View metadata, citation and similar papers at core.ac.uk

brought to you by CORE

provided by Notre Dame Law School: NDLScholarship

Notre Dame Law Review

Volume 43 | Issue 4 Article 3

1-1-1968

Is H. R. 10, As Amended and Properly Implemented, Still a Lion Who Merely Squeaks

Thomas J. McCusker

Follow this and additional works at: http://scholarship.law.nd.edu/ndlr

Part of the Law Commons

Recommended Citation

Thomas J. McCusker, *Is H. R. 10, As Amended and Properly Implemented, Still a Lion Who Merely Squeaks*, 43 Notre Dame L. Rev. 521 (1968).

Available at: http://scholarship.law.nd.edu/ndlr/vol43/iss4/3

This Note is brought to you for free and open access by NDLScholarship. It has been accepted for inclusion in Notre Dame Law Review by an authorized administrator of NDLScholarship. For more information, please contact lawdr@nd.edu.

NOTES

Is H.R. 10, As Amended and Properly Implemented, Still "A Lion Who Merely Squeaks"?

I. Introduction

Tremendous advances in medical science, hygiene, and the general standard of living have brought about substantial increases in longevity. But this obvious boon to twentieth century society has raised problems that our ancestors did not have to encounter. One of the most difficult of these challenges, assuming that individuals should curtail employment at some time before their death, is that of providing for their security during their last years of leisure. One apparent solution, and the one that was adopted in our country, is to have persons conserve a portion of their earnings during their income-producing years to provide a source of livelihood during retirement.

Oftentimes persons choose to accumulate funds for retirement in some form of a pension plan. Through the years many different types of pension plans have been developed to serve varied purposes for different classes of persons. The purpose of this Note is to discuss one of the latest developments in this area, the "Self-Employed Individuals Tax Retirement Act of 1962"[1] (hereinafter, H.R. 10). Though H.R. 10, also known as the "Keogh Act," contains many subjects for fruitful discussion, this Note is limited to a brief survey of the reasons for its enactment, a condensed description of the provisions of the Act, and an extended discussion, within the framework of the professional service organization,[2] that evaluates the impact of a recent amendment to H.R. 10[3] as such amendment is implemented in particular types of pension plans.[4]

II. Reasons for the Enactment of H.R. 10

Prior to 1962 the tax advantages enjoyed by corporations in their pension plans were not available to other business or professional associations. Some of these benefits that were previously applied only to corporations[5] are: 1) contributions made to qualified plans[6] are, within rather liberal limits, deductible

1 Act of October 10, 1962, Pub. L. No. 87-792, 76 Stat. 809. 26 U.S.C. § 401 (1964).

2 The term is used in this Note to describe partnerships as well as the professional service corporations authorized under various state laws, *see* Treas. Reg. § 301.7701-1(c) (1965).

3 26 U.S.C. § 401 (Supp. II 1966).

4 The Act covers plans other than pension plans, but this Note will deal with the Act solely in terms of pension plans. See notes 44-47 *infra*.

5 Prior to 1962, deductions were allowed under § 401(a) only for contributions made on behalf of "employees." This effectively limited these benefits to corporations, as *all* who work for a corporation are "employees," even though partnerships could have these advantages if the plan covered only the "employees" of the partnership and not the partners.

6 P-H Pension & Profit Sharing Serv. ¶ 4011, at 4011 (1967), defines a "qualified plan" as "one that meets the requirements of § 401(a) of the Internal Revenue Code of 1954 . . . and the regulations and rulings which interpret this section of the law."

Id. ¶ 4012, at 4011 notes the significance of such qualification: ". . . a taxpayer (either cash or accrual basis) can deduct in the *current year* for a contribution which is paid into a plan that year *but which will not be paid out to the employee or his beneficiary until some day in the future.*"

from income taxes as a business expense;[7] 2) the income produced by the plan is tax exempt and can be reinvested tax free;[8] 3) contributions made by the corporation for the benefit of the employee are not included in the employee's income until disbursements are made to him,[9] 4) a lump-sum distribution of funds to the employee is treated as a long term capital gain instead of ordinary income;[10] 5) death benefits are usually exempt from estate taxes.[11] The aforementioned advantages, when added to the other benefits available only to corporations,[12] severely discriminated against professional associations. Hence, these groups exerted influence to obtain these benefits for themselves.

The professionals pursued various programs to obtain the tax advantages of qualified plans. Incorporation of these associations seemed, at first glance, to be the most effective answer to the problem. However, this approach raised serious problems in the area of professional ethics,[13] and existing case law did not permit professional corporations.[14] Nonetheless, there were arguments presented showing the necessity and desirability of incorporation[15] and the professional groups took action to achieve this goal. First of all, persuasion was used, often successfully, for legislative enactments that authorized such corporations.[16] This legislation was designed to permit professional associations to achieve tax equality by use of the so-called "Kintner Regulations" which arose from the decision in *United States v. Kintner*.[17] The Ninth Circuit held in *Kintner* that even though a medical association is unincorporated, if, as allowed by state law, it had a sufficient number of the characteristics common to corporations as set out in the then-existing federal income tax regulations, it would be treated as a corporation for federal income tax purposes.[18] This holding appeared to be a license for treating professional associations as corporations; if the law of the state permitted the group to possess characteristics resembling a corporation, or an association similar to a corporation, it would be so considered for federal income tax purposes. But this holding provided no lasting solution, as the Commissioner of Internal Revenue refused to acquiesce in this decision[19] and issued a regulation which set out the criteria for determining

---

7 INT. REV. CODE of 1954, § 404(a).
8 *Id.* § 501(a).
9 *Id.* § 402(a)(1). Of course, this taxation of pension disbursements usually occurs when the employee is retired and would ordinarily be in a lower income tax bracket.
10 *Id.* § 402(a)(2).
11 *Id.* § 2039(c).
12 *Id.* §§ 101(b) (first $5,000 of death benefits under the plan are not included in gross income), 105(b) (medical expense benefits within certain limits are not included in gross income), 105(d) (benefits from wage continuation plans are not included in gross income).
13 For a summary of the "professional ethics" objections to incorporation, see H. Jones, *The Professional Corporation,* 27 FORD. L. REV. 353, 354-55 (1958).
14 *E.g.,* People v. United Medical Serv., Inc., 362 Ill. 442, 200 N.E. 157 (1936) (practice of medicine); People *ex rel.* Illinois State Bar Ass'n v. People's Stock Yards State Bank, 344 Ill. 462, 176 N.E. 901 (1931) (practice of law).
15 E. Freutel, Jr., & F. Frost, *Why Lawyers Should Have the Right to Practice in Corporate Form,* 37 CAL. STATE BAR J. 874 (1962); R. Wormser, *A Plea for Professional Incorporation Laws,* 46 A.B.A.J. 755 (1960).
16 Statutes were passed in many states, *e.g.,* GA. CODE ANN. § 84-4301 (Supp. 1967); N.J. STAT. ANN. § 14:19 (Supp. 1966); WIS. STAT. ANN. § 180.99 (Supp. 1967).
17 216 F.2d 418 (9th Cir. 1954).
18 *Id.* at 424.
19 Rev. Rul. 56-23, 1956-1 CUM. BULL. 598. After the *Kinter* decision, a new regulation

corporate status.[20] However, this latter regulation has recently been declared invalid by one district court as an exercise of a non-delegable legislative function.[21] Though the Kintner Regulations appear to be a simple answer to the problem, their unstable history, coupled with the professional ethical problems involved, should prevent the prudent attorney from placing too much reliance on them.

Partially due to the problems of incorporation, and partially due to the desire of professional associations to reach the core of the problem, continuous appeals were made to Congress to amend the tax laws to allow pension benefits for these groups. The long struggle, led by Congressman Keogh, that resulted in the enactment of H.R. 10 has been adequately treated elsewhere,[22] so this Note is concerned primarily with the fruits of those activities, H.R. 10.

III. General Provisions of H.R. 10

A full discussion of all provisions of H.R. 10 is outside the scope of this Note, and such treatment is unnecessary as it has already been done by several able commentators.[23] However, a brief discussion of the main features of the Act is necessary to establish a foundation for what will be subsequently considered.

Basically, H.R. 10 amended section 401 of the Internal Revenue Code of 1954 to provide that even though self-employed persons are included in a plan, it can still qualify for tax benefits.[24] Specifically, a self-employed individual who has "earned income"[25] is now treated as an "employee" for

---

was issued that reaffirmed one of the holdings in *Kintner* that local law is not determinative of the question of corporate status for federal income tax purposes. Treas. Reg. § 301.7701-1 (c)(1965).

20 Treas. Reg. § 301.7701-2(a)(1) (1965) provides:

> There are a number of major characteristics ordinarily found in a pure corporation which, taken together, distinguish it from other organizations. These are: (i) Associates, (ii) an objective to carry on business and divide the gains therefrom, (iii) continuity of life, (iv) centralization of management, (v) liability for corporate debts limited to corporate property, and (vi) free transferability of interests.

Obviously, the last four of these criteria cannot be met by associations of doctors and lawyers, and possibly accountants, so this regulation in effect does away with the *Kintner* holding.

21 Empey v. United States, 272 F. Supp. 851 (D. Colo. 1967).

22 G. Johnson, *The Keogh Act: Past, Present and Future,* 17 J. AM. SOC'Y C.L.U. 101 (1963).

23 W. HUEY, JR. & J. THOMPSON, THE R&R KEOGH ACT MANUAL (The Research and Review Service of America 1966); C. Hinckley, *Self-Employed Retirement Plans,* 21 J. AM. SOC'Y C.L.U., October 1967, at 25; B. Samons, *H.R. 10: A Basic, Non-technical View of Self-Employment Plans in Operation,* 17 J. TAXATION 336 (1962); B. Lane, *H.R. 10, The Self-Employed Individual's Retirement Act of 1962—A Birdseye View,* 7 TAX COUN. Q. 153 (1963); *20 Questions on Final Regulations Under H.R. 10,* 102 TRUSTS & ESTATES 1035 (1963); Note, *Self-Employed Individuals Tax Retirement Act of 1962 §§ 1-8, 76 Stat. 809—Tax Deductions for Contributions to Pension Plans: Problems and Proposed Solutions,* 58 NW. U.L. REV. 426 (1963).

24 Act of October 10, 1962, Pub. L. No. 87-792, § 2, 76 Stat. 809, 26 U.S.C. § 401 (1964).

25 INT. REV. CODE of 1954, § 401(c)(2)(A) provides: "The term 'earned income' means the net earnings from self-employment (as defined in section 1402(a) . . .)." Section 1402(a) provides:

> The term "net earnings from self-employment" means the gross income derived by an individual from any trade or business carried on by such individual, less the

purposes of section 401.[26] The Act also created a new class of employees, the "owner-employee," defined as a proprietor or partner who owns more than a 10% interest in the capital or profits of a firm.[27] When the owner-employee is included in the plan, the contributions that can be made on his behalf are limited to 10% of his "earned income" or $2,500, whichever is less.[28] The 1962 Act provided that one-half of this contribution was deductible;[29] however, a 1966 amendment now provides that the entire contribution can be deducted.[30] But the contributions that the owner-employee makes on behalf of his employees are subject to the deductibility limits that apply to all employee contributions.[31]

Generally, full-time employees with three or more years of service must be covered by the plan in order for it to qualify for special tax treatment under H.R. 10.[32] The plan may be either contributory or non-contributory.[33] It must not discriminate as to benefits or contributions in favor of "officers, shareholders, persons whose principal duties consist in supervising the work of other employees, or highly compensated employees . . . ."[34] Usually the contributions made for an employee must vest at the time they are made.[35] While there may be some provision in the plan for life insurance benefits, such benefits must be incidental to the pension benefits.[36]

There is no tax to a person covered by a qualified plan until the funds from the plan are distributed to him.[37] If such funds are distributed to self-employed participants in a lump sum, the distribution is not treated as a long-term capital gain, as is the case of a lump-sum distribution to employees of a corporation,[38] but is treated as ordinary income.[39] Because the pension pay-

> deductions allowed by this subtitle which are attributable to such trade or business, plus his distributive share (whether or not distributed) of income or loss described in section 702 (a) (9) from any trade or business carried on by a partnership of which he is a member . . . .

However, § 401(c)(2)(A)(i) limits these provisions to income ". . . with respect to a trade or business in which personal services are a material income-producing factor . . . ."

26 *Id.* § 401(c)(1) and (2).

27 *Id.* § 401(c)(3).

28 *Id.* §§ 401(d)(5)(A), 404(e).

29 Act of Oct. 10, 1962, Pub. L. No. 87-792, § 3(a)(10), 76 Stat. 820.

30 26 U.S.C. § 401 (Supp. II 1966).

31 INT. REV. CODE of 1954, § 404(a)(9)(A).

32 *Id.* § 401(d)(3); *see* Treas. Reg. § 1.401-11(c) (1963).

33 Under a contributory plan the employee pays a portion of the amount contributed on his behalf, but under a noncontributory plan the firm pays the entire cost of the plan.

34 INT. REV. CODE of 1954, § 401(a)(3)(B).

35 *Id.* § 401(d)(2)(A). The items mentioned in the text accompanying notes 32, 34 and 35 are required by the Act; it is only when a variation of the regular H.R. 10 plan is used that they may not be necessary.

36 Treas. Reg. § 1.401(b)(1)(i) (1964).

37 INT. REV. CODE of 1954, § 402(a)(1).

38 *Id.* § 402(a)(2).

39 *Id.* However, the burden of this provision is eased somewhat by a five-year spreadback provision. Section 72(n)(2) of the Internal Revenue Code of 1954 provides:

> In any case to which this subsection applies, the tax attributable to the amounts to which this subsection applies for the taxable year in which such amounts are received shall not exceed whichever of the following is the greater:
>
> (A) 5 times the increase in tax which would result from the inclusion in gross income of the recipient of 20 percent of so much of the amount so received as is includible in gross income, or
>
> (B) 5 times the increase in tax which would result if the taxable income of the recipient for such taxable year equaled 20 percent of the amount of the taxable income of the recipient for such taxable year determined under paragraph (3)(A).

ments are treated as ordinary income, it would generally seem advisable to take them in the form of periodic payments. If this practice is followed, the funds will be taxed as an annuity.[40] There are limitations on withdrawals of funds from the plan,[41] and penalties for withdrawals prior to the statutory period for payments.[42] There are certain listed prohibited transactions,[43] and, finally, provision is made for four different types of plans: 1) pension plans,[44] 2) profit-sharing plans;[45] 3) stock-bonus plans;[46] 4) bond-purchase plans.[47]

As seen earlier, under the 1962 provisions only one-half of the contributions that were made for the benefit of the owner-employee were deductible. There were many who thought that this limitation, along with other restrictions in the Act prior to the 1966 amendment,[48] made it quite useless and gave to the professional associations little of the relief that they sought.[49] The remainder of this Note will center on the continuing validity of such criticism in light of the 1966 amendment, when certain types of low-cost, high-benefit pension plans are based on that amendment.

IV. Integration With Social Security

A. Integration Generally

As noted above, a plan cannot qualify for deductions if it discriminates in favor of officers, supervisors or highly-paid employees. Despite this limitation it is still possible for a firm to contribute relatively more to its pension plan on behalf of those employees that it considers more valuable, as evidenced by their higher salaries, than it contributes for its less important employees. This result

---

40 *Id.* § 72(m), (n).
41 *Id* § 401(d)(4)(B).
42 *Id.* § 72(m)(5).
43 *Id.* § 503(j). The transactions prohibited generally involve misuse of trust funds for the benefit of the owner-employees.
44 *Id.* § 401(a)(1). Treas. Reg. § 1.401-1(b)(1)(i) (1965) defines a pension plan as ". . . a plan established and maintained by an employer primarily to provide systematically for the payment of definitely determinable benefits to his employees over a period of years, usually for life, after retirement."
45 Int. Rev. Code of 1954, § 401(a)(1). Treas. Reg. § 1.401-1(b)(1)(ii) (1965) defines a profit-sharing plan as ". . . a plan established and maintained by an employer to provide for the participation in his profits by his employees or their beneficiaries."
46 Int. Rev. Code of 1954, § 401(a)(1). Treas. Reg. § 1.401-1(b)(1)(iii) (1965) defines a stock-bonus plan as ". . . a plan established and maintained by an employer to provide benefits similar to those of a profit-sharing plan, except that the contributions by the employer are not necessarily dependent upon profits and the benefits are distributable in stock of the employer company."
47 Int. Rev. Code of 1954, § 405. Treas. Reg. § 1.405-1(b)(1) (1965) defines a bond-purchase plan:

> . . . a definite written program and arrangement which is communicated to the employees and established and maintained by an employer solely to purchase for and distribute to his employees or their beneficiaries retirement bonds. These bonds must be purchased in the name of the employee on whose behalf the contributions are made.

48 *E.g.,* the "earned income" restrictions contained in Act of October 10, 1962, Pub. L. No. 87-792, § 2(c)(2), 76 Stat. 811, 26 U.S.C. § 401 (1964).
49 W. Hoffman, Jr., *Many Limitations of H.R. 10 Make Its Use Generally Undesirable,* 18 J. Taxation 218 (1963); R. Coughlin, *A Lion Who Merely Squeaks—The Self-Employed Individual's Tax Retirement Act of 1962,* 13 Monthly Digest of Tax Articles, Nov. 1962, at 1; R. Forester, *H.R. 10—What Does It Profit A Man?* 101 Trusts & Estates 978 (1962).

is possible because it appears that the government's philosophy is that every person who is covered by Social Security, which today includes nearly everyone,[50] already has a pension plan. On this basis, a firm is allowed to coordinate its own pension plan with the Social Security program, so that the contributions or benefits of Social Security can be considered contributions or benefits of the association's plan for purposes of avoiding discriminatory classifications under section 401. Specifically, section 401(a)(5) provides:

> A classification shall not be considered discriminatory within the meaning of paragraph [401](3)(B) or (4) merely because it excludes employees the whole of whose remuneration constitutes "wages" under section 3121(a) (relating to the Federal Insurance Contributions Act) . . . or merely because the contributions or benefits based on that part of an employee's remuneration which is excluded from "wages" by section 3121(a)(1) differ from the contributions or benefits based on the employee's remuneration not so excluded, or differ because of any retirement benefits created under State or Federal law.[51]

The benefit of this provision is obvious: it allows the firm to contribute relatively less for the lower paid employees, thereby having a much lower total cost for its pension program, while making the largest share of the benefits available to those employees who contribute most to the profits of the association.

B. Integration in H.R. 10 Plans

When a corporation integrates its pension plan, it is allowed to exclude from coverage under the plan all or a portion of the earnings of employees that are covered by Social Security.[52] But when an association other than a corporation includes an owner-employee in its pension plan, there are two important limitations on integration. The first limitation may or may not be important, depending on the circumstances of the particular firm. It is provided that when the owner-employee is included in an integrated plan, the contributions made for him cannot exceed one-third of the total contributions to the plan.[53] It would seem that in a large firm, having a sizable total contribution, this limitation would not be too serious; however, the contrary would be true for a relatively small association in which the sums deposited in the plan would not be very great.

Notwithstanding the size of the group in question, the second limitation is always important. Instead of excluding the "wages" under Social Security, *only the Social Security taxes paid* by the firm for the employee can be deducted from the contribution to be made on behalf of the employee.[54] Table I depicts a hypothetical medical clinic that includes a partner who would be classified as an owner-employee when such clinic integrates its pension plan.

---

50 LIFE INSURANCE FACT BOOK 1966, 104 (Institute of Life Ins. 1966) notes that in 1965 there were 120,400,000 persons with wage credits under Social Security.
51 INT. REV. CODE of 1954, § 401(a)(5).
52 *Id.*
53 *Id.* § 401(d)(6)(A).
54 *Id.* § 401(d)(6)(B).

TABLE I[55]

	Party	Interest	Salary	SS Taxes Paid	Contribution
A.	Dr. Andrew Adenoids	30%	$85,000	$452.40	$2,047.60
B.	Dr. Bob Bronchus	10%	40,000	452.40	2,047.60
C.	Dr. Clem Corpuscle	10%	40,000	452.40	2,047.60
D.	Dr. Denis Duodenum	10%	40,000	452.40	2,047.60
E.	Dr. Edward Esophagus	10%	37,000	452.40	2,047.60
F.	Dr. Frank Fluoride	10%	35,000	452.40	2,047.60
G.	Dr. George Gallstone	5%	38,000	452.40	2,047.60
H.	Dr. Harold Humerus	5%	33,000	452.40	2,047.60
I.	Dr. Ivan Idioplasma	5%	32,000	452.40	2,047.60
J.	Dr. John Joint	5%	28,000	452.40	2,047.60
K.	Thomas Technician	0%	7,000	266.00	434.00
L.	Nancy Nurse	0%	7,200	273.60	446.40
M.	Anne Assistant	0%	6,000	228.00	372.00
N.	Rachel Receptionist	0%	5,400	204.20	335.80
O.	Theresa Transplant	0%	5,400	204.20	335.80
P.	Marty Manager	0%	12,000	452.40	747.60
Q.	Harry Handyman	0%	8,500	452.40	397.60

As Table I shows, the firm must contribute $3,069.20 for the non-partners. Being aware that the lower-paid employees are covered by Social Security to an extent that a percentage of most of their earnings is already being paid into that mandatory "pension plan," the partners, motivated also by a desire for a low-cost plan, may not want to contribute that large a sum for those employees. Is there an alternative available that would allow the partners to avoid this limitation? Yes. Some professional associations have solved this problem by simply eliminating the owner-employee from the plan.[56] Table II shows the same clinic as in Table I, but here the 30% partner has been eliminated from the plan.

55 These figures were computed on an Olivetti-Underwood Programma 101 under the direction of Mr. Leo Daub of Chas. Stedman & Co., a pension consultant firm in South Bend, Indiana. The bases and explanations of these results are on file in the *Notre Dame Lawyer* office and are available upon request. The Social Security taxes paid are based on 1968 rates, with no consideration given to that portion of the tax that provides Medicare benefits.

56 *E.g.*, Hall v. United States, (D.N.D. Jan. 31, 1967) (unreported).

TABLE II[57]

	Party	Contribution
B.	Dr. Bob Bronchus	$3,300.00
C.	Dr. Clem Corpuscle	3,300.00
D.	Dr. Denis Duodenum	3,300.00
E.	Dr. Edward Esophagus	3,018.75
F.	Dr. Frank Fluoride	2,831.25
G.	Dr. George Gallstone	3,112.50
H.	Dr. Harold Humerus	2,643.75
I.	Dr. Ivan Idioplasma	2,550.00
J.	Dr. John Joint	2,175.00
K.	Thomas Technician	206.25
L.	Nancy Nurse	225.00
M.	Anne Assistant	112.50
N.	Rachel Receptionist	56.25
O.	Theresa Transplant	56.25
P.	Marty Manager	675.00
Q.	Harry Handyman	346.88

The type of plan used in Table II is termed an "excess integration" plan,[58] and the amount of "wages" excluded is $4,800.[59] As compared to Table I, this plan calls for contributions of $1,603.13 for the non-partners, thereby achieving a savings of $1,466.07 per year in comparison with the plan used in Table I in which the owner-employee was covered. At the same time, the plan used in Table II results in a contribution on behalf of the 10% partners of $26,231.50, or $7,783.10 more than the plan used in Table I. Of course, the amount that can be deducted for the partners cannot exceed the limits of H.R. 10 ($2,500 or 10%) so that $23,175.25 is the maximum that can be deducted;[60] the excess, $3,056.25, cannot be considered an expense.

Though the partners, considered as a whole, stand to gain much by eliminating the 30% partner from the plan, it is obvious that if the decision is made to exclude the owner-employee, the partners *inter se* have a discrimination problem. At first glance, it seems quite inequitable to have a program providing benefits for the members of a firm out of the profits of the firm while excluding the partner who probably contributes most to these profits. But there are at least two compensating factors to be considered, either or both of which may eliminate any unfairness. First of all, it is often one of the main purposes

57 See note 55 *supra*.

58 There is another major type of integration called "offset integration." P-H PENSION & PROFIT SHARING SERV., ¶ 4062, at 4064 (1962), notes the differences between the two:

> An "excess" plan is a plan under which employees earning below a minimum compensation level are excluded either by eligibility requirements or by basing benefits only on compensation in excess of the level . . . . In an "offset" plan, no employee is excluded because of minimum compensation requirements, and benefit rates apply uniformly to all covered employees, except that the plan benefit is reduced or "offset" by all or a percentage of the employee's Social Security benefits.

59 It is permissible to exclude different amounts of the wages covered by Social Security so long as the amount of excluded wages is constant in each particular plan, INT. REV. CODE of 1954 § 401(a)(5). Setting the level at $4,800.00 produces an integration factor of 9.375. For an explanation of the derivation of the integration factor, see P-H PENSION & PROFIT SHARING SERV. ¶ 4076, at 4075 (1962).

60 This figure does not take into account the nondeductibility of the "pure insurance cost" which would be a very small percentage of this amount. Treas. Reg. § 1.72-16 (1963).

of a pension plan to tie employees to the firm. The person most benefited by this aspect of the pension program would usually be the owner-employee, for he has the most to gain from the firm's ability to retain successful partners. Secondly, should this employee-retention factor be insufficient, the partners could agree on some sort of a direct payment from profits to the owner-employee that would adequately compensate him for being excluded from the plan. Of course such payments do not receive any favorable tax considerations. At any rate, being cognizant of the importance of integration and the impediments of including the owner-employee, it would seem that well-advised partners could reach some equitable agreement to solve this problem.

C. Caveats

In recent years the amount of wages subject to the Social Security tax has increased greatly. In 1958 the level was $4,800;[61] in 1965 it was increased to $6,600;[62] in 1968 the level is $7,800.[63] With these current high levels, it would now be possible to exclude many low-level employees from pension plans by means of integration. However, there is presently considerable doubt as to what the proper levels of integration will be in the future. The Internal Revenue Service has undertaken a comprehensive review of the existing integration formulas indicating that a change in this level is likely.[64] At this date, however, there has been no decision promulgated. Even though this area is unsettled, it should not, and does not, prevent firms from implementing integrated plans, as the Internal Revenue Service has said that any benefits derived from integration during this period will not be forfeited if the levels are eventually set below that at which the plan integrates.[65]

Besides these uncertainties, it must be kept in mind that integration, although it does allow relatively smaller amounts to be contributed for lower-paid employees, cannot be used as a shield for discrimination. If the association's plan, when considered in connection with Social Security, does in fact operate discriminately, it may not be accorded the status of qualification.[66]

V. Funding Pension Plans

A. Trusteed vs. *Insured*

Once the decision has been made to install a pension plan, there must be a further determination concerning the method that will be used to accumulate the sums required to meet the obligations under it. Basically, the problem is

61 Act of August 28, 1958, Pub. L. No. 85-840, § 402(b), 72 Stat. 1042, 42 U.S.C. § 409 (1964).
62 Act of July 30, 1965, Pub. L. No. 89-97, § 320, 79 Stat. 393, 42 U.S.C.A. § 409 (Supp. 1967).
63 Pub. L. No. 90-248, § 108 (Jan. 2, 1968), 36 U.S.L.W. 43 (Jan. 16, 1968).
64 IRS Announcement 66-58, 1966 INT. REV. BULL. No. 38, at 87.
65 Rev. Rul. 67-10, 1967-1 CUM. BULL. 84, 85.
66 Treas. Reg. § 1.401-11(c)(2)(i) (1963).

whether the funds should be turned over to a trustee for investment, or to an insurance company under one of the many types of contracts that are offered for pension plans. Although the general rule is that a trustee must be appointed to handle the funds placed in the program,[67] it is not necessary in H.R. 10 plans to appoint a trustee if the pension is funded solely by insurance contracts.[68]

Even though there are those who argue to the contrary,[69] it would seem that insured funding is preferable.[70] The major disadvantages of a trusteed program are: 1) the costs of administration arising from trustee fees during the life of the trust,[71] and 2) the possible inexperience of the trustee, vis à vis the insurance companies, in dealing with these matters.[72] At the same time there are several advantages of varying significance enjoyed by insured plans: 1) obviously, there are no fees to be paid for the services of a trustee; 2) since the companies offer a large number of different types of plans, and may negotiate on a plan to fit the particular association, the participants can adopt a plan specifically tailored to the needs and desires of that association; 3) the skills and abilities needed to administer properly a pension plan are present in every life insurance company, for pension plans center around the concept of life expectancy which is the major concern of life insurance companies;[73] 4) the security that is the hallmark of the insurance industry provides maximum safety for the pension funds; and 5) the retiree will normally prefer to receive his funds from the plan in some form of an annuity, and it is most efficient to pre-arrange for these annuity payments as the funds are contributed, instead of forcing the pensioner to purchase an annuity in the market at the time of his retirement.[74]

Cost and security are the key factors in pension plans. From the preceding discussion it is seen that insured plans are usually less expensive and provide maximum safety. Hence, although certain situations may warrant the use of trusteed plans,[75] insured plans are generally to be preferred.

B. What Kind of Insured Plan?

Having concluded that insured plans are generally desirable, the next step involves choosing one of the many available plans. At the outset it must be recognized that the ultimate selection should always depend upon the facts

67 INT. REV. CODE of 1954, § 401(d)(1).
68 *Id.*
69 A. Haake, Jr., *Case for Trusteed Plans,* 102 TRUSTS & ESTATES 1214 (1963).
70 R. Bender, *Case for Insured Plans,* 102 TRUSTS & ESTATES 1217 (1963).
71 E. WHITE, THE PENSION TRUST MANUAL § 17-16 (The Research & Review Service of America 1966).
72 L. NEFF, THE BASICS OF INSURED PENSION AND PROFIT-SHARING PLANS 32 (The Research & Review Service of America 1967).
73 *Id.* at 31.
74 When a beneficiary retires, he would usually prefer to receive his funds in the form of an annuity. Hence, if the funds are in a trust rather than an insurance plan, it will be necessary for the beneficiary to purchase an annuity of some kind. Even assuming that the trustee outperformed the insurance company, this margin would likely be absorbed by the loading costs of the purchased annuity.
75 One commentator argues that ". . . there is no one way to handle a pension plan." He feels that it depends on the needs and wishes of the particular firm. K. Keene, *Insured vs. Trusteed Pension Programs,* 19 J. AM. SOC'Y C.L.U. 35, 45 (1965).

of the particular case. However, there are some general principles that may be profitably discussed.

Though the contracts differ slightly from one insurance company to another, the major classifications of plans include: 1) group permanent insurance contracts,[76] 2) deposit administration contracts,[77] 3) retirement income plans,[78] 4) variable annuities,[79] 5) segregated accounts,[80] and 6) various combinations of these. Since there are so many different types of plans, a discussion of all of them would be unwieldy. Hence, only the two rather common types, which are at opposite ends of the cost-benefit spectrum, retirement income and deposit administration, will be discussed at length.

1. Retirement Income Contracts

Retirement income contracts are individual annuity contracts purchased by the association on the life of the participant. These policies may have a variety of names: endowment annuity, insurance with annuity, retirement endowment, and income endowment.[81] The retirement income contract is actually a combination of a retirement annuity[82] and decreasing term insurance.[83] It provides not only for regular payments during retirement, but also for death benefits if the covered employee dies before his retirement. Largely because it has both of these valuable features, this type of insured plan has the highest gross cost. Of course, in most H.R. 10 plans the amount contributed will be the same maximum sum,[84] but variations among the plans arise in the amount and type of benefits provided.

Table III shows the same medical clinic considered previously when the clinic funds its pension plan with retirement income contracts.

---

76 "Group permanent life insurance consists in essence of a collection of individual policies of permanent life insurance that are tied into a single master contract with group underwriting and administrative simplifications." D. GREGG, LIFE AND HEALTH INSURANCE HANDBOOK 371 (2d ed. 1964).

77 See notes 86-93 *infra* and accompanying text.

78 See notes 81-85 *infra* and accompanying text.

79 ". . . [A] variable annuity is an annuity providing periodic payments, the dollar amount of each payment being determined from period to period primarily in accordance with the then current earnings and market value of a portfolio of equity assets, especially common stocks." D. GREGG, *supra* note 76, 554.

80 P-H PENSION & PROFIT SHARING SERV., ¶ 7527, at 7536 (1967), describes segregated accounts: ". . . [T]he life insurance company agrees with the employer on the percentage of contributions to be allocated to a separate account and invested in common stock. In many states, employee contributions cannot be so allocated."

81 D. GREGG, *supra* note 76, 92. Undoubtedly some insurance companies have even more names for these plans, but the above are the terms generally used to describe them.

82 *Id.*

83 *Id.* at 38.

84 This is so because no matter what type of insured plan is used, the partners will usually contribute the maximum amounts allowable for themselves.

TABLE III[85]

Name	Age	Sex	Contribution	Death Benefit	Cash Value	Monthly Income at Retirement
B. Dr. Bob Bronchus	50	M	$3,300.00	$29,750.00	$61,640.00	$379.60
C. Dr. Clem Corpuscle	47	M	3,300.00	36,570.00	79,490.00	489.60
D. Dr. Denis Duodenum	46	M	3,300.00	38,930.00	85,860.00	529.00
E. Dr. Edward Esophagus	42	M	3,018.75	44,780.00	105,050.00	647.00
F. Dr. Frank Fluoride	40	M	2,831.25	46,580.00	112,690.00	694.00
G. Dr. George Gallstone	40	M	3,112.50	51,230.00	123,940.00	763.00
H. Dr. Harold Humerus	38	M	2,643.75	47,960.00	119,570.00	736.60
I. Dr. Ivan Idioplasma	35	M	2,550.00	53,070.00	138,490.00	853.30
J. Dr. John Joint	32	M	2,175.00	51,370.00	140,570.00	866.00
K. Thomas Technician	26	M	206.25	5,820.00	17,750.00	109.30
L. Nancy Nurse	32	F	225.00	4,650.00	14,170.00	77.70
M. Anne Assistant	24	F	112.50	3,000.00	10,510.00	57.60
N. Rachel Receptionist	23	F	56.25	1,460.00	5,210.00	28.60
O. Theresa Transplant	22	F	56.25	1,500.00	5,480.00	30.00
P. Marty Manager	41	M	675.00	10,430.00	24,840.00	153.00
Q. Harry Handyman	38	M	346.88	6,130.00	15,280.00	94.10

Table III demonstrates what was said previously about retirement income contracts. It offers valuable death benefits, ranging from $1,460 up to $53,070. Also, the actual pension portion of the program provides monthly payments during retirement from $28.60 to $866. This type of plan, then, may solve the problems of insufficient insurance coverage and retirement at the same time.

2. Deposit Administration Contracts

Under this type of plan periodic deposits are made to a fund, just as the premium payments would be made into a retirement income plan. But the important difference here is that the funds contributed are not immediately allocated to the purchase of an annuity for a particular employee.[86] Instead, all the funds accumulate at a guaranteed rate of interest in the hands of the insurance company.[87] Then as each covered employee retires, a sum of money sufficient to purchase an annuity in the amount called for under the insurance contract is deducted from the fund to provide for the pension payments to the retiree.[88] In contrast to the retirement income contract, this type of plan is much less expensive; or as used in H.R. 10 plans, it will provide more retirement benefits for the same amount of contributed dollars.[89] This result stems primarily from the absence of death benefits in the plan.[90] Also, there are no

85 See note 55 *supra*.
86 D. GREGG, *supra* note 76, 525.
87 *Id.* at 530.
88 *Id.* at 525.
89 See note 84 *supra* and accompanying text.
90 There are two qualifications to this statement; 1) The amount of the contributions made on behalf of the employee will be paid on his death, as these, under the terms of the

individual policies issued to the employees until retirement,[91] and there is generally less record-keeping to be done.[92]

Table IV shows the same clinic described in previous tables when the clinic uses the deposit administration plan.

TABLE IV[93]

	Cash Value	Monthly Income at Retirement
B.	$74,760.00	$485.30
C.	97,470.00	632.80
D.	105,810.00	686.90
E.	131,320.00	582.50
F.	141,880.00	921.00
G.	155,970.00	1,012.50
H.	151,750.00	985.10
I.	177,890.00	1,154.80
J.	182,840.00	1,187.00
K.	24,700.00	160.40
L.	18,910.00	111.90
M.	15,100.00	89.40
N.	7,980.00	47.20
O.	8,440.00	50.00
P.	31,540.00	204.70
Q.	19,910.00	129.20

Table IV thus illustrates that under the deposit administration contract, the same amount of dollars can purchase more retirement benefits. Under the retirement income plan, the firm was able to purchase a total of $650,570 in retirement benefits, while under the deposit administration plan it was able to provide $862,070.

3. Life and a Fund Plans

Either of the preceding two plans may be desirable depending on the primary goal of the particular pension plan. On the corporate level, a retirement income plan is generally recommended if the main concern of the company in installing a pension plan is to secure a high level of benefits to the covered parties. On the other hand, if low cost is sought, a deposit administration plan is ordinarily used. In H.R. 10 plans, where the amount of the contribution will usually be the same under either type of plan,[94] the choice is between a plan offering a certain amount of life insurance along with the pension benefits (retirement income) or a plan providing a larger amount of retirement benefits only (deposit administration). The goals of most pension plans are, or ought to be, both of the above. With this in mind, most companies offer a plan which combines aspects of both of these plans to achieve a more balanced result. Though the label given such a plan may vary from company

law, must be vested; 2) there may be life insurance provided in the plan, but this must be "incidental" to the deposit administration contract. *See* notes 35 and 36 *supra* and accompanying text.

91 Obviously it costs more to issue many individual policies than to issue one single contract and these savings are passed on to the insured. *See* note 86 *supra* and accompanying text.

92 D. Gregg, *supra* note 76, 525.

93 See note 55 *supra*.

94 See note 84 *supra*.

to company, one popular name is the "life and a fund" plan. It features the life insurance protection and annuity provisions of the retirement income contract along with a deposit administration program. [95]

Table V shows how such a plan may be implemented for the medical clinic.

TABLE V[96]

	Contribution	Amount to Insurance Premium	Amount of Insurance	Monthly Income at Retirement
B.	$3,300.00	$1,223.50	$29,750.00	$420.70
C.	3,300.00	1,327.25	36,570.00	544.20
D.	3,300.00	1,356.98	38,930.00	589.50
E.	3,018.75	1,335.04	44,780.00	724.50
F.	2,831.25	1,288.62	46,580.00	779.40
G.	3,112.50	1,416.26	51,230.00	857.10
H.	2,643.75	1,232.98	47,960.00	829.90
I.	2,550.00	1,226.36	53,070.00	966.60
J.	2,175.00	1,072.85	51,370.00	989.10
K.	206.25	109.52	5,820.00	126.80
L.	225.00	97.28	4,650.00	93.20
M.	112.50	54.34	3,000.00	70.00
N.	56.25	28.88	1,460.00	35.40
O.	56.25	28.47	1,500.00	37.20
P.	675.00	307.15	10,430.00	171.70
Q.	346.88	166.32	6,130.00	106.10

An examination of Table V reveals the way in which the life and a fund plan operates to serve both insurance and retirement needs. The division of the contribution between insurance protection and retirement benefits is discretionary; a firm may prorate its contributions in almost any amount, but the figures used here show what may be accomplished with such a fund.

C. Conclusion

Recommendations as to a particular type of insured plan cannot profitably be made in the abstract. A plan that serves one firm well may not be proper for another. But the life and a fund plan, since it does serve the varied goals of most firms, may be generally recommended. Moreover, the life and a fund plan adopted by a particular firm is flexible enough to meet the dissimilar needs and desires of the various partners within that firm.

VI. Conclusion

The foregoing thoughts on integration and funding demonstrate the degree of sophistication employed by unincorporated associations in taking advantage of the pension benefits now available to them. This expertise, when used to design a pension program that is properly fitted to the particular firm, together with the recent increase in deductibility allowances, points to but one conclusion: H.R. 10 roars!

Thomas J. McCusker

---

95 D. GREGG, *supra* note 76, 536.
96 See note 55 *supra*.