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# TAX-FAVORED PENSIONS IN SIGHT FOR THE SELF-EMPLOYED

EARL S. MacNEILL* and GORDON T. WALLIS**

There are 11,000,000 people in the United States who are self-employed: farmers, doctors, dentists, osteopaths, chiropractors, optometrists, veterinarians, lawyers, accountants, architects, engineers, industrial designers, chemists, ministers, social workers, writers, artists, actors, musicians, dancers, real estate and insurance brokers and agents, actuaries, investment counsel, professional athletes, funeral directors, and a host of others.

To these 11,000,000 are denied certain tax privileges enjoyed by some 8,000,000 employees of others who are participants in pension plans established by their employers and "qualified" under Section 165 of the Internal Revenue Code. Payments made by the employer into the fund from which the pensions will be paid under a plan so qualified are deductible by the employer. Income which may be earned by this fund is tax-free—as are capital gains also. Most important to the individual: the payments made by the employer into the fund for the employee's ultimate benefit are not currently taxable as income to the employee. He will be taxed only on the pension when he receives it, and normally he will be in lower brackets then because the pension will be lower than his wage or salary while employed.

Now consider the plight of the 11,000,000 self-employed. Whatever they may be able to put aside to provide for their old age they will have paid a tax on first. If they invest their old-age reserve, the income and gains of the reserve will be taxable. It would seem only fair to give them the same tax treatment as the 8,000,000. A measure is pending in Congress which would do this. Curiously it has met with objections that it is discriminatory, favoring the rich. We'll come back to the objections later: first, the bill.

Actually there are two identical bills in the House of Representatives, one introduced by Representative Eugene J. Keogh and the other by Representative Daniel A. Reed, both of New York; one a Democrat and the other a Republican—thus a bipartisan aspect is given.

There's a little history to these bills. They were introduced early in 1951; and a companion proposal was offered by Senator Irving M. Ives as an amendment to the then-pending Revenue Act of 1951. The amendment "died in committee," as the quaint phrase is, because there was inadequate time to study it. The Keogh-Reed bills survived in their original form (H.R. 4371 and H.R.

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4373) to be the subject of a one-day hearing before the House Ways and Means Committee on May 13, 1952. Many constructive suggestions came out of the hearing, as a consequence of which the bills were redrafted and presented anew as H.R. 8390 and H.R. 8391. Hereafter, for simple syntax' sake we'll refer to the bills in the singular; and the modified version will be described, with but occasional passing reference to the original.

### COVERAGE OF PROPOSED LAW

It is called, "A Bill to encourage the establishment of voluntary pension plans by individuals."

What individuals? They are not necessarily self-employed. A "qualified individual" is defined as any individual except one who is employed *and* who is a member of a pension or profit-sharing plan established by his employer and qualified under Section 165(a); or is eligible to become a member of such a plan upon meeting certain requirements; or is already a pensioner under such a plan. Excluded also are employees and pensioners of national, state and local governments and agencies having retirement plans.

So now we have qualified individuals, who generally will be self-employed but may be the employees of employers having—as to them, at least—no qualified tax-privileged retirement plan. Any such person may exclude from his gross income, in any taxable year, subject to certain limitations, that portion of his earned income that he has paid within 60 days after the close of such year to a "restricted retirement fund" or to a life insurance company as premiums under a "restricted retirement annuity contract."

What are the limitations? Basically, the annual exclusion cannot exceed 10% of the taxpayer's earned net income, or $7,500, whichever is the lesser; and the aggregate excludable during the taxpayer's lifetime is fixed at $150,000. But there are variations. To make it possible for older persons to build up worth-while retirement funds during the relatively few years remaining to them before they must cease to work, there is this special provision: that anyone over 55 years of age on January 1, 1952, may increase his excludable amount each year by 1% of earned net income, or $750, whichever is the lesser, multiplied by the number of full years of his age over 55—but not over 20 years or beyond age 75. In the interest of flexibility there are provisions for the carry-over of "unused exclusions" which are rather too technical for our purposes here.

Payments must be made in a certain way, as we have noted: either into a restricted retirement fund or as premiums on a restricted retirement annuity contract.

A restricted retirement fund is defined as a trust fund forming part of a bona fide retirement plan for the exclusive benefit of its participating members. Who may—or should—sponsor such a plan is not specified. The trustee must be a bank. Investments are not necessarily limited to the "legals" of any state; the trust instrument may set the investment rules—to the extent permitted by local law. Income from investments will be added to the principal and re-invested; the income of the trust will be tax-free. A separate account will be kept of each member's contributions and the earnings derived from their investment. The share of the contributing taxpayer in the trust fund *cannot be withdrawn* until he is age 65, unless he sooner dies or suffers total and permanent disability.

On retirement, payment of the participant's accumulation of contributions, gains, interest and dividends, and the re-investments thereof, may be made under one or more of the following options:

(1) In a lump sum;
(2) In annual, quarterly or monthly installments of a designated amount over a period of years;
(3) By purchase by the trustee, in the name of the member, of one or more single premium life annuity contracts with or without a guaranteed minimum return and with or without a survivorship option.

If payment is made in a lump sum it will be treated as a long term capital gain (which is the same treatment as under Section 165(a) plans) provided it represents the accumulations of at least 5 years. Any other payments will be taxable as ordinary income when received.

In the original version of the bill, payment through a trust was mandatory. That is, there was no provision for direct dealing between taxpayer and insurance company in the purchase of annuity contracts. This was not a capricious omission: deferred annuity contracts presently available have such features as cash surrender value and assignability which would defeat the purposes of the statute. Upon representations by the insurance companies that suitable contracts could be devised, an alternative method of "funding" was provided: the purchase of "restricted retirement annuity contracts" which would be issued in conformity with Treasury regulations so that the contracts could not be surrendered or assigned and generally would conform—as to time and manner of payment—with the requirements laid down for restricted retirement funds.

One matter of definition remains: what is "earned income?" It includes wages, salaries and professional fees, of course. It includes, also, income received from literary, musical or artistic compositions or from the copyright thereof. It excludes compensation which represents a distribution of corporate profits rather than a reasonable allowance as compensation for personal services actually rendered. Troublesome problems relating to partnerships and proprietorships where both personal services and capital are income-producing factors are relegated to regulations to be prescribed by the Secretary of the Treasury.

Such is the general outline of the proposed law and one well may wonder what the shooting was all about that sought to kill the bill as "class legislation."

It may have been a fault that committees of the American Bar Association, the New York State Bar Association and the Association of the Bar of the City of New York joined in formulating the original bill. Indeed, the impression somehow got about that this was primarily a "lawyers' retirement project." But the roster of organizations whose representatives appeared or filed statements in support of the measure (in principle, if not in every detail) was impressive testimony to the universality of its application—and its appeal:

American Bar Association, American Dental Association, American Farm Bureau Association, American Federation of Radio Artists, American Guild of Musical Artists, American Guild of Variety Artists, American Institute of Accountants, American Institute of Chemists, *American Life Convention, American Medical Association, American Osteopathic Association, Actors' Equity Association, Artists' Managers Guild, Association of the Bar of the City of New York, Association of Stock Exchange Firms, Authors League of America, Inc., Chicago Bar Association, Chorus Equity Association, Conference of Actuaries in Public Practice, District of Columbia Bar Committee on Legislation, Engineers Joint Council, Illinois Bar Association, Investment Counsel Association of America, *Life Insurance Association of America, National Society of Professional Engineers, New York State Bar Association, Pennsylvania Bar Association, Society of Industrial Designers, Television Authority (AFL).

True, there are a few bar groups scattered throughout the list, but it must be admitted that they are in varied company—doctors, brokers and writers on one side; chorus girls, actuaries and engineers on the other. And it is hardly on the whole, a Who's-Who of the ultra-rich.

Particularly convincing on this point was Dr. Frank G. Dickinson, speaking for the American Medical Association. Basing his computations on recent surveys of professional incomes by the United States Department of Commerce, he stated that the monthly cash refund annuity under the plan, starting at age 70, would average: for physician, $208; for lawyers, $146; for dentists, $140. The average amount excludable annually would be $1,290 per physician; $860 per lawyer and $756 per dentist, " . . . *if every* physician, lawyer and dentist (and their wives) were actually willing to set aside 10% of their earned incomes. . . ." Among performers in the television radio and concert fields, it was stated by their representatives more than 50% earn less than $2,000 a year in a single entertainment medium—although total income might be somewhat higher.

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*The insurance groups approved the objectives of the bill but suggested substantial amendments.

Verily, few are the nabobs among the self-employed as compared to the richly rewarded executives of large corporations who are permitted to participate in their corporations' tax-favored plans—and frequently without any ceiling on the benefits payable to them! But the ceiling of $150,000 in tax-favored contributions permitted by the Keogh-Reed bill (assuming uniform payments of $7,500 annually into the fund during the years between age 45 and 65, and an investment income rate of 3½%) would permit purchase, at age 65, of a cash refund annuity, at prevailing rates, of no more than about $950 monthly. This would represent at most only about 15% of the average earnings during those years. Compare that with the approximately 50% of average earnings which the retirement benefit of many up-to-date corporate plans represents. And how many self-employed people, struggling to educate children and pay off mortgages, would be able to save the $150,000 maximum out of earned income, even with the privilege of tax exclusion? Not many.

In various ways, it was pointed out by speakers at the hearing, if any discrimination is involved it presently exists in favor of employees and officers of corporations—and in favor of corporations themselves. For example, said Mr. George Roberts, Chairman of the Special Committee of the American Bar Association on Retirement Benefits:

> . . . It is now practically universal in corporations of any size to have a pension plan which, in most cases, is a non-contributory plan and which gives a substantial amount of security against old age and disability. Scarcely a month goes by but some young lawyer talks to me about the advisability of his abandoning the independent practice of law and joining a corporation, sometimes as a lawyer and sometimes as one of the corporation's executives. The persuasive argument is always the security afforded by the corporation's pension plan. I have no doubt that the same tendency exists in the other professions. . . .
>
> I ask you, gentlemen, to consider this problem, not only from the standpoint of fairness and equity to the individuals involved, but also from a standpoint of public policy. Is it for the best interests of this country that legislation should be so framed that the professions and self-employment are not encouraged, but are discriminated against in favor of employment with corporations—the bigger, the better?

Another kind of discrimination was described by Mr. Leslie M. Rapp, representing the New York State Bar Association and other professional groups, and principal draftsman of the Keogh-Reed bill:

> A doctor may have to spend $40,000 to become a

> doctor, but he cannot even write off the cost of becoming a doctor..
>
> If I go out and buy a peanut-vending machine, and vend peanuts, I can write off the cost of the machine against profits pro rata over the life of the machine, and ultimately get my money back tax-free. But I cannot recover the cost of my education, and I get no deduction on account of the depreciation of my earning power or the depletion of the human body.

Any profession one can think of costs some money for training—if not $40,000; and dancers and professional athletes come quickly to mind as examples of activities wherein physical depletion is not merely important—it is a frightening prospect.

During the hearing on May 13th quite a little was made of the fact that lawyers and some other professional groups had excluded themselves from the benefits of Social Security. As an argument against the Keogh-Reed bill it failed of aim, we feel, as if a man should be condemned for saying, "I don't like persimmons but I like apples." Certainly, no one would deny him his apples.

Representatives of the bar who spoke at the hearing conceded that personally they would like to have the benefits of Social Security but patiently explained that they were not endorsing the Keogh-Reed bill as a substitute for Social Security—indeed it would be a supplement to Social Security for millions of self-employeds, not now excluded from Social Security, who would be entitled as "qualified individuals" to accumulate their own supplementary pension reserves. Proponents of the bill strove to make this fact understood: that the essential purpose of the bill is to bring to the self-employed no greater benefit—if as much—than is available to wage and salary earners under the Revenue Act of 1942 upon which the present structure of corporate pension and profit-sharing plans is founded. Dr. Dickinson put it in the plainest possible words:

> Now the Social Security Act is the first part of the triad in developing the new social theory about pensions; namely, that the government ought to do something to help people provide for their old age.
>
> The second part of that triad is the Revenue Act of 1942, Section 165, that has been referred to so often.
>
> The third part of it is the Keogh-Reed bill. Without the Keogh-Reed bill your triad of new social attitude toward pensions and retirement allowances is just like a tripod supporting a camera with one leg broken.
>
> "The self-employed grow old and suffer the vicissitudes of old age just as much as the people who have been employed [by others] during their working lives. Nature does not permit them to escape just because they are self-employed and excluded under the Act of 1942.

Mr. Rapp prefaced his statement by obeserving that, "Some 17 years ago in this room we saw the birth of the Federal Social Security Act. I would venture the hope that today we might witness at least the labor pains of another act of equal social significance."

The words were well chosen. There is much labor still to be done and great pains laboriously to be taken, if not suffered.

First, a truly vast amount of education must be done on the subject. Consider that but a day was given to the hearing, which involved some other simialr bills; and many of the speakers were hurried along. The public study given was scarcely commensurate with the importance of the subject. Much study in private has been made, notably by the American Medical Association. There should be wide dissemination of the arguments for the measure through newspapers, magazines and other vehicles of information and discussion—as well as of any arguments against the measure or directed toward its improvement.

Second, there is a great deal to be done along legislative lines. Some further refining of the provisions of the Keogh-Reed bill is inevitable and changes in state laws will also be necessary. For example, the provision in the bill limiting a contributor's ability to withdraw his interest in the fund poses problems relating to the rights of creditors. Again, present state laws which grant immunity from statutes against perpetuities and accumulations to pension and profit-sharing trusts apply only to trusts established by *employers,* not by employees. Committees of the American Bar Association and State Bar Associations are ready with the texts of simple revisions which will extend the necessary immunities to plans established under the Keogh-Reed or similar acts.

Third, there is much planning of a practical nature to be done. The Keogh-Reed measure is but the framework of a plan. Trust companies and life insurance companies must formulate plans and policies. In its earlier version, the Keogh-Reed bill required that plans be sponsored by professional or trade associations, farmers' guilds and similar groups, with participation limited in each case to their own membership. While this requirement has been dropped—at the instance of some of the associations themselves, who did not want their disciplinary processes complicated by consideration of loss of pension rights—it is probable that the principal associations will formulate plans tailored to the needs of their members; and, as a matter of organizational pride, membership in the association, guild, council, society or league plan will be sought and encouraged.

It is not too soon for organizations such as these to set up committees, if they have not already done so, for the study and perfection of plans and to make tentative arrangements for their funding, be it with insurance companies or bank trustes. Much valuable time thereby will be gained should action on the bills be favorable in the next session of Congress.

## NOTE

The Keogh-Reed bills were reintroduced on January 3, 1953 under the title of Jenkins-Keogh bills, H.R. 10 and H.R. 11. As a consequence of the election the House of Representatives came under Republican control and Representative Daniel A. Reed, co-sponsor of the bills, became Chairman of the Ways and Means Committee in which tax legislation in the House of Representatives originates. For Procedural reasons Congressman Reed's name is no longer connected with the proposed legislation.

The new members of the House Ways and Means Committee are as follows:

| REPUBLICANS | DEMOCRATS |
|---|---|
| Daniel A. Reed, of New York, Chairman | Jere Cooper, of Tennessee |
| Thomas A. Jenkins, of Ohio | John D. Dingell, of Michigan |
| Richard M. Simpson, of Pennsylvania | Wilbur D. Mills, of Arkansas |
| Robert W. Kean, of New Jersey | Noble J. Gregory, of Kentucky |
| Carl T. Curtis, of Nebraska | A. Sidney Camp, of Georgia |
| Noah M. Mason, of Illinois | Aime J. Forand, of Rhode Island |
| Thomas E. Martin, of Iowa | Herman P. Eberharter, of Pennslvania |
| Hal Holmes, of Washington | Cecil R. King, of California |
| John W. Byrnes, of Wisconsin | Thomas J. O'Brien, of Illinois |
| Angier L. Goodwin, of Massachusetts | Hale Boggs, of Louisiana |
| Antoni N. Sadlak, of Connecticut | |
| Howard H. Baker, of Tennessee | |
| Thomas B. Curtis, of Missouri | |
| Victor A. Knox, of Michigan | |
| James B. Utt, of California | |

The Board of Governors of the Colorado Bar Association unanimously resolved to support this legislation at a meeting held February 9, 1952, and the members of the Denver Bar Association adopted similar resolutions on April 7, 1952.

These bills should have the full and active support of the members of every profession. Each member of the legal profession is urged to write his Congressman and members of the Ways and Means Committee to support this worthwhile legislation.

KENNETH L. SMITH,
*Chairman, Committee on Taxation*
COLORADO BAR ASSOCIATION

## FROM THE LOS ANGELES BAR BULLETIN

The following notice appeared in *Dicta,* publication of the Colorado Bar Association:

COUNTRY LAWYER NEEDED

Paonia and the entire north portion of Delta County is in need of a lawyer to take over an established law office. Anyone interested may contact Clair H. Hadley, Town Clerk of Paonia, Colorado, or phone FRemont 0113 or AComa 3771 in Denver.

B. Nonymous, little known brother of the prolific A. Nonymous, was so touched on reading of Paonia's plight that he dashed off the following touching lines:

*Oh there's panic in Paonia,*
*Not a lawyer can be found*
*Within the village limits*
*Or the county half around.*

*Decedents die intestate*
*Who'd prefer the testate route*
*And claims are lapsing all about*
*That should be brought to suit.*

*The minors go unminded,*
*Endorsers unrecoursed,*
*Encumbrances are unforeclosed*
*And couples undivorced.*

*No smog corrupts Paonia's sky,*
*But o'er her like a pall*
*There broods this melancholy thought:*
*No lawyer—none at all.*

*What that the woods abound with game,*
*The mountain streams with trout—*
*When lawyers scattered on the map*
*They left Paonia out.*

*Attend again Paonia's plea:*
*"Oh Lawyer, Come, We'll love you.*
*Why tarry in the city then*
*Which holds so many of you?"*

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NOTE TO MR. B. NONYMOUS: The editor of *Dicta* is happy to report that the crisis in Paonia is passed and that one full time and one part time lawyer are now serving her needs. Your deep concern for Paonia's plight is appreciated by the Bar of Colorado and the people of Delta County.

# DENVER INSTITUTE IS SCHEDULED

The Junior Bar Sections of the Colorado and Denver Bar Associations and the University of Denver School of Law are the co-sponsors of an institute on "Practical Ethics and Practice" to be held on Tuesday and Thursday afternoons from 4:30 to 6:00 with an optional additional half hour for questions, beginning April 14, 1953, and concluding May 5, 1953.

The sessions will be held in the auditorium of the School of Business Administration located in the Civic Center campus of the University of Denver.

The topics to be covered in the institute include: (1) Professional Conduct and Ethics, (2) Relations with Courts and Other Lawyers, (3) Standardized Pleadings in Colorado Courts, (4) Public Legal Services of the Organized Bar, (5) Relations with Clients, the Public and the Community, (6) Law Office Records, Practices and Determination of Fees, (7) Unauthorized Practice, (8) State Appellate Practice, and (9) Federal Court Practice. It will be noted that these nine topics will be combined into seven sessions.

A fine array of speakers has been obtained, and it is the intention of the committee in charge of the institute to mail a complete program to each member of the Denver Bar Association.

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# LAW DAY SET FOR MAY 2ND

The Boulder County Bar Association and the University of Colorado School of Law announce that Saturday, May 2nd, has been selected for their annual Law Day. The subject chosen for this year's program is "Pitfalls in Probate and Trust Practice".

The morning conference, starting at 9:30 a.m. in the Geology auditorium, will consist of three speeches on the following subdivisions of the topic:

1. "Estate Administration," Judge Howard O. Ashton, County Judge, Boulder County.
2. "Liabilities of Personal Representatives," Edward C. King, Vice Chairman and Director of the Trust Division, American Bar Association.
3. "Fiduciary Investment and Taxation Problems," Richard P. Brown, Vice President, International Trust Company, Denver.

Following the conference there will be a luncheon at Wayne's Cafe for all guests and their wives. Tickets are $2.00 a plate. Harold Reeve, retiring Chairman of the Probate Section, American Bar Association and Vice President of the Chicago Trust Company, will speak. The winners of the Rothgerber Appellate Briefing and Argument Competition will also be presented and the selection for the Order of The Coif will be announced.