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

For use in preparing
1998 Returns



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Important Changes

Includible compensation. Beginning in 1998, your includible compensation for purposes of figuring your exclusion allowance includes:

- 1) Elective deferrals (your employer's contributions made on your behalf under a salary reduction agreement),
- 2) Amounts contributed or deferred by your employer under a Section 125 cafeteria plan, and
- 3) Amounts contributed or deferred under a Section 457 plan (state or local government or tax-exempt organization plan).

Your exclusion allowance is the amount of employer contributions (including elective deferrals) to your tax-sheltered annuity that you can exclude from income. For more information on includible compensation, see *Includible Compensation*, later.

Contributions — Employed ministers. Beginning in 1998, contributions made to a church plan on behalf of a minister not employed by the church that has the plan may be excluded from the minister's gross income. They are excluded if they would have been excluded had the minister been an employee of the church.

For more information on exclusion of contributions to church plans, see *Special Rules*, under *Includible Compensation*, later.

Introduction

This publication explains the federal tax provisions that apply to tax-sheltered annuity (TSA) plans offered to employees of public schools and certain tax-exempt organizations. The discussions primarily cover employer contributions (elective deferrals) made under a salary reduction agreement. The publication is for employees who participate in TSA plans. It is not for custodians or plan administrators because it does not cover many of the operating requirements of these plans.

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

A qualified employer can purchase TSAs for eligible employees. Three types of employers qualify — public schools, certain tax-exempt organizations, and certain employers of ministers. Your employer may be able to help you determine whether you are an eligible employee.

The most common way to contribute to TSA plans is through a salary reduction agreement. This is an agreement under which an employee agrees to take a reduction in salary or to forgo a salary increase, and the employer contributes that amount to a TSA plan for that employee. These employer contributions made on your behalf are called "elective deferrals." A TSA plan can also be funded through non-elective employer contributions, employee contributions, or a combination of these contributions.

There is an annual limit on elective deferrals. Generally, you cannot defer more than \$10,000 for 1998 for all plans covering you, including TSAs. If elective deferral contributions on your behalf are more than the allowable amount, you must include the excess in your gross income.

Limits are placed on the contributions that can be made by an employer to TSA plans. If you also are covered by a qualified plan, special rules may apply in determining the limit on employer contributions for you to a TSA plan.

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

Employees of educational organizations, hospitals, home health service agencies, health and welfare service agencies, churches, and certain church-related organizations can make a "catch-up" election to increase the limit on employer contributions for the exclusion allowance.

The *Other Rules* section includes discussions on the taxability of the cost of insurance under a TSA and on employer contributions subject to social security and Medicare taxes.

In most cases, the payments you receive, or that are made available to you, under your TSA contract are taxable in full as ordinary income. In general, the same tax rules apply to distributions from TSAs that apply to distributions from other retirement plans. These rules are explained in Publication 575, *Pension and Annuity Income*. If you transfer all or part of your interest from a TSA contract or account to another TSA contract or ac-

count, the transfer may be tax free. You can generally roll over tax free all or any part of a distribution from a TSA plan to an IRA or another TSA plan.

You can use the worksheets at the end of this publication to figure many of the limits that apply to your TSA.

Useful Items

You may want to see:

Publication

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

Form (and Instructions)

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

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

What Is a Tax-Sheltered Annuity (TSA) Plan?

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

The TSA plan can invest funds for participating employees in:

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

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

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

Qualified Employer

A qualified employer can purchase TSAs for eligible employees. Three types of employers qualify — public schools, certain tax-exempt

organizations, and certain employers of ministers.

Public Schools

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

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

Tax-Exempt Organizations

Generally, a qualified employer includes an organization that is tax exempt because it is organized and operated exclusively for religious, charitable, scientific, public safety testing, literary, or educational purposes. A qualified employer also includes a tax-exempt organization that is organized and operated exclusively to encourage national or international amateur sports competition (but only if no part of its activities involve the provision of athletic facilities or equipment), or for the prevention of cruelty to children or animals. The organization can be a corporation, community chest, fund, or foundation.

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

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

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

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

Certain Employers of Ministers

A duly ordained or licensed minister of a church who, in connection with the exercise of his or her ministry, is either:

- 1) Self-employed or
- 2) Employed by an organization other than a tax-exempt organization (a chaplain),

is treated as employed by a tax-exempt organization.

Eligible Employees

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

The employer who pays you for services you perform may be able to help you determine whether you are an eligible employee.

Employees of Public School Systems

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

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

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

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

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

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

Employees of Certain Tax-Exempt Organizations

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

Physicians Who Perform Services in a Hospital

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

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

- Does not take on outside duties that would negatively affect primary services to the hospital,
- Does not furnish services to other hospitals without the employer's consent,
- Obeys all rules and regulations of the hospital, and
- Receives a pay adjustment if the percentage of pay is less than an amount guaranteed by the agreement.

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

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

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

Ministers of Certain Employers

A duly ordained or licensed minister of a church who is working as a minister or chaplain, but is self-employed or is working for an employer that is not a qualified tax-exempt organization, is treated as employed by a qualified tax-exempt organization for purposes of participating in a retirement income account (TSA plan).

Contributions

A TSA can be funded by the following contributions:

- Elective deferrals,
- Non-elective employer contributions,
- After-tax employee contributions, or
- A combination of the above.

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

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

Non-elective employer contributions defined. An employer contribution to a TSA is treated as a non-elective contribution if employees are not required to choose the contributions. The employer chooses to make these contributions to the TSAs and generally must make them on behalf of all eligible employees. The employer must be a qualified employer (defined earlier) for the contributions to be excluded from the employee's gross income. These contributions are subject to the limit on employer contributions discussed later.

After-tax employee contributions. If the plan permits these contributions, an employee contribution made with funds on which income taxes have already been paid is treated as an after-tax contribution. A salary payment on which income tax was withheld is an example of such funds. These contributions are subject to the limit on employer contributions.

Funding by elective deferrals. Employers contribute to a TSA primarily through a salary reduction agreement (discussed later). Under this agreement, you (the employee) agree to take a reduction in salary or to forego a salary increase and your employer agrees to contribute the amount of the salary reduction or the foregone salary increase toward the purchase of your TSA.

These employer contributions made on your behalf are excluded (within limits discussed next) from your income when made. The excluded amounts are included in your income when you withdraw them. These contributions generally are called "elective deferrals." See *Limit on Elective Deferrals*, later, for more information.

Exclusion From Gross Income

Generally, if you are an eligible employee (defined earlier), you can exclude from gross income your qualified employer's (defined earlier) contributions to your TSA.

 **Contributions made by a self-employed minister or chaplain who is treated as employed by a qualified tax-exempt organization to a retirement income account that is treated as a TSA are deductible (rather than excludible) up to the exclusion limits for TSAs (discussed next). This is true unless the contributions are made by the employer of a chaplain and excluded from the chaplain's income as discussed un-**

der Specials Rules under Includible Compensation, later.

Exclusion Limits

The amount you exclude for a tax year cannot be more than any of the following limits.

- 1) The exclusion allowance (discussed later) for your tax year.
- 2) The limit on employer contributions (discussed later) for the limitation year (discussed later) ending with or within your tax year.
- 3) The limit on elective deferrals (discussed later) for the year.

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

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

Rollover contributions. For purposes of applying these limits, your employer's contributions do not include a rollover contribution from another TSA or a traditional individual retirement arrangement (IRA). A traditional IRA is any IRA that is not a Roth, SIMPLE, or education IRA.

Only elective deferrals. If all of the contributions are elective deferrals, the total must not be more than the smallest of the three limits in the preceding list.

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

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

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

Treatment of Excess Contributions

If the contributions to your TSA for a year are more than any of the limits discussed above under *Exclusion Limits*, you must include the excess in your income for that year. Further, if you have an excess because the contributions are more than limit (2), that excess reduces the amount of your exclusion allowance for future years, even though the excess has already been included in your income.

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

Salary Reduction Agreement

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

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

Treatment of contributions. Amounts contributed by the employer under the salary reduction agreement and invested in a TSA for the employee are generally treated as elective deferrals (defined earlier under *Contributions*).

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

Limit on Elective Deferrals

In addition to the exclusion allowance and the limit on employer contributions (both discussed later), which apply to TSA contributions, there is an annual limit on combined elective deferrals. Elective deferrals are defined earlier under *Contributions*.

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

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

Dollar limit. Generally, you cannot defer more than an allowable amount each year for all plans covering you, including TSAs. For 1998, the allowable amount (limit) is \$10,000.

This limit applies without regard to community property laws. If you defer more than the allowable amount for a tax year, you must include the excess in your gross income for that year. See *Excess Deferrals*, later.

Increase for 15-year employees. If you have a TSA and you have completed at least 15 years of service with an educational organization, hospital, home health service agency, health and welfare service agency, church, or convention or association of churches (or associated organization), the \$10,000 limit for the TSA is increased each tax year. The limit is increased by the **smallest** of the following amounts.

- 1) \$3,000.
- 2) \$15,000, reduced by increases to the \$10,000 limit you were allowed in earlier years because of this rule.
- 3) \$5,000 times the number of your years of service for the organization, minus the total elective deferrals made by the organization for you for earlier years.

For example, if you qualify, you may increase your elective deferrals to \$13,000. For the computation, see Step 2 of Worksheet 3.

Cost-of-living adjustment. Under current law, the \$10,000 limit is to be increased to reflect any increases in the Consumer Price Index in future years.

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

Excess Deferrals

Excess deferrals are total elective deferrals for the year minus the limit on elective deferrals.

Tax Treatment

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

Distribution of excess. If the plan allows you to receive the excess amount and that is what you choose to do, you must notify the plan as explained next.

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

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

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

Distribution of excess by the required date. If you receive the excess amount by April 15, do not include it again in your gross income and do not subject it to the additional 10% tax for premature distributions. However, any income earned on the excess deferral that is distributed to you is taxable to you in the tax year paid.

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

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

Limit on Employer Contributions

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

- 1) \$30,000, or
- 2) 25% of the employee's compensation (defined later) for the year.

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

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

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

Contributions in excess of employer limit. An excess employer contribution must be included in your gross income in the tax year when it is made.

For future tax years, the exclusion allowance (see *The Exclusion Allowance*, later) must be reduced by this excess contribution even though it was not excludable from your gross income in the tax year when it was made.

TSA and qualified plan. If because you must combine a TSA with a qualified plan, the limit is exceeded, the same rule applies. You must include the excess in your gross income

for the tax year the excess contribution is made and reduce your exclusion allowance for any future years in which you are a participant in a TSA plan.

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

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

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

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

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

Generally, compensation **does not include:**

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

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

The Exclusion Allowance

The exclusion allowance is the amount of employer contributions (including **elective**

deferrals) to your tax-sheltered annuity (TSA) that you can exclude from income. To figure the amount of the exclusion allowance, see *How To Figure*, later. You pay tax on the excluded amount when you receive a distribution from the TSA.

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

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

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

How To Figure

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

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

Reduction of the exclusion allowance.

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

For future years, treat the excess as though it were an amount previously excludable.

Example. At the end of 1998, you had completed 3 years of service with your employer. Your salary for 1998 was \$32,000 after being reduced under a revocable salary reduction agreement by \$3,600 to finance your employer's contributions toward the purchase of a TSA for you. Your employer's contributions for the year totaled \$3,600, \$100 of which was for current term life insurance protection.

In previous years, your employer's contributions to the regular retirement plan totaled \$7,200, all of which you properly excluded from gross income. You figure your exclusion allowance (the amount excludable from gross income) and the amount of any employer contributions includible in your gross income for 1998 as follows.

Step 1—Limit on Employer Contributions

1) a) Maximum	\$30,000
b) 25% of employee's compensation (25% × \$32,000 = \$8,000)	\$8,000
c) Limit (Lesser of (a) or (b))	<u>\$8,000</u>

Step 2—Contributions in Excess of Employer Limit

2) 1998 contribution for purchase of TSA	\$3,600
3) Minus: Portion of line 2, if any, representing cost of term life insurance (treated as paid by employee)	100
4) Employer contribution	\$3,500
5) Minus: Limit on employer contributions [line 1(c)]	8,000
6) Excess contribution (if any) [line 4 minus line 5, but not less than zero]	<u>\$ -0-</u>

Step 3—Exclusion Allowance

7) Includible compensation	\$32,000
8) Percentage limit	20%
9) Years of service	3
10) Multiply (7) × (8) × (9)	\$19,200
11) Minus: Amounts previously excludable	7,200
12) Exclusion allowance	<u>\$12,000</u>

Step 4—Amount Excludable From Gross Income

13) a) Employer contribution [line 4]	\$3,500
b) Limit on employer contributions [line 1(c)]	8,000
c) Exclusion allowance [line 12]	\$12,000
d) Limit on elective deferrals	\$10,000
14) Amount excludable [least of 13(a), (b), (c), or (d)]	<u>\$3,500</u>

Step 5—Amount Includible in Gross Income

15) Employer contribution [line 4]	\$3,500
16) Minus: Amount excludable [line 14] ..	3,500
17) Amount includible [line 15 minus line 16]	<u>\$ -0-</u>

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

Catch-up election for certain employees.

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

Minimum exclusion allowance for church employees.

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

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

Includible Compensation

For purposes of figuring your exclusion allowance, includible compensation generally is the amount of pay that you received from the employer who made contributions to your TSA and that you must include in income for the most recent period (ending no later than the end of your tax year) which you can count as one year of service. It does not include your employer's contributions to your TSA. You determine the amount that must be included in income without taking into account the foreign earned income exclusion. See *Most Recent One-Year Period of Service*, later.

For purposes of figuring your exclusion allowance, the following amounts (which you generally do not have to include in income) are includible compensation.

- Elective deferrals (employer's contributions made on your behalf under a salary reduction agreement).
- Amounts contributed or deferred by your employer under a Section 125 cafeteria plan, and
- Amounts contributed or deferred under a Section 457 nonqualified deferred compensation plan (state or local government or tax-exempt organization plan).

Self-employed ministers. Compensation of a self-employed minister who is treated as employed by a tax-exempt organization is the minister's earnings from self-employment reduced by contributions to retirement plans and the deduction for one-half of the self-employment tax.

Special Rules

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

Employer not qualified. Only the compensation earned from the employer purchasing your TSA contract is includible compensation. Do not include compensation earned while your employer was not a qualified employer. However, your employer's status when you actually receive the compensation does not matter.

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

Contributions for a TSA. Contributions by your employer for a TSA are not part of includible compensation.

Foreign missionary. However, if you are a foreign missionary during the tax year, your includible compensation includes contributions by the church during the year toward your TSA.

You are a foreign missionary if:

- 1) You are a duly ordained, commissioned, or licensed minister of a church, or a lay person,
- 2) You are an employee of a church or a convention or association of churches, and
- 3) Your principal duties are spreading religious doctrine or performing sacerdotal

functions or humanitarian good works for the church outside the United States.



Beginning in 1998, contributions made to a church plan on behalf of a duly ordained, commissioned, or licensed minister employed by an employer other than the church that has the plan, are excluded from the minister's gross income if they would have been excluded had the minister been an employee of the church.

For purposes of this rule, a minister of a church also includes:

- 1) A self-employed minister, and
- 2) A minister employed by an organization other than a tax-exempt organization that shares a common religious bond with the minister.

Contributions to a TSA and a qualified retirement plan. If your employer makes contributions for you toward both a TSA contract and a qualified retirement plan, your employer's contributions to the qualified retirement plan that you can exclude from income are not part of includible compensation for figuring your exclusion allowance.

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

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

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

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

Most Recent One-Year Period of Service

When determining your includible compensation for purposes of figuring the exclusion allowance, first take into account the services you performed during the tax year for which you are figuring the exclusion allowance. Keep in mind that your most recent one-year period of service may not be the same as your employer's most recent annual work period. This can happen if your tax year is not the same as that of your employer.

Tax year different than that of employer. If your tax year is not the same as that of your employer, your most recent one-year period of service is made up of parts of at least two of your employer's annual work periods.

Example. A professor who reports her income on a calendar year basis is employed on a full-time basis by a university that operates on an academic year (October through May). For purposes of computing her exclusion allowance for 1998, the professor's most recent one-year period of service consists of her service performed during January through May of 1998 and her service performed during October through December of 1998.

Part-time or employed only part of year. If you are a part-time employee, or a full-time employee who is employed for only part of the year, your most recent one-year period of service consists of your service this year and your service for as many previous years as is necessary to total one full year of service. (See *Full year of service* later under *Rules for Figuring*.) You add up your most recent periods of service to determine your most recent one-year period of service. First take into account your service during your tax year for which the exclusion allowance is being determined. Then add your service during your next preceding tax year and so forth until your service totals one year of service.

Example. You were employed on a full-time basis during the months July through December 1996 (1/2 year of service), July through December 1997 (1/2 year of service), and October through December 1998 (1/4 year of service). Your most recent one-year period of service for purposes of computing your exclusion allowance for 1998 is the total of your service during 1998 (1/4 year of service), your service during 1997 (1/2 year of service), and your service during the months October through December 1996 (1/4 year of service).

Not yet employed for one year. If at the close of your tax year, you have not yet worked for your employer for one year (including time you worked for the same employer in earlier tax years), use the period of time you have worked for the employer as your most recent one-year period of service.

Years of Service

For purposes of figuring your exclusion allowance, your years of service depend on your employment status with the employer who maintains the plan for this tax year and earlier tax years. How you figure your years of service depends on whether you were a full-time or a part-time employee, whether you worked for the full year or only part of the year, and whether you have worked for your employer for one year.

Definition

Your years of service are the total number of years you worked for your employer figured as of the end of the tax year for which you are figuring an exclusion allowance. The service need not be continuous.

Rules for Figuring

Take the following rules into account when figuring your years of service.

Less than one year of total service. Your years of service cannot be less than one year. If at the end of your tax year, you have less than one year of service (including service in any previous years), figure your exclusion al-

lowance as if your years of service is one year.

Status of employer. Your years of service will only include periods that your employer was a qualified employer (defined earlier).

Service with one employer. Generally, you cannot count service for any other employer.

Church employee. If you are a church employee, treat all of your years of service with related church organizations as years of service with one employer. If during your church career you transfer from one organization to another within that church or to an associated organization, treat all this service as service with a single employer. When these organizations make contributions to your annuity contracts, treat them as made by the same employer.

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

Self-employed ministers. If you are a self-employed minister, your years of service include full and part years in which you have been treated as employed by a qualified tax-exempt organization.

Full-time employee for full year. Count each full year during which you were employed full-time as one year of service. In determining whether you were employed full-time, compare the amount of work you were required to perform with the amount of work normally required of others who held the same position with the same employer and who generally received most of their pay from the position.

How to compare. You can use any method that reasonably and accurately reflects the amount of work required. You can use the number of hours of classroom instruction as a measure of the amount of work required.

In determining whether positions with the same employer are the same, consider all of the facts and circumstances concerning the positions, including the work performed, the methods by which pay is determined, and the descriptions (or titles) of the positions. For example, an assistant professor employed in the English department of a university will be considered a full-time employee if the amount of work that he is required to perform is the same as the amount of work normally required of assistant professors of English at that university who get most of their pay from that position.

If no one else works for your employer in the same position, compare your work with the work normally required of others who held the same position with similar employers or similar positions with your employer.

Full year of service. A full year of service for a particular position means the usual annual work period of anyone employed full-time in that general type of work at that place of employment.

Example. If a doctor works for a hospital 12 months of a year except for a one-month vacation, the doctor will be considered as employed for a full year if the other doctors at that hospital also work 11 months of the year with a one-month vacation. Similarly, if the usual annual work period at a university

consists of the fall and spring semesters, an instructor at that university who teaches these semesters will be considered as working a full year.

Part-time or employed only part of year. You include a fraction of a year of service for each year during which you were a full-time employee for part of the year or a part-time employee for the entire year or for a part of the year.

Full-time for part of year. If you worked full time for part of the year, you figure the fraction of a year of service to include by dividing the number of weeks (or months) during which you were a full-time employee by the number of weeks (or months) considered the usual annual work period for the position you held.

Example. If you were employed full time as an instructor by a university for the 1998 spring semester (which lasts from February 1998 through May 1998) and the academic year of the university is 8 months long, (from October 1997 through May 1998), you completed 4/8 of a year of service.

Part-time for full year. If you worked part time for a full year, you figure the fraction of a year of service to include by dividing the amount of work required of you by the amount of work normally required of someone holding the same position on a full-time basis. You can use any method that reasonably and accurately reflects the amount of work required. You can use the number of hours of classroom instruction as a measure of the amount of work required.

Example. A practicing physician teaches one course at a local medical school 3 hours per week for two semesters and other faculty members at the same school teach 9 hours per week for two semesters. The practicing physician is considered as having completed 3/9 of a year of service.

Part-time for part of year. If you worked part time for part of the year, you figure the fraction of a year of service to include by multiplying two fractions. Figure one fraction as if you worked full time for part of the year and figure the other fraction as if you worked part time for the full year.

Example. An attorney who is a specialist in a subject teaches a course in that subject for 3 hours per week for one semester at a law school. The full-time instructors at that law school teach 12 hours per week for two semesters. The fractional part of a year of service for the part-time instructor is computed as follows. The fractional year of service if the instructor were a part-time employee for a full year is 3/12 (number of hours employed divided by the usual number of hours of work required for that position). The fractional year of service if the instructor were a full-time employee for part of a year is 1/2 (period worked or one semester, divided by usual work period, or 2 semesters). These fractions are multiplied to obtain the fractional year of service: 3/12 times 1/2, or 3/24 (1/8).

Amounts Previously Excludable

To figure your exclusion allowance, you must know the amounts previously excludable from your income.

Definition

Amounts previously excludable is the total of all contributions for retirement benefits made for you by your employer that you could exclude from your gross income. It does not include amounts for the tax year for which the current exclusion allowance is being figured.

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

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

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

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

How To Figure



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

Formula. Determine the contributions your employer made for you as of the end of any tax year by multiplying the following four items.

- 1) The **projected annual amount** of your pension (as of the end of the tax year) to be provided at normal retirement age from employer contributions, based on the plan provisions in effect at that time, and assuming your continued employment with that employer at your then current salary rate.
- 2) The value from **Table I** based on the normal retirement age as defined in the plan.
- 3) The amount from **Table II** for the sum of the following two items.

- a) The number of years remaining from the end of the tax year to normal retirement age.
 - b) The lesser of the number of years of service credited through the end of the tax year or the number of years that the plan has been in existence at that time.
- 4) The **lesser** of the number of years of service credited through the end of the tax year or the number of years that the plan has been in existence at that time.

An example of the use of this formula follows *Table I* and *Table II*.

Table I

[Value at normal retirement ages of annuity of \$1.00 per year payable in equal monthly installments during the life of the employee.]

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

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

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

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

Table II

[Level annual contribution which will accumulate to \$1.00 at the end of a number of years.]

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

Example. Joe Blue, who was 29 at the end of 1998, has been employed by the Oak County school system since 1995. In 1995, Joe's employer contributed to a TSA plan. Since 1995, Joe's employer has contributed to both the TSA plan and a statewide retirement system that provides a straight-life annuity upon retirement. Joe is covered by both plans.

Joe wishes to figure the amounts previously excludable under both plans so that he can figure the exclusion allowance for 1998. His employer's contributions to the statewide retirement system were not allocated among the individual employees.

Joe's employer gives him the following information:

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

1995	\$2,000
1996	2,400
1997	2,800

The **projected annual amount** of Joe's retirement system pension (as of the end of 1997 when Joe was 28) is \$12,000. The pension begins at age 65 from his employer's contributions. This is based on 1997 plan provisions and assumes that Joe works for the same employer until age 65 at his 1997 salary. Normal retirement age is 65.

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

1. **Projected annual amount** of pension at normal retirement age (65) \$12,000
2. **Table I** value at normal retirement age (65) 8.08
3. **Table II** amount for the sum of:
 - a) Number of years from end of the preceding tax year (1997) to normal retirement age (65 minus 28) 37
 - b) Plus: Lesser of years of plan existence or years of service 3
 - Total 40
4. **Table II** amount for total of 400039
4. **Lesser** of years of plan existence or years of service 3

Joe multiplies (1) × (2) × (3) × (4).

\$12,000 x 8.08 x .0039 x 3 = **\$1,134.43**

Joe then adds his employer's contributions to the pension plan (\$1,134.43) to the excludable contributions to the TSA plan in years prior to the 1998 tax year (\$7,200) to determine the amounts previously excludable of \$8,334.43.

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

Catch-up Election — Alternative Limits for Certain Employees

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

An educational organization and a church employee were defined earlier.

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

Church. For this purpose, "church" includes a church, convention or association of churches, or a tax-exempt organization controlled by or associated with a church or a convention or association of churches.

Alternative limits. There are three alternative limits.

- 1) The "year of separation from service limit."
- 2) The "any year limit."
- 3) The "overall limit."

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

Effect of election. Generally, the election to use one of the first two alternative limits listed above will permit you to exclude from gross income a larger amount of employer contributions than allowed under the part of the "overall limit" that limits employer contributions to 25% of your compensation. If you elect to use the "overall limit," you may be able to exclude a larger amount because you

can disregard the exclusion allowance (discussed earlier) that would otherwise apply.

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

Year of Separation from Service Limit

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

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

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

If your employer's contributions for the year are more than the smallest of:

- 1) Your modified exclusion allowance,
- 2) \$30,000, or
- 3) The limit on elective deferrals, if it applies,

you must include the excess in gross income.

Example. Frank Green, who is president of a university, plans to retire on December 31, 1998, after 20 years of service. His compensation for 1998, which was not reduced by any elective deferrals, is \$100,000. During the 10-year period before the date of separation from service, Frank's employer contributed \$40,000 to Frank's TSA. The contributions, which were non-elective, were excludable from Frank's gross income. During all his years of service, his employer contributed a total of \$60,000 that was excludable from Frank's gross income. For 1998, Frank elects to have his employer contribute the maximum amount permitted for non-elective employer contributions to his TSA. He figures that amount using the "year of separation from service limit" as follows:

Step 1—Exclusion Allowance (before modification)

1) Includible compensation	\$100,000
2) Percentage limit	20%
3) Years of service	20
4) Multiply (1) × (2) × (3)	\$400,000
5) Minus: Amounts previously excludable	60,000
6) Exclusion allowance	<u>\$340,000</u>

Step 2—Limit on Employer Contributions

1) Maximum	<u>\$30,000</u>
2) 25% of compensation limit	
(a) Compensation	\$100,000
(b) Percentage limit	25%
(c) Limit	<u>\$25,000</u>
3) Limit on Employer Contributions (lesser of (1) or (2))	<u>\$25,000</u>

Step 3—Year of Separation from Service Limit

1) Employer Limit on Contributions — Maximum	<u>\$30,000</u>
2) Exclusion allowance (modified)	
(a) Includible compensation	\$100,000
(b) Percentage limit ..	20%
(c) Years of service (Limited to 10 years) ..	10
(d) Multiply (a) × (b) × (c)	\$200,000
(e) Minus: Amounts previously excludable during 10-year period ..	40,000
(f) Exclusion allowance (modified)	<u>\$160,000</u>
3) Alternative Limit — Year of Separation from Service Limit [lesser of (1) or (2)(f)]	<u>\$30,000</u>

Because Frank elected this alternative limit, and because there are no elective deferrals, his employer can contribute \$30,000 to Frank's TSA during the year of his separation from service without making an excess contribution. In Step 1, Frank's unadjusted exclusion allowance is \$340,000. In Step 2, employer contributions to Frank's TSA are limited to \$25,000. If it were not for this election, the limit on employer contributions for Frank would be \$25,000 (Step 2). Instead, the limit is \$30,000.

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

Any Year Limit

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

- 1) \$4,000, plus 25% of your includible compensation for the tax year in which the limitation year ends.
- 2) The exclusion allowance for the tax year in which the limitation year ends.
- 3) \$15,000.

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

If your employer's annual contributions are more than the smallest of:

- 1) Your "any year limit,"
- 2) The exclusion allowance, or

- 3) The limit on elective deferrals (to the extent the contributions are elective deferrals),

you must include the excess in your gross income.

Example. Bill Black is a principal with the Maple County school system. In 1998, his 17th year of service, Bill's salary is \$39,000 without reduction for an amount under a salary reduction agreement. Bill's employer had contributed \$34,400 to the TSA plan in earlier years and all the contributions were excluded from Bill's income. Under a salary reduction agreement, Bill and his employer agree to elective deferral contributions of \$9,000 that may be excluded from Bill's gross income. To find the maximum employer contribution allowed, Bill figured the "any year limit" as follows.

Step 1—Exclusion Allowance

1) Includible compensation	\$30,000
2) Percentage limit	20%
3) Years of service	17
4) Multiply (1) × (2) × (3)	\$102,000
5) Minus: Amounts previously excludable	<u>34,400</u>
6) Exclusion allowance	<u>\$67,600</u>

Step 2—Any Year Limit

7) a) \$4,000 plus 25% of includible compensation (\$4,000 + \$7,500 (25% × \$30,000))	<u>\$11,500</u>
b) Exclusion allowance (from Line (6))	<u>\$67,600</u>
c) Maximum under this election	<u>\$15,000</u>
d) Alternative limit (Least of (a), (b), or (c))	<u>\$11,500</u>

Under this alternative limit, Bill's employer can contribute \$11,500 to the annuity plan.

In Step 1, the exclusion allowance is \$67,600; in Step 2, the maximum amount the employer can contribute on Bill's behalf is \$11,500. Since the \$9,000 contribution is less than the limit in Step 1, the limit in Step 2, and the limit on elective deferrals; \$9,000 can be excluded from gross income.

If it were not for the alternative limit (the "any year limit"), the maximum amount Bill's employer could contribute under the general rule would be \$7,500 (the lesser of \$30,000 or \$7,500 (25% × \$30,000)). See also *Examples of Catch-up Elections*, later.

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

Overall Limit

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

Include in your gross income any contribution to your TSA that is more than the lesser of the limit on employer contributions (\$30,000 or 25% of compensation) or the elective deferral limit (\$10,000), if it applies.

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

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

Her compensation for 1998 is \$35,000. She figures the "overall limit" on contributions to be \$8,750, as follows.

Her compensation for 1998 is \$35,000. She figures the "overall limit" on contributions to be \$8,750, as follows.

1) Maximum employer contributions	<u>\$30,000</u>
2) 25% of compensation (25% × \$35,000)	<u>\$8,750</u>
3) Overall limit on employer contributions—(lesser of (1) or (2))	<u>\$8,750</u>

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

Examples of Catch-up Elections

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

Example 1. Eli Green was an employee of Maple Hospital, a tax-exempt charitable organization, for the entire 1998 calendar year. His employer's contributions to a TSA for him are not subject to the elective deferral limit. Eli has a salary of \$30,000 for the year. He has 4 years of service with his employer as of December 31, 1998. During Eli's prior service with Maple Hospital, his employer had contributed \$12,000 on Eli's behalf to a TSA, and Eli excluded the amount from gross income in earlier years. For 1998, Eli's exclusion allowance is \$12,000, figured as follows.

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

The limit under the general rule is \$7,500 (the lesser of \$30,000 or \$7,500 (25% × \$30,000)).

Without the catch-up elections provided for certain employees, \$7,500 would be the maximum contribution Maple Hospital could make for TSAs on behalf of Eli for 1998 without increasing Eli's gross income for that year.

Since Eli is an employee of a hospital, he can elect one of the catch-up limits. Eli can elect either the "any year limit" or the "overall limit." He cannot elect the "year of separation from service limit" since he does not separate from service in 1998.

If Eli elects the "any year limit," Maple Hospital could contribute \$11,500 on his behalf for 1998 to a TSA, figured as follows.

1) \$4,000, plus 25% of includible compensation	<u>\$11,500</u>
2) Exclusion allowance	<u>\$12,000</u>
3) Maximum under this election	<u>\$15,000</u>
4) Any year limit [least of (1), (2), or (3)] ..	<u>\$11,500</u>

If Eli elects the "overall limit," Maple Hospital could contribute only a maximum of \$7,500 without increasing Eli's gross income for the year. This is figured as follows.

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

Example 2. Assume the same facts as in *Example 1*, except that Maple Hospital contributed \$18,000 on Eli's behalf in earlier years to the TSA. The contributions were excludable from his gross income. For 1998, Eli's exclusion allowance is \$6,000 figured as follows.

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

The limit under the general rule (the limit on employer contributions) for 1998 is the lesser of \$30,000 or \$7,500 (25% × \$30,000).

Without the catch-up elections, \$6,000 (the lesser of the two limits that apply) would be the maximum amount Maple Hospital could contribute on Eli's behalf for TSAs without increasing Eli's gross income. However, if Eli elects the "overall limit," Maple Hospital could contribute up to \$7,500 without increasing Eli's gross income for 1998. This is because the election of this limit substitutes the limit under the general rule for the exclusion allowance.

Example 3. Bob White, a teacher, is employed by Elm School, a tax-exempt educational organization. Bob has a salary, after reduction for elective deferrals under a TSA plan, of \$44,000 for 1998.

Bob has 20 years of service with Elm School as of May 30, 1998, the date he separates from the service of Elm School. During Bob's service with Elm School before tax year 1998, Elm School had contributed elective deferrals of \$68,000 toward the purchase of TSAs on behalf of Bob. The amount was excludable from his gross income for the prior years. Of this amount, \$38,000 was contributed and excluded during the 10-year period ending on May 30, 1998. Bob's elective deferrals limit is increased because he has completed at least 15 years of service. For the tax year 1998, Bob's limit on elective deferrals is \$13,000 determined as follows.

1) General limit	\$10,000
2) Maximum additional	3,000
3) \$15,000 less "additional" deferrals allowed in prior years	\$15,000
4) Prior year deferrals limit:	
a) Annual amount	\$5,000
b) Years of service	<u>20</u>
c) Multiply (a) × (b)	\$100,000
d) Less elective deferrals made under plan for earlier years	<u>68,000</u>
e) Balance	32,000
5) Least of lines 2, 3, or 4(e)	3,000
6) Increased elective deferrals limit (line 1 plus line 5)	<u>\$13,000</u>

Bob's limit on employer contributions is \$11,000 determined as follows.

1) Maximum	<u>\$30,000</u>
2) 25% of compensation (\$44,000 × 25%) ..	<u>11,000</u>
3) Lesser of line 1 or 2	<u>\$11,000</u>

Bob's exclusion allowance is \$108,000 figured as follows.

1) Includible compensation	\$44,000
2) Percentage limit	20%
3) Years of service	20
4) Multiply (1) × (2) × (3)	\$176,000
5) Minus: Amounts previously excludable ..	<u>68,000</u>
6) Exclusion allowance	<u>\$108,000</u>

Bob's limit under the general rule (limit on employer contributions) is the lesser of \$30,000 or \$11,000 (25% of \$44,000).

Without the catch-up elections, \$11,000 would be the maximum excludable contribution Elm School could make to a TSA on Bob's behalf for 1998. This is the least of the exclusion allowance (\$108,000), the general rule (\$11,000), or the increased elective deferral limit (\$13,000).

However, because Bob was an employee of an educational organization and has separated from service, he can elect any one of the three catch-up elections (alternative limits) to increase his allowable 1998 contribution.

Before deciding which catch-up election to make, Bob considers the following.

If Bob elects the "year of separation from service limit" for 1998, Elm School could contribute up to \$30,000 for that year without increasing Bob's gross income, figured as follows.

1) Includible compensation	\$44,000
2) Percentage limit	20%
3) Years of service (not to exceed 10)	10
4) Multiply (1) × (2) × (3)	\$88,000
5) Minus: Amounts previously excludable	38,000
6) Exclusion allowance (modified)	\$50,000
7) Employer Limit on Contributions —	
Maximum	\$30,000
8) Maximum contribution under "year of separation from service limit" (lesser of line 6 or line 7)	\$30,000

If Bob elects the "any year limit" for 1998, Elm School could contribute up to \$15,000, which is the least of the following amounts.

1) \$4,000, plus 25% of includible compensation	\$15,000
2) Exclusion allowance	\$108,000
3) Maximum under this alternative	\$15,000
4) Maximum contribution under "any year limit" (least of lines 1, 2, or 3)	\$15,000

If Bob elects the "overall limit" for 1998, Elm School could contribute up to \$11,000, which is the lesser of the following amounts.

1) Maximum under this alternative	\$30,000
2) 25% of compensation	\$11,000
3) Maximum contribution under the "overall limit" (lesser of line 1 or 2)	\$11,000

Special Election for Church Employees

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

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



You cannot make this special election for a tax year in which you use the "year of separation from service limit" described earlier.

Making the Election

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

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

One election allowed. If you elect one of the alternative limits, you cannot elect to have any of the others apply for any future year for any TSA purchased for you by any employer.

If you elect the "any year limit" or the "overall limit," it is the only alternative limit you can use for later years.

If you elect the "year of separation from service limit," you cannot elect any alternative limit in any later year for any TSA. You can use this limit only once.

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

Limit for Contributions to More Than One Plan

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

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

If you elect the "overall limit," discussed earlier, you must combine contributions whether or not you have this control.

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

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

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

Other Rules

The following additional rules generally relate to contributions to your tax-sheltered annuity (TSA) and to other transactions that could affect your TSA before you retire or begin receiving benefits.

Voluntary Employee Contributions

You cannot deduct voluntary employee contributions you make to your TSA.

However, there may be amounts in your TSA that are from deductible voluntary employee contributions you made in earlier years. If these amounts are distributed to you, you must include them in gross income unless you roll them over into an IRA or into another TSA. For tax years 1982 through 1986, employees could make deductible voluntary employee contributions to a TSA.

Tax on Excess Contributions to a Custodial Account

There is a 6% excise tax on certain excess contributions. The tax applies to contributions that are more than either the exclusion allowance or the limit on employer contributions in effect when a TSA plan invests in mutual fund shares through a custodial account. The tax **does not apply** to excess contributions made to pay premiums on an annuity contract. Also see *Taxability of Excess Contributions*, later.

You cannot deduct the excise tax. You must pay it each year until the excess contribution is corrected. Excess contributions can be corrected by making smaller contributions in later years. For example, if there is an excess contribution in 1998 and no corrective action is taken for that year, you are liable for the tax for 1998. If after 1998 you do not withdraw the excess (if not otherwise restricted) or reduce it by carrying it over to a later year (or years) in which you contribute less than your allowable contribution for that later year (or years), you will continue to be liable for the tax on the excess each year it remains. This tax will be in addition to any tax due because of additional excess contributions in a later year.

How to figure tax. You figure the excise tax on excess contributions as follows.

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

- 6) Total of all prior years' distributions out of the account included in your gross income (not including amounts received as an annuity) and not previously used to reduce excess contributions
- 7) Adjusted preceding years' excess contributions (line 4 minus the total of lines 5 and 6)
- 8) Taxable excess contributions (line 3 plus line 7)
- 9) Excise tax on excess contributions. Enter the lesser of 6% of line 8 or 6% of the value of your account as of the last day of the year

Reporting requirement. You must file Form 5330 if there has been an excess contribution to a custodial account and that excess has not been corrected in any year.

When to file. File Form 5330 by the last day of the 7th month after the close of your tax year (July 31 for calendar year taxpayers). You can request an extension (not to exceed 6 months) by filing Form 5558, *Application for Extension of Time To File Certain Employee Plan Returns*, early enough to give IRS time to consider and act on it before the due date of Form 5330.

Where to file. You should file Form 5330 with the Internal Revenue Service Center listed in the instructions.

Cost of Insurance Protection

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

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

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

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

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

Uniform One-Year Term Premiums for \$1,000 Life Insurance Protection
(Based on Table 38, U.S. Life Table and Actuarial Table (U.S. Government Printing Office, Washington, D.C.—1946), and 2½% interest.)

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

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

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

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

Federal Insurance Contributions Act (FICA)

Contributions toward the TSA under a salary reduction agreement are wages for purposes of the FICA (social security and Medicare) tax. Your employer must take into account the entire amount of these contributions for FICA tax purposes, even if you can exclude some or all of the contributions. These wages are credited to your social security account for benefit purposes.

However, if your employer makes a contribution to purchase an annuity and the contribution is not under a salary reduction

agreement, that amount is not wages for social security tax purposes.

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

Self-Employment Contributions Act (SECA)

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

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

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

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

Reporting by Employer

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

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

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

Reporting by Self-Employed Minister or Chaplain

Contributions made by a self-employed minister or chaplain, who is treated as employed by a qualified tax-exempt organization, to a retirement income account that is treated as a TSA must be reported as a deduction by the individual making the contributions.

Self-Employed Minister

A self-employed minister can report these contributions on line 29 of Form 1040.

Chaplain

A chaplain, who is not self-employed can report these contributions on line 32 of Form 1040.

Income Tax Withholding by Employer

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

Taxability of Excess Contributions

If your employer makes contributions to a TSA contract for your benefit, the contributions that are more than the amount you can exclude from income are taxable to the extent your rights in the contributions are substantially vested at the time contributed. If your interest in the contract changes from non-vested to vested, part of the value of the contract may be included in your income at that time. The amount you can exclude from income is explained earlier under *Exclusion From Gross Income*. The amount you may have to include in income when your interest becomes vested is explained later under *Taxability of rights that change from non-vested to vested*.

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

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

Substantial risk of forfeiture. There is substantial risk of forfeiture when your rights in property depend (directly or indirectly) on someone's future performance or nonperformance of substantial services. There is also a substantial risk of forfeiture when your rights in property depend on the occurrence of a condition related to the purpose of the transfer and the possibility of forfeiture is substantial if the condition is not satisfied.

Taxability of rights that change from non-vested to vested. If any of your interest in the contract changes from nonvested to substantially vested, you must include in income in the year of the change the value of the annuity contract that, on the date of change, is both:

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

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

Partial vesting. If only part of the beneficial interest in an annuity contract becomes substantially vested during your tax year, you only have to include a portion of the annuity contract value in your gross income for that tax year. Figure the amount to include in your gross income as follows.

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

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

Gift Tax

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

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

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

Distributions and Rollovers

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

- Reaches age 59½,
- Separates from service,
- Dies, or
- Becomes disabled.

In most cases, the payments you receive, or that are made available to you, under your TSA contract are taxable in full as ordinary income. In general, the same tax rules apply to distributions from tax sheltered annuities that apply to distributions from other retirement plans. These rules are explained in Publication 575. Publication 575 also discusses the additional tax on early distributions from retirement plans.

Minimum Distributions

You must receive all, or at least a certain minimum, of your interest accruing after 1986 in the TSA plan by April 1 of the calendar year following the later of the calendar year in which you become age 70½ or the calendar year in which you retire.

Check with your employer, plan administrator, or provider to find out whether this rule

also applies to pre-1987 accruals. If not, a minimum amount of these accruals must begin to be distributed no later than the end of the calendar year in which you reach age 75. For each year thereafter, the minimum distribution must be made by the last day of the year. If you do not receive the required minimum distribution, you are subject to a non-deductible 50% excise tax.

For more information on minimum distribution requirements and the additional tax that applies if too little is distributed each year, see Publication 575.

No Special 5- or 10-Year Tax Option

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

Transfer of Interest in TSA

If you transfer all or part of your interest from a TSA contract or account to another TSA contract or account, the transfer is tax free. However, this treatment applies only if the transferred interest is subject to the same or stricter distribution restrictions. This rule applies regardless of whether you are a current employee, a former employee, or a beneficiary of a former employee.

Transfers that do not satisfy this rule are plan distributions and are generally taxable as ordinary income.

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

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

In addition to the preceding requirements, you must provide the new insurer with a written statement containing **all** of the following information.

- 1) The gross amount of cash distributed under the old contract.
- 2) The amount of cash reinvested in the new contract.

- 3) Your investment in the old contract on the date you receive your first cash distribution.

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

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

Tax-Free Rollovers

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

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

- 1) Minimum distributions (generally required to begin at age 70½),
- 2) Substantially equal payments over your life or life expectancy,
- 3) Substantially equal payments over the joint lives or life expectancies of you and your beneficiary, or
- 4) Substantially equal payments for a period of 10 years or more.

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

Withholding. If you *receive* a distribution that qualifies to be rolled over, the payer must withhold 20% of it for taxes (even if you plan to roll the distribution over). You cannot choose to have no withholding unless you elect the direct rollover option.

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

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

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

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

Its transfer does not affect the rollover treatment of the eligible portion of the transferred amounts. However, the ineligible portion is subject to the traditional IRA contribution limits and may create an excess IRA contribution subject to a 6% excise tax (see chapter 1 of Publication 590).

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

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

Second rollover. If you roll over a qualifying distribution to a traditional IRA, you can, if certain conditions are satisfied, later roll the distribution into another TSA. For more information, see *IRA as a holding account (conduit IRA) for rollovers to other eligible plans* in Publication 590.

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

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

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

How To Get More Information

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

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

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

- *Frequently Asked Tax Questions* to find answers to questions you may have.
- *Fill-in Forms* to complete tax forms online.
- *Forms and Publications* to download forms and publications or search publications by topic or keyword.
- *Comments & Help* to e-mail us with comments about the site or with tax questions.
- *Digital Dispatch* and *IRS Local News Net* to receive our electronic newsletters on hot tax issues and news.

You can also reach us with your computer using any of the following.

- Telnet at iris.irs.ustreas.gov
- File Transfer Protocol at ftp.irs.ustreas.gov
- Direct dial (by modem) **703-321-8020**

 **TaxFax Service.** Using the phone attached to your fax machine, you can receive forms, instructions, and tax

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The CD-ROM can be purchased from National Technical Information Service (NTIS) for \$25.00 by calling 1-877-233-6767 or for \$18.00 on the Internet at www.irs.ustreas.gov/cdorders. The first release is available in mid-December and the final release is available in late January.

Worksheets



Contributions to your TSA are subject to various limits. Contributions that are more than the limits are excess contributions or excess deferrals that must be included in your income and can result in additional taxes. See *Treatment of Excess Contributions*, earlier.

You can use the worksheets that follow to figure the amount that can be contributed to your TSA without penalty and excluded from your income for the year.

Limits. There are three limits that apply to contributions to your TSA. Contributions for a year must be tested by each of the limits to determine the amount that your employer can contribute and the amount you can exclude from your income for that year. See *Exclusion Limits*, earlier.

Elective deferrals only. If the only employer contributions for the year are elective deferrals, as defined earlier under *Contributions*, the amount that can be contributed and excluded from your income for the year is the smallest of the following limits.

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



Elective deferrals for a year cannot be more than \$10,000 unless the exception for 15-year employees applies (see Step 2 of Worksheet 3). If the exception applies, your elective deferrals cannot be more than \$13,000.

Elective deferrals and other contributions. If employer contributions for the year include matching contributions and/or nonelective contributions in addition to elective deferrals, the total that can be contributed and deferred (excluded from your income for the year) can be more than the limit on elective deferrals.



The contributions that are elective deferrals cannot be more than the limit figured at Step 3, line 16 of Worksheet 3. See Both elective deferrals and nonelective contributions, earlier, under Exclusion Limits.

Figuring the limit. To figure the limit on the amount (including elective deferrals) that can be contributed and deferred for a year, complete the following worksheets.

- 1) Worksheet 1 (the exclusion allowance).
- 2) Worksheet 2, Step 1 (the limit on employer contributions).

Your overall limit on employer contributions that can be deferred (excluded from your income) is the smaller of line 6, Worksheet 1,

or line 3, Worksheet 2, unless you can use one of the alternative limits.

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

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

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

Worksheet 1—Computation of Exclusion Allowance

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

Worksheet 2—Limit on Employer Contributions

Step 1—Limit on Employer Contributions		Step 3—Amount Excludable from Gross Income	
1) Maximum (\$30,000) [See <i>Limit on Employer Contributions</i> .]	\$	7) a) Employer contribution (line 4)	\$
2) 25% of compensation	_____	b) Limit on employer contributions (line 3)	\$
3) Limit on employer contributions [lesser of (1) or (2)]	\$	c) Exclusion allowance (Worksheet 1, line 6)	\$
	_____	d) Limit on elective deferrals (Worksheet 3, line 16)	\$
	_____	8) Amount excludable from gross income [least of (a), (b), (c) or (d)]	\$
	_____		_____
Step 2—Contributions in Excess of Employer Limit		Step 4—Amount Includible in Gross Income	
4) Current year contribution by employer (excluding cost of life insurance)*	\$	9) Employer contribution (line 4)	\$
5) Minus: Limit on employer contributions (line 3)	_____	10) Minus: Amount excludable (line 8)	_____
6) Excess (if any)	\$	11) Amount includible in gross income	\$
	_____		_____

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

Worksheet 3—Limit on Elective Deferrals

Step 1—Total Elective Deferrals

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

Step 2—Increase in Limit for Long Service

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

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

Step 3—Limit on Elective Deferrals

- 12) Enter \$10,000 plus the amount from line (11) \$ _____
- 13) Basic allowable amount (enter \$10,000 for 1998) _____
- 14) Subtract line (13) from line (12) \$ _____
- 15) Enter the smaller of line (1) or line (14) _____
- 16) Add lines (13) and (15). This is your limit on elective deferrals for the year \$ _____
- 17) Excess elective deferrals—Subtract line (16) from line (4). Do not enter less than zero. Include this amount in your income for the year the excess deferrals were made (see *Excess Deferrals* under *Limit on Elective Deferrals*) \$ _____

Worksheet 4—Year of Separation from Service Limit Election¹

<p>Step 1—Limit on Employer Contributions</p> <p>1) Maximum [See <i>Limit on Employer Contributions</i>.] _____ \$30,000</p> <p>2) Exclusion allowance (modified)</p> <p style="padding-left: 20px;">a) Includible compensation \$ _____</p> <p style="padding-left: 20px;">b) Percentage limit _____ 20%</p> <p style="padding-left: 20px;">c) Years of service (limited to 10 years) _____</p> <p style="padding-left: 20px;">d) Multiply (a) × (b) × (c) \$ _____</p> <p style="padding-left: 20px;">e) Minus: Amounts previously excludable during 10 years (including prior year excess contributions) _____</p> <p style="padding-left: 20px;">f) Exclusion allowance (modified) \$ _____</p> <p>3) Limit on employer contributions [lesser of (1) or (2)(f)] \$ _____</p>		<p>Step 3—Amount Excludable from Gross Income</p> <p>7) a) Employer contribution (line 4) \$ _____</p> <p style="padding-left: 20px;">b) Limit on employer contributions (line 3) \$ _____</p> <p style="padding-left: 20px;">c) Exclusion allowance (Worksheet 1, line 6) \$ _____</p> <p style="padding-left: 20px;">d) Limit on elective deferrals (Worksheet 3, line 16) \$ _____</p> <p>8) Amount excludable from gross income [least of (a), (b), (c), or (d)] \$ _____</p>	
<p>Step 2—Contributions in Excess of Employer Limit</p> <p>4) Current year contribution by employer (excluding cost of life insurance)² \$ _____</p> <p>5) Minus: Limit on employer contributions (line 3) \$ _____</p> <p>6) Excess (if any) \$ _____</p>		<p>Step 4—Amount Includible in Gross Income</p> <p>9) Employer contribution \$ _____</p> <p>10) Minus: Amount excludable (line 8) _____</p> <p>11) Amount includible in gross income \$ _____</p>	

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

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

Worksheet 5—Any Year Limit Election¹

Step 1—Limit on Employer Contributions		Step 3—Amount Excludable from Gross Income	
1) \$4,000 plus 25% of includible compensation	\$ _____	8) a) Employer contribution (line 5)	\$ _____
2) Exclusion allowance		b) Limit on employer contributions (line 4)	\$ _____
a) Includible compensation	\$ _____	c) Exclusion allowance (Worksheet 1, line 6)	\$ _____
b) Percentage limit	_____ 20%	d) Limit on elective deferrals (Worksheet 3, line 16)	\$ _____
c) Years of service	_____	9) Amount excludable from gross income [least of (a), (b), (c), or (d)]	\$ _____
d) (a) × (b) × (c)	\$ _____		
e) Minus: Amounts previously excludable (including prior year excess contributions)	_____		
f) Exclusion allowance	\$ _____		
3) Maximum	_____ \$15,000	Step 4—Amount Includible in Gross Income	
4) Limit on employer contributions [least of (1), (2)(f), or (3)]	\$ _____	10) Employer contribution (line 5)	\$ _____
		11) Minus: Amount excludable (line 9)	_____
		12) Amount includible in gross income	\$ _____
Step 2—Contributions in Excess of Employer Limit			
5) Current year contribution by employer (excluding cost of life insurance) ²	\$ _____		
6) Minus: Limit on employer contributions (line 4)	\$ _____		
7) Excess (if any)	\$ _____		

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

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

Worksheet 6—Overall Limit Election^{1 & 2}

Step 1—Limit on Employer Contributions	Step 4—Amount Includable in Gross Income
1) Maximum [See <i>Limit on Employer Contributions</i>]	9) Employer contribution (line 4)
\$ 30,000	\$ _____
2) 25% × compensation [See <i>Compensation</i> , earlier, under <i>Limit on Employer Contributions</i> .]	10) Minus: Amount excludible (line 8)
\$ _____	_____
3) Limit on employer contributions [lesser of (1) or (2)]	11) Amount includable in gross income
\$ _____	\$ _____
Step 2—Contributions in Excess of Employer Limitation	
4) Current year contributions by employer (excluding cost of life insurance) ³	
\$ _____	
5) Minus: Limit on employer contributions (line 3)	
\$ _____	
6) Excess (if any)	
\$ _____	
Step 3—Amount Excludable from Gross Income	
7) a) Employer contribution (line 4) ⁴	
\$ _____	
b) Limit on employer contributions (line 3)	
\$ _____	
c) Limit on elective deferrals, (Worksheet 3, line 16)	
\$ _____	
8) Amount excludable from gross income [least of (a), (b), or (c)]	
\$ _____	

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

²Limit on employer contributions is substituted for the exclusion allowance.

³The cost of life insurance is includable in gross income.

⁴If you participate in other qualified plans of your employer besides your TSA, contributions to those accounts must be included here.

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Tax Publications for Individual Taxpayers

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

General Guides

- 1 Your Rights as a Taxpayer
- 17 Your Federal Income Tax (For Individuals)
- 225 Farmer's Tax Guide
- 334 Tax Guide for Small Business
- 509 Tax Calendars for 1999
- 553 Highlights of 1998 Tax Changes
- 595 Tax Highlights for Commercial Fishermen
- 910 Guide to Free Tax Services

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- 378 Fuel Tax Credits and Refunds
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- 970 Tax Benefits for Higher Education
- 971 Innocent Spouse Relief
- 1542 Per Diem Rates
- 1544 Reporting Cash Payments of Over \$10,000
- 1546 The Problem Resolution Program of the Internal Revenue Service

Spanish Language Publications

- 1SP Derechos del Contribuyente
- 579SP Cómo Preparar la Declaración de Impuesto Federal
- 594SP Comprendiendo el Proceso de Cobro
- 596SP Crédito por Ingreso del Trabajo
- 850 English-Spanish Glossary of Words and Phrases Used in Publications Issued by the Internal Revenue Service
- 1544SP Informe de Pagos en Efectivo en Exceso de \$10,000 (Recibidos en una Ocupación o Negocio)

Commonly Used Tax Forms

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

Form Number and Title	Catalog Number	Form Number and Title	Catalog Number
1040 U.S. Individual Income Tax Return	11320	2106 Employee Business Expenses	11700
Sch A & B Itemized Deductions & Interest and Ordinary Dividends	11330	2106-EZ Unreimbursed Employee Business Expenses	20604
Sch C Profit or Loss From Business	11334	2210 Underpayment of Estimated Tax by Individuals, Estates and Trusts	11744
Sch C-EZ Net Profit From Business	14374	2441 Child and Dependent Care Expenses	11862
Sch D Capital Gains and Losses	11338	2848 Power of Attorney and Declaration of Representative	11980
Sch E Supplemental Income and Loss	11344	3903 Moving Expenses	12490
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Sch SE Self-Employment Tax	11358	8283 Noncash Charitable Contributions	62294
1040A U.S. Individual Income Tax Return	11327	8582 Passive Activity Loss Limitations	63704
Sch 1 Interest and Ordinary Dividends for Form 1040A Filers	12075	8606 Nondeductible IRAs	63966
Sch 2 Child and Dependent Care Expenses for Form 1040A Filers	10749	8812 Additional Child Tax Credit	10644
Sch 3 Credit for the Elderly or the Disabled for Form 1040A Filers	12064	8822 Change of Address	12081
1040EZ Income Tax Return for Single and Joint Filers With No Dependents	11329	8829 Expenses for Business Use of Your Home	13232
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