Boston College Law Review

Volume 4 | Issue 2 Article 11

1-1-1963

Federal Taxation

Edward F. Barry Jr

Follow this and additional works at: http://lawdigitalcommons.bc.edu/bclr

Part of the Taxation-Federal Commons

Recommended Citation

Edward F. Barry Jr, *Federal Taxation*, 4 B.C.L. Rev. 359 (1963), http://lawdigitalcommons.bc.edu/bclr/vol4/iss2/11

This Current Legislation is brought to you for free and open access by the Law Journals at Digital Commons @ Boston College Law School. It has been accepted for inclusion in Boston College Law Review by an authorized administrator of Digital Commons @ Boston College Law School. For more information, please contact nick.szydlowski@bc.edu.

CURRENT LEGISLATION

FEDERAL TAXATION

The President of the United States signed into law on October 10, 1962 the Self-Employed Individuals Retirement Act of 1962.[1] This article will discuss some of the specific amendments of the Internal Revenue Code of 1954 as affected by this act.

In general, the bill grants a deduction to self-employed persons who contribute to their own pension fund. This deduction is arrived at by permitting such persons to contribute in one year no more than ten per cent of his earned income for the year or $2,500, whichever is the lesser. Half the contribution, or a maximum of $1,250, can be deducted from his taxable income at the time of contribution. This $1,250 will be later treated as taxable income when he is the recipient of the benefits under the pension plan. Since at retirement the taxpayer will probably be in a lower tax bracket than he is at the time of contribution, the $1,250 will be taxed at lower rates.

An excess contribution is an amount greater than the total of permitted deductible and nondeductible contributions. The excess is in no case deductible and such excess contributions must be returned to the employee on whose behalf it was made together with the income earned on the excess contribution. The income so returned will be taxable to the person for whom the contribution was made. If an excess contribution is not repaid within six months after notification has been received that the contribution was excessive, the plan, until the excess is returned, is temporarily disqualified with regard to the person on whose behalf the excess contribution was made, and he is taxed on the annual income earned by the entire fund in the plan which is attributable to his interest. The reason for the limit on contributions and the penalty for extending beyond the limit is because the income from a qualified fund is not taxable until distribution, and, therefore, the government wishes to restrict the amount of income producing capital.

Under present law,[2] a qualified pension plan can cover only those individuals who are employees as defined by common law.[3] After December 31, 1962, the term "employee" will include individuals who have earned income[4]

---

[1] Pub. L. No. 792, 87th Cong., 2d Sess. (October 10, 1962).

[2] Int. Rev. Code of 1954, § 401(a).

[3] Ibid.

[4] The term "earned income" means wages, salaries or professional fees, and all amounts received as compensation for personal services actually rendered, but does not include that part of the compensation derived by the taxpayer for personal services rendered by him to a corporation which represents a distribution of earnings or profits rather than a reasonable allowance as compensation for the personal services actually rendered. In the case of a taxpayer engaged in the trade or business in which both personal services and capital are material income producing factors, under regulations prescribed by the Secretary or his delegate, a reasonable allowance as compensation for the personal services rendered by the taxpayer, not in excess of 30% of his share of the net profits of such trade or business, shall be considered as earned income. The new subsection will be Section 401(c)(2) of the Int. Rev. Code of 1954.

for the taxable year and are presently subject to the self-employment tax. This group of individuals is composed of professionally licensed practioners, owner-employees,[5] and all other employed persons deemed not to be employees under existing law. An owner-employee's pension plan must provide retirement for all employees (except part-time and seasonal employees)[6] who have more than three years' service, whether or not they are salaried employees or wage earners, or that they work in different departments or different trades or businesses under the control of the same owner-employee. This alters the present law which allows retirement plans to exclude employees with less than five years' service.[7] Having established a qualified plan for himself and his employees, an owner-employee under this act is permitted, as was earlier stated, to contribute for himself up to ten per cent of his earned income or $2,500, whichever is the lesser, and deduct a maximum of $1,250 from taxable income, provided that contributions for himself are not discriminatory as compared to contributions for his employees under the plan formula.[8] The $1,250 limitation would apply to any self-employed individual, whether he be an owner-employee with other employees, or be strictly self-employed with no other employees.

Each employee's rights to or derived from the contributions under the plan must be nonforfeitable at the time that such contributions are paid to or under the plan. This requirement is made a condition governing the qualification of a plan covering such owner-employees, and, unless a provision for vesting is included in the terms of the plan, a contribution for an owner-employee would not be allowed, nor would it be deductible; however, employees as defined by existing law[9] would still be allowed to deduct their contributions. Due to the fact that an owner-employee always has a vested right to contributions that he makes to a retirement plan for his own benefit, it is deemed only fair and equitable that he provide similar vested rights for his employees. In the case of a partnership, where no partner owns more than a ten per cent interest, the rules of present law[10] would apply,

---

[5] Owner-employees are defined as those owning the entire interest in an unincorporated trade or business or a partner who owns more than 10% of either the capital interest or the profits interest in an unincorporated trade or business. The new subsection will be section 401(c)(3).

[6] The term "employee" does not include any employee whose customary employment is not for more than twenty hours in any one week, or is not for more than five months in any calendar year. The new subsection will be section 401(d)(3).

[7] Int. Rev. Code of 1954, § 401(a)(3)(A).

[8] For example, a real estate broker with four full time employees has earned income of $30,000 from commission selling. He anticipates that it will continue at or about that level. All employees have more than three years' service. Two of the employees earn $4,000 each, the other two earn $10,000 each. The owner-employee establishes a qualified retirement plan which calls for non-forfeitable contributions for each employee who has more than three years' service of 10% of earned income. Thus, for his employees, he would contribute and deduct $2,800 (10% of $28,000), and for himself he would contribute $2,500 (the lesser of $2,500 or 10% of $30,000) and deduct $1,250 (50% of $2,500). The new subsection will be section 404(a)(10).

[9] Supra note 2. This means that employees who are not owner-employees will be allowed to deduct their contributions even though the provision for vesting is disregarded, because there is no such provision for employees under existing law in relation to retirement plans.

[10] Int. Rev. Code of 1954, § 401(a)(3).

and the plan could provide for complete vesting, partial vesting or no vesting until retirement.[11]

Under a newly created subsection in the Internal Revenue Code of 1954,[12] no distribution may be made to an owner-employee, except in the case of his becoming disabled,[13] prior to his attaining the age of fifty-nine and one-half, but a distribution to an owner-employee must begin no later than age seventy and one-half. A distribution to employees who are not owner-employees would have to begin either at age seventy and one-half or retirement, whichever is later. However, if retirement is later, a distribution could be made starting with the year in which seventy and one-half is attained over the life of the employee or over the lives of the employee and his spouse for a period not exceeding the life expectancy of such employee or the life expectancy of such employee and his spouse.[14]

Similar to a qualified plan under present law,[15] qualified retirement plans covering self-employed individuals or self-employed individuals and their employees may be funded either through contributions to a trust or by purchase of annuity contracts (including variable annuity contracts) directly from an insurance company.[16] Self-employed individuals establishing such plans are permitted to use associations to pool their separate funds for investment purposes. Custodial accounts, in lieu of a trust, are allowed if its investments are made solely in the stock of a regulated investment company which issues only redeemable stock, or solely in life, endowment or annuity contracts issued by an insurance company.[17] Although a custodial account may be utilized by a retirement plan whether or not it includes an owner-employee, it will be particularly beneficial to small owner-employees because of its lower cost. Such lower costs result from the fact that the

[11] The new subsection will be section 401(a)(7).

[12] The new subsection will be section 72(m)(5).

[13] For definition see Int. Rev. Code of 1954, § 213(g)(3).

[14] The new subsection will be section 401(a)(9). A distribution to employees who are not owner-employees cannot begin before retirement or age seventy and one-half because the funds so accumulated are to be used strictly for retirement purposes, and it was not contemplated that such funds should be diverted to other private purposes prior to the prescribed time of distribution. If the employee is to retire at age sixty-five, benefits are not payable to him until he reaches age seventy and one-half, but if the employee is to retire at age seventy-five, benefits may be payable to him at age seventy and one-half based on his life expectancy. Assume that his life expectancy is eighty, then benefits will be paid according to this ten year base, and this schedule of payments will continue beyond the year that retirement (75) is reached, if he elects this method of payment. The same is true for an employee and his spouse when they are both beneficiaries.

[15] Int. Rev. Code of 1954, § 401.

[16] The new subsection will be section 401(d)(1).

[17] Some 7 million self-employed persons are expected to be affected by the new law. By contrast, about 26 million Americans are already covered by company pension and profit sharing plans. The New England Life Insurance Company of Boston, Massachusetts expects a 50% pickup in its pension business in five years. The company presently has 7 billion dollars of assets, of which 1 billion represents pension plan investments. The company developed new policies for the self-employed during the years the tax measure was in Congress and is prepared to sell these policies when the treasury issues regulations implementing the new law.

bank[18] would not be required to assume the duties and responsibilities of a trustee, but would serve as a mere custodian of amounts contributed under retirement plans or of the policies deposited with it.[19]

An alternative to the use of conventional employee trusts and annuity plans permits an employer to establish a plan which meets the exemption requirement for employee trusts under which he could purchase for himself and his employees a new type of government bond.[20] Although the plan could be established with or without the use of a trust, the contributions would have to be used solely for the purchase of this new type of bond for employees and their beneficiaries. The bond provides for payment of interest or investment yield only upon redemption, and it may be redeemed before the death of the individual in whose name it is purchased only if such individual has attained the age of fifty-nine and one-half or has become disabled.[21] The distributee of the bond would not have to include any amount in gross income when he receives the bond, but upon redemption the proceeds would be subject to tax. The annuity rules of Section 72 of the Internal Revenue Code[22] would not apply to these proceeds nor would the exemption be treated as a sale or exchange. An individual who was a regular employee at the time the bond was purchased would have a basis equal to the amount of his contributions.[23] If he was a self-employed individual at the time the bond was purchased, his basis would be equal to the

[18] Int. Rev. Code of 1954, § 581:

> . . . the term 'bank' means a bank or trust company incorporated and doing business under the laws of the United States (including laws relating to the District of Columbia), of any State, or of any Territory, a substantial part of the business of which consists of receiving deposits and making loans and discounts, or of exercising fiduciary powers similar to those permitted to national banks under section 11(k) of the Federal Reserve Act (38 Stat. 262, 12 U.S.C. 248(k)), and which is subject by law to supervision and examination by State, Territorial, or Federal authority having supervision over banking institutions. Such term also means a domestic building and loan association.

[19] The bank will still remain in the capacity of a fiduciary, but the duties of a trustee regarding responsible investments will not be exercised because, if a custodial account is preferred, the investments are required to be solely in stock of a regulated investment company which issues only redeemable stock. Custodial accounts may also purchase life insurance, endowment or annuity contracts issued by an insurance company. A custodial account may be used by a plan even though it does not include the owner-employee. The new subsection will be section 401(f).

[20] The new subsection will be section 405(a). The new United States bonds will be issued in the name of the employee (including owner-employees) and thus will be nonforfeitable. They will be nontransferable and may not be cashed by the employee until age fifty-nine and one-half or until disabled or deceased. Interest on the bonds will stop within five years after the death of the bond owner, this provision being intended to deter the use of the bonds for purposes other than retirement. An employee will realize no income upon the distribution of the bonds. The bonds plus the accrued income are subject to taxation at the time of redemption. The costs of such bonds will be deductible for federal income tax purposes only if they are purchased under a qualified purchase plan pursuant to a qualified retirement plan.

[21] Supra note 13.

[22] "General Rule for Annuities: . . . gross income includes any amount received as an annuity (whether for a period certain or during one or more lives) under an annuity, endowment or life insurance contract." Int. Rev. Code of 1954, § 72(a).

[23] The new subsection will be section 405(d)(2).

amount of contributions made in his behalf which were used to buy the bond, provided the contributions were not allowed as a deduction for contributions to a bond purchase plan.

In order to determine the significance of the benefits granted by enactment of the statute under consideration, it would be best to examine certain state laws and their effects. Twenty states[24] have enacted laws permitting professional people to incorporate or to combine in associations to be taxed as corporations and as corporate employees. These self-employed individuals are eligible for treasury approved retirement plans under which taxes on an individual's income contributed to the plan are postponed until the benefits are paid out. The twenty states are broadly split into three groups. One group[25] adopted liberal professional corporation acts permitting the incorporation of individuals, distinct from associations of individuals, and allowing those professionally licensed individuals (physicians, attorneys, accountants, architects, veterinarians, life insurance agents, etc.) to be treated as corporations for tax purposes.[26] Another group of states[27] has similar legislation but limits the eligible participants to physicians and dentists.

The last and probably most acceptable to the treasury is that group of states[28] which passed laws permitting the incorporation of professional associations for tax purposes.[29] These states follow the ruling of *United States v. Kintner*[30] which allowed professionally licensed individuals to join

---

[24] Alabama, Arizona, Arkansas, Colorado, Connecticut, Florida, Georgia, Illinois, Kentucky, Michigan, Minnesota, Ohio, Oklahoma, Pennsylvania, South Carolina, South Dakota, Tennessee, Texas, Virginia, and Wisconsin.

[25] Arizona, Florida, Kentucky, Michigan, Ohio, Oklahoma, and Wisconsin.

[26] See, e.g., Ohio Rev. Code Ann. § 1785 (Baldwin 1962). An individual or group of individuals, each licensed to render some kind of professional service within Ohio, may organize and become a shareholder or shareholders of a professional association. Any such individual or group of individuals may incorporate and the agreement shall constitute articles of incorporation. Professional service means any type of professional service which may be performed only pursuant to a license, certificate or other legal authorization.

[27] Arkansas, Minnesota and South Dakota.

[28] Alabama, Connecticut, Georgia, Illinois, Pennsylvania, South Carolina, Tennessee, Texas, and Virginia.

[29] See, e.g., Ill. Ann. Stat. ch. 106½, § 101-109 (Smith-Hurd Supp. 1961). Any two or more persons duly licensed to practice a profession under the laws of Illinois may form a professional association in order to render professional service and divide the gain as stated in the articles of association. Only one type of professional service will be permitted by any one professional association. It is a professional service to the public with a condition precedent of a license to the rendering of such service. The association in its own name may invest its funds in any type of investment, and may own real estate or personal property necessary or appropriate for rendering its professional services. Each member of the association is personally liable for services rendered. There must be provisions for continuity of life within the articles of association as well as centralization of management. The association must provide for free transferability of shares to persons similarly licensed to perform that professional service which is peculiar to the association. If the association meets these requirements, it may be treated as a corporation for tax purposes.

[30] 216 F.2d 418 (9th Cir. 1954). Doctor Kintner, a physician, was a member of an association of physicians and contributed $976.14 to a pension plan under the control of the association. The association was endowed with the attributes of a corporation and

in an association, which association was treated as a corporation for tax purposes as long as the association generally had the characteristics of a corporation. Internal Revenue Regulations[31] promulgated after the *Kintner* case provide:

> Although it is the Internal Revenue Code rather than local law which establishes the tests or standards which will be applied in determining the classification in which an organization belongs, local law governs in determining whether the legal relationships which have been established in the formation of an organization are such that the standards are met. Thus, it is local law which must be applied in determining such matters as the legal relationships of the members of the organization among themselves and with the public at large, and the interests of the members of the organization in its assets.[32]

An association will be a corporation for tax purposes, as the regulations state, if it more nearly resembles the characteristics of a corporation than a partnership or trust. Once a group of professionals has met the qualifications of the Kintner regulations, the members of the organization as employees are entitled to the same benefits as any other corporate employees. Members may obtain social security benefits, participate in tax deferred retirement, profit sharing or pension plans, etc. Premiums on group life insurance and group medical policies may be deducted by the organization and are not taxable to the employees. The members can receive up to $100 per week tax free during a period of injury or illness under a corporate-financed plan.[33]

Therefore, the benefit of the Self-Employed Individuals Retirement Act of 1962 is to allow professional individuals to defer the federal tax on contributions to pension plans, but on a more restrictive basis than the state laws permitting self-employed professional people to incorporate. The self-employed under the state laws are eligible for other tax fringe benefits

---

the court treated it as a corporation for federal tax purposes. The business of the corporation was managed by an executive committee, all members received salaries, the association collected accounts receivable and paid expenses required for the professional work of the members and the association couldn't be dissolved by the death or retirement of a member. The pension committee of this association was given power to control the investment of funds, such investments being limited to insurance and retirement annuity contracts or as otherwise provided in the trust. The committee was held responsible for willful misconduct. Title was vested in the trustee subject to the rights of the participating employees which were not transferable and/or assignable, thus eliminating any power on the part of the association to deprive a participant of his right to receive the benefits of the plan.

[31] Treas. Reg. §§ 301.7701-1 to -4 (1960).

[32] Treas. Reg. § 301.7701-1(c) (1960).

The tests or standards: Associates, an objective to carry on a business and divide the gains, continuity of life, centralization of management and free transferability of shares.

An example of the effect of local law: An agreement by which an organization is established provides for continuity through its remaining members. It will lack continuity of life, however, if under local law the withdrawal of a member causes a dissolution of the organization.

[33] 6 CCH 1962 Stand. Fed. Tax Rep. ¶ 5943.02.

such as group life and hospitalization insurance and "sick pay" exclusions. A reason why many people living in some of the twenty states[34] in which the corporation law has been passed may not take advantage of it, but rather will choose the federal approach, is because the treasury still hasn't ruled whether the corporate type organizations formed under the state laws qualify for corporate tax treatment. However, those states following the Kintner regulations[35] will be permitted to rule that associations formed for professional services may permit their members to be taxed as corporate employees, but there are no federal regulations allowing professional individuals as individuals to incorporate for tax purposes. This is solely a matter of state law,[36] and the people in those states[37] acting under such laws are doing so without a treasury ruling. "The execution of the power to tax income is not subject to state control. It is the will of Congress which controls, and the expression of its will in legislation, in the absence of language evidencing a different purpose, is to be interpreted so as to give a uniform application to a nation wide scheme of taxation. State law may control only when the federal taxing act, by express language or necessary implication, makes its own operation depend on state law."[38]

The proponents of the act applaud it for reasons of fairness and uniformity among the working public. They say that the bill is designed to encourage the establishment of voluntary retirement plans by self-employed persons by extending to these people some of the favorable tax benefits that present law now provides in the case of qualified retirement plans established by employers for their employees.[39] Some of the objections to the act are that it singles out for assistance a class of people, the self-employed, who as a group are, generally speaking, least in need or deserving of assistance, and that the act badly erodes the tax base at the time when the crying need is for tax reform through broadening that base.[40]

EDWARD F. BARRY, JR.

LABOR LEGISLATION

THE RETRAINING ACT

During the second session of the 87th Congress, the Manpower Development and Training Act of 1962[1] was passed. Enactment of this major piece of labor legislation manifests congressional cognizance of the problem of unemployment caused by automation.[2] The legislation recognizes the

[34] Supra note 24.
[35] Supra note 28.
[36] Supra note 26.
[37] Supra note 25.
[38] Burnett v. Harmel, 287 U.S. 110 (1932).
[39] S. Rep. No. 992, 87th Cong., 1st Sess. 1 (1961).
[40] Id. at 56.

[1] Pub. L. No. 87-415, 76 Stat. 23 (1962) (hereinafter referred to by section).
[2] Section 101 states that "Government leadership is necessary to insure that the benefits of automation do not become burdens of widespread unemployment . . . ."