Volume 63
Issue 4 *Dickinson Law Review - Volume 63, 1958-1959*

6-1-1959

H.R. 10-The Self-Employed Individuals Retirement Act of 1959

John W. Pelino

NOTES

H. R. 10—THE SELF-EMPLOYED INDIVIDUALS RETIREMENT ACT OF 1959

A French statesman once said, "The art of taxation consists in so plucking the goose as to obtain the largest amount of feathers with the least amount of hissing." [1] The House of Representatives, apparently taking heed, has recently enacted H. R. 10, the Self-Employed Individuals Retirement Act of 1959. It is hoped the bill will still the hissing of the self-employed and the organizations and associations which they compose.[2] Essentially, the complaint of the self-employed is that they are and have been, since 1939, the victims of a gross inequity. While sometimes exaggerated, their complaint has merit. Perhaps a little history and some mathematical calculation will serve to illustrate.

The Internal Revenue Code (I.R.C.) of 1939 [3] introduced the qualified pension plan, whereby an employer may deposit annually in a restricted fund an amount equal to 5% of the amount otherwise paid to the employee [4] plus whatever amount over 5% is necessary to fund an annuity for the employee,[5] or under a plan approved by the Secretary, an amount up to 10% of the compensation otherwise paid.[6] This amount may be deducted from the gross income by the employer from the employee's gross income [7] and neither the amounts paid in nor the interest which they earn are included in the income of the employee until received.[8]

The obvious consequence is that employees may have a pension plan funded by untaxed funds, which are permitted to accrue untaxed interest, all of which may be withdrawn in installments or through an annuity during retirement years, and included, as withdrawn, in the gross income of the recipient at a time when his tax bracket is lower.[9] In addition, if the employee, because of death *or for any other reason* terminates his employment and with-

[1] Jean Baptiste Colbert (1619-1683).

[2] See 65 CONG. REC. 3822 (daily ed. March 16, 1959) for a list of the many professional organizations which have endorsed the bill.

[3] INT. REV. CODE OF 1954, § 401.

[4] INT. REV. CODE OF 1954, § 404(a)(1)(A).

[5] INT. REV. CODE OF 1954, § 404(a)(1)(B).

[6] INT. REV. CODE OF 1954, § 404(a)(1)(C).

[7] INT. REV. CODE OF 1954, § 404.

[8] INT. REV. CODE OF 1954, §§ 501(a), 402.

[9] INT. REV. CODE OF 1954, § 402 subjects amounts received under a qualified plan as if distributed under § 72 (relating to annuities).

draws, within one taxable year, the entire amount to which he is entitled will be taxed as a long term capital gain.[10]

If you are mathematically inclined you might try computing the difference in *earned dollar* cost of such a plan to an employee in the 50% bracket and a self-employed person in the same bracket. Bear in mind that by reducing his salary 10% by arrangement with the employer to deposit the amount instead of giving it as salary, the employee may receive the remainder of his salary taxed at a lower rate. Next consider that every *earned dollar* the self-employed individual deposits in his account will be reduced 50% by taxes as will every dollar of income, while the employees fund grows on compounded untaxed earnings. True, the self-employed man need not pay tax on any funds which he withdraws (except, of course, the tax on realized capital gains), but remember that if the employee resigns or retires, he may withdraw the entire amount at the capital gains rate. The net result in terms of *earned dollars* is that the cost of a retirement fund (if 15 annual contributions are made) is doubled in the case of the self-employed.

To take some of the sting away you should also know that not every employee participates in a qualified plan. If for one reason or another his employer will not or cannot set up such a plan an employee is in the same situation as the self-employed, except that he will not obtain relief under H. R. 10. Nevertheless, it is at least possible for him to take advantage of this tax benefit, but proprietors, partners and professionals (in most cases) cannot because they are not employees.

Apparently intrigued by section 165 of the 1939 Code, a group of doctors in Missoula, Montana, decided to dissolve their partnership and form an association for the practice of medicine, styling themselves "employees". The Court of Appeals of the Ninth Circuit decided that it was possible to treat the association as a corporation for tax purposes, even though doctors were prohibited from incorporating.[11] The doctors were thus able to fend off the attempts of the Internal Revenue Service to apply the income tax to funds deposited in a fund for "employees" of the association. However, joy among the doctors was short-lived for the Commissioner refused to follow the decision.[12]

Other attempts to gain equal tax benefits for the self-employed began with agitation by professional groups immediately after the 1939 Code was

---

10 INT. REV. CODE OF 1954, § 402(a)(2).

11 U.S. v. Kitner, 216 F.2d 418 (1954).

12 Rev. Rul. 56-23, 1956-1 CUM. BULL. 598. But see article in Taxes, April, 1959, p. 321 indicating that the service is drafting new regulations which permit a wider use of this device.

adopted. The big push began about 1947 when a rash of plans appeared,[13] including one which proposed that a taxpayer be allowed to deduct from his income the amount used to purchase 1% non-assignable government bonds, redeemable on death or within ten years thereafter; the proceeds on redemption to be included in the income of the heirs.[14] In 1950 the American Bar Association appointed a committee to study the problem of retirement benefits. The result was the forerunner of H. R. 10. Drafted by Leslie M. Rapp of the New York Bar the bill was introduced in the 82nd Congress by Representatives Reed [15] and Keogh.[16] The bill died in committee, as it did when introduced again in 1952 and in 1955. Originally, the bill was drafted to include employees not participating in a qualified plan, but in the face of strong opposition to such a revenue reducing bill it was amended to limit application to the self-employed. As amended the bill passed the house late in 1957, only to die in the Senate Finance Committee. But, like the proverbial nine-lived cat it sprang back, was reintroduced by Representatives Keogh and Simson in 1958, and was passed by the House on March 16, 1959. Since then the bill has been referred to the Senate Finance Committee where it now rests.

While at present the outlook is not very favorable [17] there is still a possibility that the Senate will pass the bill. Even if it fails this time, any bill with such exhibited staying power and with such concentrated support [18] is likely to become law in the near future. For this reason the following analysis is offered.

The bill would permit self-employed individuals an annual deduction of amounts deposited in a "Restricted Retirement Fund" or paid as premiums on a "Restricted Retirement" on or before the 15th day of the fourth month of the next taxable year (normally April 15). Every self-employed person is covered except those currently receiving benefits, either in the form of distribution or in the form of contribution to a qualified plan by an employer.[19] In general, the allowable annual deduction is 10% of net earnings from self-

[13] See *e.g.* 33 A.B.A. JOURNAL 302, 1001 (1947).

[14] Silverson Plan, 44 AMER. MER. 345 (March, 1947).

[15] H.R. 47373, 82 Cong. 1st Sess. (1951).

[16] H.R. 4371, 82 Cong. 1st Sess. (1951).

[17] The Treasury Department is violently opposed to the bill on the ground that there should be no selective relief when general relief is not possible. Moreover the estimated revenue loss (estimated from 100 to 365 million) is not viewed with favor. Compare the known revenue loss of 1.8 million dollars on 40,000 qualified pension plans covering more than 15 million employees in 1957. See CONG. REC. note 2 *supra*.

H.R. 10 has been criticized as a gift to the rich, but as one stated, "What's wrong with equality for the rich?"

[18] See note 2 *supra*.

[19] INT. REV. CODE OF 1954, § 1401. This is the equivalent of Social Security.

employment or $2,500, whichever is less, with a lifetime limit of $50,000.[20] Taxpayers over 70 at the beginning of the taxable year are allowed no deduction [21] while those over 50 on the effective date (January 1, 1959) of the bill are allowed, in addition to the annual deduction of 10%, an increase of 1% of his net earnings from self-employment for each full year of age over 50. If the taxpayer was 54 on January 1, 1959, his annual allowable deduction would be 14% of net self-employment earnings or $3,500 whichever is less.

The lifetime exemption never increases. It does, however, decrease in the case of an individual who obtains money or has acquired non-forfeitable rights under a qualified employee plan. Since qualified employee plans are funded according to the number of years of employment, the reduction is computed by multiplying the maximum annual deduction by the number of years of employment to which the employees rights are attributable. In the case of a taxpayer whose previous employer has made contributions attributable to 8 years of service the lifetime limit would be $30,000 or $50,000 less 8 x $2,500.[22]

It must be remembered that the deduction is allowed only for amounts actually deposited in a restricted retirement fund or paid as premiums on a restricted retirement policy. Qualification as a restricted retirement fund is also essential to secure tax exempt status as to the income of the fund. "Restricted Retirement Funds" is no misnomer for restrictions abound. Proposed section 405 sets forth the following requirements:

1. The Fund must be established by a written trust instrument and must be for the exclusive benefit of a member or members of a retirement plan.
2. The trustee must be a bank.
3. A member's interest must be nonassignable by the terms of the trust, except that he may designate one or more beneficiaries in the event of death or he may direct the transfer of his entire interest in the fund to another restricted retirement fund.
4. The agreement must provide that each member's interest shall be proportionate to the amount he has paid in and the "income and other adjustments properly attributable thereto." In addition, it must require the trustee to return to any member in every taxable year the amount by which his contribution to the fund exceeds his allowable annual deduction.
5. The trust must terminate as to each member at age 70.
    A. Before a member reaches age 70 he may elect to have his entire interest distributed to him, in which event if he is over 64½, he

[20] Proposed § 217 to INT. REV. CODE OF 1954; H.R. 10, 86 Cong. 1st Sess. (1959).
[21] *Id.* at (a).
[22] *Id.* at (b).

has been allowed deductions under Section 217 for any 5 prior years and if no person has theretofore received any amounts under any of the member's retirement funds or policies it will be taxed in an amount equal to 5 times the tax which would result if 1/5 or 20% were included in his gross income of that year. Thus, if he elects to receive his entire interest of $20,000, the tax will be 5 times the amount his tax would be increased by adding $4,000 to his gross income.[23]

B. Before a member reaches age 70 he may elect to have the entire fund used to purchase a retirement annuity which does not provide life insurance protection, or he may elect to have his entire interest distributed before age 80 at the rate of not less than 10% (of the value at age 70) each year beginning with the taxable year in which he reaches 70. If an annuity is purchased and immediately distributed, the amounts are taxed as other annuities under section 72 of the present code, except that section 72 (e) (3), relating to lump sum payments, would not apply, and the basis of the annuity would be zero (the basis of the fund). If the fund is distributed in installments the amounts would be included in the member's gross income in the year received.[24]

C. If the member dies before reaching age 70 his entire interest must be distributed within 5 years after death or used to purchase an immediate annuity for the surviving spouse. In the case of a lump sum distribution to the estate or other beneficiary, the tax would be 5 times the tax resulting from inclusion or 20% of the amount in the gross income of the estate or beneficiary in the year received. The spouse's income from an annuity would be taxed in accordance with section 72 except that section 72 (e) (3) would not apply.[25]

6. The trustee may invest and reinvest the fund only in stock or securities listed on a national exchange registered with the S.E.C., provided that any purchase of stock does not result in ownership by the trust and its members (including stock ownership attributed to a member under section 318 of the code, relating to constructive ownership) of more than 10% of the voting stock of the corporation, stock in a regulated investment company, Government bonds or notes (Federal, State, Territory, D. C. or Municipal), or the purchase for each member of an annuity providing restricted retirement benefits.[26] If the trustee makes only permissible investments, the fund will be exempt from taxation.[27]

[23] Proposed § 78.

[24] *Ibid.*

[25] *Ibid.*

[26] Proposed § 405.

[27] Proposed amendment to § 501.

7. In addition to the above limitations there are listed certain prohibited transactions:

   A. Lending of any part of the corpus or income of the fund to;

   B. Paying compensation for personal services to;

   C. Making any part of its services available on a preferential basis to; or

   D. Acquiring for the fund any stock, securities or evidences of indebtedness of the fund from, or selling to,

   any member of the plan or certain related parties.[28] If the trustee knowingly engages in a prohibited transaction, the fund will lose its exempt status for the year in which the transaction occurs and every year thereafter. If, on the other hand, he acts unknowingly, the exempt status is lost only for the years following the taxable year in which the trustee is notified by the Secretary or his delegate.[29]

In view of all these restrictions it may prove difficult to induce banks to act as trustees. However, it is suggested that if the bill is enacted an early amendment would probably permit the taxpayer to invest in common funds already established by many banks.

Insurance companies are expected to have a field day if H. R. 10 becomes law, since the restrictions imposed on "Retirement Policies" are not nearly so cumbersome. The requirements under proposed section 217 (f) are that the policy be a contract (other then a term insurance contract) which is an annuity, endowment or life insurance contract. It must be issued by a domestic life insurance company[30] and provide for payment of the entire value of the policy to the insured:

1. Not later than age 70½; or
2. As a life annuity beginning not later than age 70½, which may provide for a minimum term not exceeding his life expectancy; or
3. And his spouse as a joint life or joint and survivor annuity beginning not later than age 70½. (Like the life annuity the policy may provide for a term certain not exceeding the insured's life expectancy).
4. Or his beneficiary (in the event of his death) as an annuity for a fixed period not exceeding the insured's life expectancy.

Annuities that provide for payments which may increase for any reason other than dividends or increases in investment income are not deemed to be "Restricted Retirement Policies".[31]

[28] Proposed § 405 (d) (3).
[29] Proposed § 78(a) (3).
[30] As defined in INT. REV. CODE OF 1954, § 801.
[31] Proposed § 217 (f).

Further requirements are that the policy be non-assignable, that no person other than the insured shall have any incidents of ownership, and that it not provide for life insurance protection after age 70½. The taxpayer may, however, designate one or more beneficiaries to receive the proceeds in the event he dies before age 70½.

Lump sum distributions under a retirement policy would receive the same tax treatment as lump sum distributions from a fund. Again the periodic distributions, if elected, would be taxed as annuities under section 72, except that section 72 (e) (3) would not apply and the basis would be reduced by the amounts allowed as deductions under section 217 and increased where any previously allowed deduction was treated as income because of penalty provisions. If the policy does provide life insurance protection and death benefits are paid before the taxpayer reaches age 70½, the amounts received in excess of the cash surrender value of the policy on the day before the death would be taxed in accordance with current section 101.[32] Premiums attributable to other retirement benefits would not be allowed as deductions under proposed section 217.

Certain general and special rules may result in disallowance of the deduction or "penalties."

1. No deduction is allowed, either for premiums paid or funds deposited, unless the policy has been identified as a "Restricted Retirement Policy" or the fund as a "Restricted Retirement Fund", in accordance with treasury regulations (to be drafted). Proposed section 6047 would require trustee banks and policy issuers to file returns, etc. and would require the taxpayers involved to furnish such information as is required by the bank or insurance company.[33]

2. The taxpayer may not borrow from the insurer any amount exceeding the current annual premium and then only if the amount borrowed is used to pay the premium and is repaid in full within one year of the due date of such premium. Money borrowed under other conditions will be treated as income received during such taxable year [34] (computation of tax will be discussed below).

3. If any portion of the value of a retirement policy is applied to the purchase of other than restricted retirement benefits under any arrangement with the insurance company, the entire cash surrender value shall be treated as an amount received under the policy, unless said portion of the value is irrevocably converted into a contract which provides only for restricted retirement benefits.[35]

---

[32] Proposed § 78 (b).
[33] Proposed § 217 (a).
[34] Proposed § 78 (b)(3)(B).
[35] Proposed § 78 (b)(3)(c).

4. The tax on distributions from either policies or funds are normally taxed as ordinary income when received, except as previously noted. Penalties are imposed as follows:

   A. If the self-employed taxpayer before age 64½ receives an amount less than $2,500, it will be included in his gross income in the year received and subject to tax in an amount equal to 110% of the tax which would normally result from such inclusion.[36]

   B. If the amount exceeds $2,500 it will be taxed in an amount not less than 110% of the increase that would result if the amount received had been included ratably in the taxpayers income for the taxable year and the four preceding taxable years. In the case of a taxpayer who had been allowed the deduction in less than any four prior years the ratable inclusion would be made in the taxable year and a number of preceding years equal to the number of years in which deductions had been allowed.[37]

One very important provision of the bill is that in no event will the tax imposed in the year in which benefits are received from a fund or policy be less than the tax which would be imposed if such benefits were the only income with no deductions or allowances other than personal exemptions. In short, the taxpayer cannot reduce his "retirement income" by losses or deductions, but he can receive it by personal exemptions.

There is no doubt that the self-employed will derive considerable benefit if H. R. 10 becomes law. Neither is there any doubt that those in the higher income groups will benefit most. It does not, however, do much for the employee who cannot participate in a qualified plan. From that point ot view it seems the plan is selective in its benefits. A stronger objection has been raised because the moderate penalties would induce people with fluctuating incomes, to "use the plan for averaging their incomes rather than for retirement purposes." [38]

There is no doubt that the bill will prove an extremely useful estate planning device. True, it will not, because of restrictions on assignability of interest and incidents of ownership, permit any proceeds paid to a beneficiary to escape the estate tax. You may, however, compare the result when income is taxed at 50% and then passes to a beneficiary subject to estate tax with the result of double that amount first subject to the estate tax and then to the income tax at the rate of 5 times the tax which would result if 20% of the amount were included in the recipient's gross income. In addition to the certain income tax saving and the possible estate tax saving, there is the at-

---

[36] Proposed § 78 (c).
[37] *Ibid.*
[38] House Committee Minority Report,

tractive feature of permitting the client to retain control of his funds until death.

The foregoing is offered as an analysis of H.R. 10 but it is not a substitute for a true reading of the bill. Some technicalities have been omitted in the interest of continuity. One should refer to the bill for any problem not specifically discussed here, and if the bill is finally passed, it should be carefully scrutinized for amendments.

JOHN W. PELINO.