Form 1040), *Self-Employment Income,* and Form 1040, later.

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

Rate Worksheet for Self-Employed

1) Plan contribution rate as a decimal (for example, 10½% = 0.105) 0.085
2) Rate in line 1 plus 1 (for example, 0.105 + 1 = 1.105) 1.085
3) Self-employed rate as a decimal rounded to at least 3 decimal places (line 1 ÷ line 2) 0.078

Portion of Schedule SE (Form 1040)

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

1	Net farm profit or (loss) from Schedule F, line 36, and farm partnerships, Schedule K-1 (Form 1065), line 15a	1	
2	Net profit or (loss) from Schedule C, line 31; Schedule C-EZ, line 3; Schedule K-1 (Form 1065), line 15a (other than farming); and Schedule K-1 (Form 1065-B), box 9. Ministers and members of religious orders, see page SE-1 for amounts to report on this line. See page SE-2 for other income to report	2	200,000
3	Combine lines 1 and 2	3	200,000
4	**Net earnings from self-employment.** Multiply line 3 by 92.35% (.9235). If less than $400, **do not** file this schedule; you do not owe self-employment tax ▶	4	184,700
5	**Self-employment tax.** If the amount on line 4 is: • $84,900 or less, multiply line 4 by 15.3% (.153). Enter the result here and on **Form 1040, line 56.** • More than $84,900, multiply line 4 by 2.9% (.029). Then, add $10,527.60 to the result. Enter the total here and on **Form 1040, line 56.**	5	15,884
6	**Deduction for one-half of self-employment tax.** Multiply line 5 by 50% (.5). Enter the result here and on **Form 1040, line 29.** — 6 — 7,942		

For Paperwork Reduction Act Notice, see Form 1040 instructions. Cat. No. 11358Z **Schedule SE (Form 1040) 2002**

Portion of Form 1040

Adjusted Gross Income

23	Educator expenses (see page 29)	23			
24	IRA deduction (see page 29)	24			
25	Student loan interest deduction (see page 31)	25			
26	Tuition and fees deduction (see page 32)	26			
27	Archer MSA deduction. Attach Form 8853	27			
28	Moving expenses. Attach Form 3903	28			
29	One-half of self-employment tax. Attach Schedule SE	29	7,942		
30	Self-employed health insurance deduction (see page 33)	30			
31	Self-employed SEP, SIMPLE, and qualified plans	31	14,981		
32	Penalty on early withdrawal of savings	32			
33a	Alimony paid **b** Recipient's SSN ▶	33a			
34	Add lines 23 through 33a			34	22,923
35	Subtract line 34 from line 22. This is your **adjusted gross income** ▶			35	

For Disclosure, Privacy Act, and Paperwork Reduction Act Notice, see page 76. Cat. No. 11320B Form **1040** (2002)

6.

How To Get Tax Help

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

Contacting your Taxpayer Advocate. If you have attempted to deal with an IRS problem unsuccessfully, you should contact your Taxpayer Advocate.

The Taxpayer Advocate represents your interests and concerns within the IRS by protecting your rights and resolving problems that have not been fixed through normal channels. While Taxpayer Advocates cannot change the tax law or make a technical tax decision, they can clear up problems that resulted from previous contacts and ensure that your case is given a complete and impartial review.

To contact your Taxpayer Advocate:

- Call the Taxpayer Advocate at **1–877–777–4778.**
- Call, write, or fax the Taxpayer Advocate office in your area.
- Call **1–800–829–4059** if you are a TTY/TDD user.

For more information, see Publication 1546, *The Taxpayer Advocate Service of the IRS.*

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

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

- See answers to frequently asked tax questions or request help by e-mail.
- Download forms and publications or search for forms and publications by topic or keyword.
- Order IRS products on-line.
- View forms that may be filled in electronically, print the completed form, and then save the form for recordkeeping.
- View Internal Revenue Bulletins published in the last few years.
- Search regulations and the Internal Revenue Code.
- Receive our electronic newsletters on hot tax issues and news.
- Learn about the benefits of filing electronically (IRS e-file).
- Get information on starting and operating a small business.

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

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

For help with transmission problems, call the FedWorld Help Desk at **703 – 487 – 4608.**

Phone. Many services are available by phone.

- *Ordering forms, instructions, and publications.* Call **1 – 800 – 829 – 3676** to order current and prior year forms, instructions, and publications.
- *Asking tax questions.* Call the IRS with your tax questions at **1 – 800 – 829 – 4933.**
- *Retirement plan assistance.* If you own a business and have questions about starting a pension plan, an existing plan, or filing **Form 5500**, call our **Tax Exempt/ Government Entities Customer Account Services** at **1 – 877 – 829 – 5500**. Assistance is available Monday through Friday from 8:00 a.m. to 6:30 p.m. EST. **If you have questions about a traditional or Roth IRA or any individual income tax issues, you should call 1 – 800 – 829 – 1040.**
- *Solving problems.* Take advantage of Everyday Tax Solutions service by calling your local IRS office to set up an in-person appointment at your convenience. Check your local directory assistance or **www.irs.gov** for the numbers.
- *TTY/TDD equipment.* If you have access to TTY/TDD equipment, call **1 – 800 – 829 – 4059** to ask tax questions or to order forms and publications.
- *TeleTax topics.* Call **1 – 800 – 829 – 4477** to listen to pre-recorded messages covering various tax topics.

Evaluating the quality of our telephone services. To ensure that IRS representatives give accurate, courteous, and professional answers, we use several methods to evaluate the quality of our telephone services. One method is for a second IRS representative to sometimes listen in on or record telephone calls. Another is to ask some callers to complete a short survey at the end of the call.

Walk-in. Many products and services are available on a walk-in basis.

- *Products.* You can walk in to many post offices, libraries, and IRS offices to pick up certain forms, instructions, and publications. Some IRS offices, libraries, grocery stores, copy centers, city and county governments, credit unions, and office supply stores have an extensive collection of products available to print from a CD-ROM or photocopy from reproducible proofs. Also, some IRS offices and libraries have the Internal Revenue Code, regulations, Internal Revenue Bulletins, and Cumulative Bulletins available for research purposes.
- *Services.* You can walk in to your local IRS office to ask tax questions or get help with a tax problem. Now you can set up an appointment by calling your local IRS office number and, at the prompt, leaving a message requesting Everyday Tax Solutions help. A representative will call you back within 2 business days to schedule an in-person appointment at your convenience.

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

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

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

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

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

CD-ROM for small businesses. IRS Publication 3207, *Small Business Resource Guide,* is a must for every small business owner or any taxpayer about to start a business. This handy, interactive CD contains all the business tax forms, instructions and publications needed to successfully manage a business. In addition, the CD provides an abundance of other helpful information, such as how to prepare a business plan, finding financing for your business, and much more. The design of the CD makes finding information easy and quick and incorporates file formats and browsers that can be run on virtually any desktop or laptop computer.

It is available in March. You can get a free copy by calling **1-800-829-3676** or by visiting the website at **www.irs.gov/smallbiz**.

Index

To help us develop a more useful index, please let us know if you have ideas for index entries. See "Comments and Suggestions" in the "Introduction" for the ways you can reach us.

■

Tax Publications for Business Taxpayers

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

General Guides

1 Your Rights as a Taxpayer
17 Your Federal Income Tax (For Individuals)
334 Tax Guide for Small Business (For Individuals Who Use Schedule C or C-EZ)
509 Tax Calendars for 2003
553 Highlights of 2002 Tax Changes
910 Guide to Free Tax Services

Employer's Guides

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

Specialized Publications

225 Farmer's Tax Guide
378 Fuel Tax Credits and Refunds
463 Travel, Entertainment, Gift, and Car Expenses
505 Tax Withholding and Estimated Tax
510 Excise Taxes for 2003
515 Withholding of Tax on Nonresident Aliens and Foreign Entities
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 (NOLs) for Individuals, Estates, and Trusts
537 Installment Sales
538 Accounting Periods and Methods
541 Partnerships
542 Corporations
544 Sales and Other Dispositions of Assets
551 Basis of Assets
556 Examination of Returns, Appeal Rights, and Claims for Refund
560 Retirement Plans for Small Business (SEP, SIMPLE, and Qualified Plans)
561 Determining the Value of Donated Property
583 Starting a Business and Keeping Records
587 Business Use of Your Home (Including Use by Day-Care Providers)
594 The IRS Collection Process
595 Tax Highlights for Commercial Fishermen
597 Information on the United States-Canada Income Tax Treaty
598 Tax on Unrelated Business Income of Exempt Organizations
686 Certification for Reduced Tax Rates in Tax Treaty Countries
901 U.S. Tax Treaties
908 Bankruptcy Tax Guide
911 Direct Sellers
925 Passive Activity and At-Risk Rules
946 How To Depreciate Property
947 Practice Before the IRS and Power of Attorney
954 Tax Incentives for Empowerment Zones and Other Distressed Communities
1544 Reporting Cash Payments of Over $10,000
1546 The Taxpayer Advocate Service of the IRS

Spanish Language Publications

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

Commonly Used Tax Forms

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

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