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SELF-EMPLOYED INDIVIDUALS TAX RETIREMENT ACT OF 1960

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Mr. SMATHERS, from the Committee on Finance, submitted the following

REPORT

[To accompany H.R. 10]

The Committee on Finance, to whom was referred the bill (H.R. 10) to amend the Internal Revenue Code of 1954 so as to encourage self-employed individuals to establish voluntary pension plans, having considered the same, report favorably thereon with an amendment, and recommend that the bill as amended do pass.

I. GENERAL STATEMENT

Your committee's bill is an amendment in the nature of a substitute for H.R. 10 as passed by the House. It allows self-employed persons to participate in qualified retirement plans as though they were employees, and to take limited income tax deductions for contributions they make to these plans to finance their own and their employees' retirement benefits. Generally, the contributions, plus the accumulated earnings thereon, will be taxed when drawn as retirement benefits. Such benefits for the self-employed may not begin before age 59½ years, except in case of earlier disability or death, nor later than age 70½ years.

The bill also imposes new restrictions on retirement plans covering corporate employees who own more than 10 percent of the stock of the employer corporation. These restrictions are imposed in order to make the availability of retirement plans substantially similar to both unincorporated and incorporated businesses. The new restrictions on these corporate plans are explained later in this report.

Generally, a self-employed person is allowed under this bill to contribute to a retirement plan for himself, and to deduct from his gross income not more than 10 percent of his earned income or $2,500, whichever is smaller, each year. To obtain this deduction for him-

self he must also contribute to a fund for retirement benefits for his employees, if any, who are covered under the plan, on a nondiscriminatory basis. Part-time, seasonal, and temporary workers may be excluded from pension coverage as may those who have not been employees for more than 3 years. In limited circumstances, a self-employed person may contribute and deduct more than $2,500 a year for himself if he makes substantial contributions which are vested in his employees.

The retirement funds which this bill allows self-employed persons to establish must be lodged with a bank as trustee, invested in annuities with an insurance company, or placed in a new series of U.S. Government bonds described in the bill. These bonds will be nontransferable, nonredeemable before retirement, and issued only in the names of individuals. They are intended to provide a convenient and simple form of investment for retirement funds.

Your committee's bill amends the Internal Revenue Code of 1954 in a number of places, but chiefly in the area of part I of subchapter D of chapter 1 (dealing with qualified pension and profit-sharing plans). In addition to the requirements of existing law concerning qualified retirement plans, some new requirements contained in this bill must be met by plans that include owner-employees. An owner-employee is one who owns (directly or through stock in a corporation) more than 10 percent of the business and who also performs personal services for which he receives earned income.

A. Present Law

Present law accords favorable tax treatment to pension and profit-sharing plans established for the exclusive benefit of employees or their beneficiaries. Employees covered under qualified plans are not taxed currently on contributions made on their behalf to these plans by their employers nor on the income from amounts so contributed. Instead, the employees generally include the benefits from such plans in taxable income only in the year they are received or made available.

The deferment of tax on retirement benefits until ultimate distribution applies whether or not the employee has vested (nonforfeitable) rights in the contributions made on his behalf. Typically, under corporate plans the employee does not have immediate vested rights to all such contributions, although plans vary considerably; they range from immediate vesting to vesting after reaching a certain number of years of service or attaining a specified age, or upon actual retirement.

The income of trusts established to administer qualified pension plans is exempt from income tax. Similarly, the Life Insurance Company Income Tax Act of 1959 granted exemption, fully effective in 1961, to income earned on insurance reserves established in connection with qualified pension plans. In addition, under present law, employers are permitted to take tax deductions (within specified limits) for their contributions to qualified plans. The law grants this favored tax treatment only to retirement plans which do not discriminate as to coverage, contributions, or benefits in favor of employees who are stockholders, officers, or supervisors, or employees who are highly compensated.

A qualified retirement plan cannot provide a higher rate of contribution or benefit for higher paid employees than for lower paid employees, or for shareholder-employees than for those who are not shareholders.

However, the dollar amount of benefits or contributions for the higher paid employees may be larger than for the lower paid employees, provided that such amounts constitute a uniform percentage of the compensation of participants.

Under appropriate circumstances, the private plan may be integrated with the social security system; if thus integrated, the proportion of social security benefits not attributable to the employee's own contributions is taken into consideration in determining whether the benefits paid by the private plan meet the nondiscrimination test. Under the law and administrative rules the benefits of the higher paid employees, after being combined with a designated portion of social security benefits, must not be larger in relation to salary than the similarly combined benefits of lower paid employees.

Under existing law more than 50,000 corporate pension plans have been established. These plans cover nearly 20 million employees and have, at the present time, somewhat more than $40 billion in assets. Corporations contribute more than $4 billion per year to qualified retirement plans.

More than 7 million self-employed persons who pay income taxes can establish retirement plans under this bill. Because self-employed persons generally have only a limited number of employees, their retirement plans will ordinarily be much smaller than most of the corporate plans already in existence. These new small retirement plans would, if present law rules were not supplemented, also offer somewhat greater opportunities for abuse than do large corporate plans. For this reason, tighter rules for these retirement plans are believed to be necessary.

B. H.R. 10 and Your Committee's Substitute

H.R. 10 as it passed the House would have allowed self-employed persons to set aside funds before tax for their own retirement without making any provision for their employees. Your committee held public hearings on this bill in June, July, and August 1959. In this hearing the Treasury Department opposed the House bill, not only because of the revenue loss involved, but also because the bill did not provide uniform tax treatment as between corporate retirement plans and those retirement plans which H.R. 10 would have allowed the self-employed to establish. The Treasury also wished to tighten somewhat the rules applicable to certain corporate retirement plans, in order to deal with some abuses that are possible under existing law.

In a letter dated April 1, 1960, from the Under Secretary of the Treasury to the chairman of the Committee on Finance, the Treasury again outlined its objections to the original version of H.R. 10 and indicated the type of retirement program for the self-employed it felt could be regarded as sounder and more equitable. Additional public hearings on those features of the Treasury alternative approach that would restrict the pension plans of corporations covering owner-employees were held in May 1960. At the direction of the Finance Committee, a substitute for H.R. 10 as passed by the House was prepared, incorporating most of the Treasury's suggestions. This substitute, modified by your committee as a result of new information developed at this hearing, is the bill now being reported.

Generally, your committee's bill does not impose additional restrictions on retirement plans already established by corporations

where the plans, in reality, are for the general benefit of employees as contrasted to the owners of the business. Most new provisions in the present bill apply to existing corporate retirement plans only if they cover employees who are more than 10 percent owners and then, in general, not until 1964. New corporate plans, covering owner-employees, that are established after 1960 will, however, be subject to most of the new rules immediately.

C. Revenue Effects

It has been estimated by the Treasury Department that the revenue cost of extending retirement plan coverage to the self-employed will range between $150 million and $250 million annually. These estimates do not take into account the offsetting increase in revenues resulting from the changes in the corporate area. It is difficult to obtain a precise estimate of revenue loss because of uncertainty as to the number of self-employed individuals who will establish voluntary retirement programs under this bill. H.R. 10 as passed by the House was estimated to cost $365 million of revenue in a full year of operation.

The lower cost of your committee's bill is due for the most part to the facts (*a*) that additional deductions in excess of the basic annual limitations—10 percent of earned income or $2,500—will not be allowed for individuals who are age 50 or more, as under the House bill, and (*b*) that pension contributions under this bill must be based on self-employment income only to the extent it constitutes earned income, whereas under the House version of H.R. 10 they would have been based on self-employment income without any reduction. Generally speaking, earned income will be below self-employment income in trades or businesses where capital is a material income producing factor. Finally, because self-employed persons must cover their employees as well as themselves, they will probably be more reluctant to establish retirement plans than they would have been under the House bill. On the other hand, tax deductions may be larger if employees are covered than they would have been if the self-employed person could cover only himself.

This full-year revenue loss may increase somewhat in subsequent years as additional retirement plans covering self-employed individuals are established.

II. REASONS FOR THE BILL

The primary reason for the bill is to give self-employed persons access to retirement plans on a reasonably similar basis to that accorded corporate stockholder employees. It thus corrects a discrimination in present law under which self-employed individuals and partners are prevented from participating in retirement plans established for the benefit of their employees although owner-employees of corporations may do so. Another reason for the bill is to place some additional restrictions on pension plans of owner-managed corporations, to keep these plans from being used to obtain unwarranted tax advantages for a few individuals.

The bill seeks to encourage self-employed persons to establish voluntary plans in order to make some provision for their retirement, provided they also cover in these retirement plans on a nondiscriminatory basis any employees they may have or may later acquire.

The bill allows contributions to retirement plans to be a deduction for income-tax purposes at the time these contributions are made, but requires that retirement benefits when received be subject to taxation. The bill thus allows deferment of tax on certain forms of savings set aside for retirement, but limits the amount of these retirement savings which are made tax deductible.

Your committee is of the opinion that extending the coverage of individuals under voluntary retirement plans is in the public interest; and that self-employed persons should have the opportunity to obtain retirement benefits on substantially the same basis as do corporate owner-employees. The bill will make self-employment somewhat more attractive than at present compared to employment with a corporation, and will thus help to keep small business strong and independent professional practice thriving.

Your committee is also of the opinion that retirement plans covering those who own a business should be subject to the same general restrictions regardless of whether they are established by an individual proprietorship, a partnership, or a corporation. For these reasons the new limitations on qualified retirement plans contained in the bill are applicable (immediately or after 3 years) to all plans covering owner-employees, whether in an unincorporated or incorporated business. For pension-plan purposes an owner-employee is the owner of a greater than 10 percent interest in the business who also renders personal services in the business from which he derives earned income. Partners who perform no personal services and corporate stockholders who are not employees of the corporation will not be entitled to coverage under the bill.

Your committee's bill tightens somewhat the rules now applicable to corporate pension plans covering more than 10 percent owner-employees. The application of these new rules to existing retirement plans of corporations is deferred for 3 years, or until 1964. To have applied these new rules to existing retirement plans immediately would have produced some hardships. Moreover, corporations with owner-employees would have restrictions on their pension plans that are not applicable to corporations in which no one shareholder owns more than 10 percent of the stock. The 3-year period allowed before the application of the new, more restrictive rules to existing retirement plans will allow time for additional study to be made of the tax provisions applicable to all pension and profit-sharing plans and will allow Congress to determine whether further change in these provisions is needed.

Under the bill there will be some differences between the rules covering retirement plans established by self-employed individuals and corporations with owner-employees and those rules in present law covering corporations without owner-employees. Generally, the special rules for retirement plans covering owner-employees require that employees be given greater vested rights than they might obtain under the pension plan of a widely held corporation.

H.R. 10 as it passed the House would have allowed individuals to take tax deductions for savings earmarked for their own retirement; this would have created a precedent of allowing tax deductions for other forms of savings. Your committee has concluded that, in lieu of the approach of the House bill, it would be more appropriate to allow self-employed persons to participate in qualified pension plans established for the benefit of employees.

III. SUMMARY OF BILL

A. Self-Employed Retirement Plans

Subject to limitations, your committee's bill would allow self-employed individuals (including partners) to be covered in qualified retirement plans. This would permit self-employed individuals to secure the benefits of current tax deductions, plus a tax-free buildup of pension-fund investments, by establishing a plan which meets the requirements of the Internal Revenue Code as to nondiscrimination of benefits and coverage. In other words, a self-employed person would have to give his employees, if any, access to retirement benefits on a comparable basis in order to obtain these benefits himself. His plan, however, would not necessarily have to cover all employees, but could exclude seasonal and part-time workers, as well as full-time employees with not more than 3 years of service. Under present law, retirement plans can exclude employees with up to 5 years of service. Your committee's bill reduces this period to 3 years in the case of retirement plans which cover self-employed individuals or owner-employees, including owner-employees of corporations. Existing corporate plans which cover an owner-employee will not be affected by this new 3-year rule until 1964. While an owner without employees could establish a qualified retirement plan for himself, the terms of the plan would have to provide for granting comparable benefits to any future employees he might have.

B. Profit-Sharing and Stock Bonus Plans

Your committee's bill does not limit owner-employee participation to fixed contribution pension plans. Rather, it also permits them to participate in profit-sharing or stock bonus plans paying retirement benefits under which contributions may be made in profitable years but there will be no obligation to make contributions in years of little or no profit. However, in order for an owner-employee to participate in such a plan, it must provide a definite formula for determining the amount of contributions to be made on behalf of other employees and it must provide that contributions or benefits for employees must be nonforfeitable at the time the contributions are made. The definite formula rule will apply to new plans immediately and to existing corporate plans after 1963. The vesting requirements, on the other hand, will not apply to any profit-sharing or stock bonus plan established by a corporation (other than a new plan established by a subchapter 5, corporation or a professional association taxable as a corporation) until after 1963. To avoid the abuse of making larger or smaller contributions in years when surtax rates are lower or higher, a definite formula appears to be necessary. Furthermore, since under present law these plans, unlike true pension plans, offer greater opportunity for abuse through the possibility of an owner-employee obtaining greater benefits for himself through forfeitures by employees, your committee believes vested rights for the employees is appropriate in profit-sharing and stock bonus plans.

C. Methods of Funding

As under present law, qualified retirement plans covering self-employed individuals and their employees could be funded either through contributions to a trust or by purchase of annuity contracts directly from an insurance company. Self-employed individuals establishing such plans for themselves and their employees could, if they chose to do so, use associations to pool their separate funds for investment purposes.

D. Bond Purchase Plans

As an alternative form of investment which will be of particular interest to new pension plans established by small business, direct investment in U.S. Government securities of a new series is authorized. These new bonds, which must be issued in the names of the individual employees on whose behalf they are purchased (and thus will be nonforfeitable), will be nontransferable and may not be cashed until the individual in whose name the bonds are issued has attained insurance age 60 (59½) or has become disabled or deceased. In order to prevent these bonds from being used for purposes other than retirement, the bill provides that interest on them must stop no later than 5 years after the death of the bond owner. This period corresponds generally to other provisions of the bill requiring distribution of a deceased owner-employee's interest in a retirement plan within a specified period after his death. The purpose of direct bond purchases under a qualified retirement plan is to avoid the expense of establishing a trust to administer the retirement fund assets. The new series of Government securities may also be purchased by the trustee of an existing pension plan if it is desired to make that form of investment. Where a pension plan has invested in these retirement bonds, the bill provides that no income will be realized by the employee at the time the bonds are distributed to him; rather the principal and interest on the bonds will be included in the employee's income at the time they are redeemed. Although these new bonds may be purchased by anyone, their cost will be deductible for income tax purposes only if they are purchased under a qualified bond purchase plan or by a qualified retirement plan. By making the earliest redemption date for these bonds age 59½, except in the case of death or disability, these bonds would generally be unattractive to ordinary investors because they may hesitate to freeze their capital for long periods of time.

E. Earned Income

Under your committee's bill, a proprietor or partner may be covered under a qualified retirement plan only if he performs personal services. Since the objective of such plans is to provide retirement benefits based on personal services, inactive owners who derive their income entirely from investments would not be allowed to participate. This limitation places proprietors and partners on the same basis as corporate shareholders, who can participate in a qualified pension plan under present law only if they are employees of the corporation. Moreover, benefits and contributions for covered self-employed individuals engaged in activities involving significant capital investment are based on that part of the business income which is attributable to

personal services. This is done by making earned income the measuring rod for benefits and contributions for self-employed persons. Under the bill, earned income is defined generally as income from self-employment, but, where such income is derived from a trade or business in which capital is a material income producing factor, the proportion of income which is deemed to be earned is limited to 30 percent of the net profits from the trade or business, or $2,500, whichever is greater. The entire amount received as professional fees will be treated as earned income if the taxpayer is engaged in the practice of a profession such as medicine or the law even though he employs assistants to perform part or all of the services, provided the patients or clients are those of the taxpayer and look to the taxpayer as the person responsible for the services performed. The bill permits doctors and ministers, as well as certain people who work in their own homes and commission salesmen (other than full-time life insurance salesmen, who are treated, under present law, as employees for pension purposes) to participate even though they do not have self-employment income within the meaning of the Internal Revenue Code.

F. Owner-Employees

The bill provides new requirements for qualification of retirement plans which cover owner-employees. Owner-employees are proprietors, partners with more than a 10-percent interest in the capital or profits of the partnership, and corporate employees who own more than 10 percent of the stock or voting power of a corporation. Partners and corporate stockholder employees who own not more than 10 percent of the business are also permitted to participate in pension plans; but they are not bound by the special limitations on deductible contributions the bill applies to owner-employees. Generally, the special requirements for qualification will be applicable to new plans covering owner-employees established after 1960. As to existing retirement plans covering corporate owner-employees, the new limitations would not be effective for 3 years, or until 1964.

G. Limitations on Contributions for Self-Employed

A self-employed person without employees would be allowed under the bill to make annual deductible contributions, pursuant to a qualified plan, equal to 10 percent of his earned income, or $2,500, whichever is smaller. If he has employees, to make such deductible contributions for himself he must make contributions on a nondiscriminatory basis for his covered employees as well as for himself, and if he controls the business through a more than 50 percent ownership interest he must give all these covered employees immediate vested (nonforfeitable) rights in any contributions made on their behalf. (This is because generally the owner of the business will have a vested right to any contributions he makes on his own behalf.) Otherwise, his deductible contributions will be limited to one-half the aggregate of such deductible contributions for other employees as are vested.

Under certain circumstances a self-employed person may be allowed to exceed the 10 percent of earned income or $2,500 annual limitation on deductible contributions for himself. The bill allows the self-employed person to deduct for himself one-half of the amount con-

tributed and deducted on behalf of all covered employees (other than owner-employees) who have immediate vested rights to those contributions. Therefore, if a self-employed individual contributes substantial vested amounts for his employees, his deductible contributions for himself can exceed the 10 percent–$2,500 limit.

The following examples illustrate the application of the limitations on deductible contributions which may be made by self-employed individuals.

Example 1.—A real estate broker without employees earns $10,000 in a certain year from commission selling. He may deduct up to $1,000 contributed in that year to a qualified retirement plan—either an insured or trusteed program.

Example 2.—A physician earns $25,000 and has two employees each earning $5,000. He establishes a qualified plan and contributes 10 percent of salary—$2,500 for himself and $500 for each employee. A total of $3,500 is deductible. In this case the employees would have to be given immediate vested rights.

Example 3 (a nonintegrated plan).—A merchant has an earned income of $50,000 and a payroll of $110,000 spread among 20 unrelated employees. He establishes a plan calling for contributions equal to 10 percent of salary. The plan grants covered employees vested rights after 3 years of service. He puts in $11,000 (10 percent of $110,000) for his employees, all of whom have vested rights at the time, and is allowed $5,000 for himself (10 percent of $50,000). His total tax deduction is $16,000.

Example 4 (an integrated plan).—A contractor has an earned income of $35,000 a year. He has 18 employees with salaries ranging from $4,000 to $15,000 who are not his relatives and have no proprietary interest in the business. He establishes a pension plan covering himself and all his employees. The plan provides for an annual contribution for each covered individual amounting to 9⅜ percent of that part of earned income in excess of $4,800 a year. Such contributions are vested in all covered employees.

Based on these assumptions, the deductible contributions made on behalf of the self-employed individual amount to $2,831 (9⅜ percent of $30,200 [$35,000 minus $4,800]). Contributions vested in all other employees are found to amount to $5,730 or more than twice the total contribution made for the self-employed individual. Accordingly, the contribution of $2,831 for the self-employed individual is permissible even though it exceeds $2,500. For the same reason the plan can take credit for social security benefits under the integration rules by providing no contributions with respect to earnings up to $4,800 and a 9⅜-percent contribution for that part of earnings over $4,800.

H. Limitations on Contributions for Owner-Employees of Corporations

The same basic limitation—10 percent of earned income of $2,500 on deductible contributions will also apply to corporate retirement plans covering owner-employees which are established in or after 1960, and will apply to all such plans after 1963. As in the case of self-employed persons, this basic limitation on deductible contributions may be exceeded in certain situations. First, a corporation

may contribute for its owner-employees as much as it contributes for other employees (if benefits are not integrated with social security benefits), except that, after 1963, this limitation will be based on contributions for other employees only to the extent that these employees have nonforfeitable rights to them. Second, a corporation may contribute and deduct for an owner-employee whatever amount is necessary to fund a life annuity amounting to no more than 20 percent of the owner-employee's average annual salary for the 10 years preceding retirement of age 64½, whichever is earlier. After 1963, this option will apply in the case of an owner-employee who controls the corporation by means of more than a 50-percent ownership interest only if all the other employees are given immediate and complete vested rights to contributions made on their behalf. This is because generally the owner of the business will have vested (nonforfeitable) right to any contributions he makes on his own behalf. Existing corporate plans covering owner-employees would not be subject to these limitations until 1964. Owner-employees of subchapter S corporations (small corporations which may elect to be treated as partnerships for Federal income-tax purposes) and certain professional service associations which are taxable as corporations would have the same limitations as apply to self-employed persons. However, plans established by these organizations before 1961 would not be subject to the new limitations until 1964.

The following examples illustrate the application of the limitations on deductible contributions relating to corporate retirement plans covering an owner-employee:

Example 1.—John Smith owns all the stock of corporation X and is its only employee. His earned income is $24,000 a year. Corporation X establishes a retirement plan in 1962. Under the bill the corporation may contribute and deduct not more than $2,400 (10 percent of $24,000).

Example 2.—William Brown owns all of the stock of corporation Y which has three other employees. Brown's salary is $20,000 a year and the salaries of the other employees total $25,000. The corporation establishes a retirement plan in 1964 under which all of the employees are given immediate vested rights to contributions made for them. The plan calls for contributions to be made at a rate of 15 percent of salary. Under the bill the corporation would be permitted to contribute and deduct $3,750 for the employees and $3,000 for the owner-employee, or a total deduction of $6,750. This is so because the bill allows a contribution to be made for an owner-employee of a corporation of as much as it contributes for other employees, provided that other employees have immediate vested rights and the benefit for the owner is not discriminatory.

Example 3.—Robert Jones is an employee of corporation Z in which he owns 40 percent of the stock and which has two other employees who have had over 3 years of service. Jones' salary has averaged $20,000 a year for the past 5 years. The corporation establishes a retirement plan in 1961 (with the taxable year beginning after December 31, 1960) which provides all employees with pensions payable for life and commencing at age 65 equal to 20 percent of average salary in the 10 years before retirement. The corporation has no other plan. Assuming that Jones is age 55 when the plan is adopted, the corporation will be allowed to deduct a contribution for him in the taxable year starting in 1961 amounting to $3,450, assuming that

amount to be (on the basis of acceptable assumptions as to mortality and interest) the annual payment required, over the 10-year period ending with the taxable year in which he attains the age of 64½ years, to fund a pension benefit of $4,000, that is, 20 percent of $20,000.

I. Contributory Plans

Under the bill contributory retirement plans, as well as those to which the employer alone makes contributions, may be established. If the employees who are not owner-employees are permitted to make nondeductible contributions to the plan, the owner-employee may make corresponding contributions on his own behalf up to $2,500 or 10 percent of his earned income or $2,500. Such contributions will not be deductible either by the employee or the owner-employee, but must be made out of income that has already been taxed. An owner-employee with no true employees would not be permitted to make nondeductible contributions.

J. Integration with Social Security

Although your committee has provided different limitations on deductible contributions in the case of self-employed individuals and owner-employees of corporations, it has provided a single uniform rule under which retirement plans may be integrated with social security. The bill does not permit retirement plans which cover owner-employees to be integrated with the social security program except where deductible contributions for true employees, with respect to which the employees have nonforfeitable rights, exceed twice the deductible contribution for owner-employees. Thus, your committee's bill prevents abuse which may arise where all or most of the true employees of the business earn salaries of less than $4,800. If integration with the social security program were permitted in such cases, the private plan ostensibly might cover all employees, but as a practical matter little or no contributions would be made for them because their benefits under the integrated plan would be provided by social security.

K. Vested Benefits for Certain Corporate Employees

Although the limitations on contributions described above apply to owner-employees covered by new corporate retirement plans, established after 1960, the requirements that there be vested benefits for the employees of such corporations will not apply until 1964. This is true even of new corporate pension plans established after the effective date.

L. Excess Contributions

The bill provides certain penalties where excess contributions are made under a pension plan. An excess contribution is an amount greater than the permitted deductible and nondeductible contributions. The bill requires that any such excess contributions must be returned to the person or to the business that made it, together with income earned on the excess contribution. If an excess contribution is not repaid within 6 months after notification has been received, the plan 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 plan which is attributable to his interest. Where

an excess contribution is willfully made, however, the entire interest of the individual on whose behalf it was made (including the corpus allocated to his account) is required to be distributed to him by all plans in which he participates as an owner-employee and he is further disqualified from participating in any pension plans as an owner-employee for a 5-year period. Furthermore, no opportunity is given to repay a willful excess contribution and escape the consequences.

M. Payment of Benefits to Owner-Employees

The bill requires that new retirement plans established by self-employed persons for their own benefit and for the benefit of their employees, and also corporate pension plans covering owner-employees to which the limitations will apply, may not begin paying retirement benefits before insurance age 60 (59½) except in the event of death or disability. Under your committee s bill an individual is considered disabled if unable to engage in any substantial gainful activity because of a medically determinable physical or mental impairment which can be expected to result in death or to be of long-continued and indefinite duration. Distributions of retirement benefits, however, must begin not later than insurance age 71 (70½). Thus, under the bill, if the self-employed person dies, his interest in the retirement plan must be distributed within 5 years from the date of his death or used within 5 years to purchase an immediate annuity for his beneficiary.

N. Premature Distributions

A penalty tax is imposed by the bill in cases where a premature distribution of the retirement fund is made before the self-employed individual or corporate owner-employee reaches age 59½. In these cases, if the premature distribution amounts to $2,500 or more, the tax imposed would not be less than 110 percent of the increase in tax that would have resulted if the income had been received ratably over the 5 years ending with the year of distribution. If the premature distribution amounts to less than $2,500, the tax due would be 110 percent of the increase in tax resulting from inclusion of the entire amount of the premature distribution in gross income for the current year. For purposes of this penalty, taxable income for any of those years is deemed to be not less than the appropriate portion of the distributed amount reduced only by the deduction for personal exemptions, and the tax so computed can be reduced only by the credit for withheld taxes. As a further penalty in case of a premature distribution, the owner-employee is disqualified from participating in a retirement plan on his own behalf for 5 years following the year in which the total distribution is made. These penalties are imposed in order to prevent retirement plans from, in effect, becoming income-averaging plans under which deductible contributions would be made to the plan in high income-high tax years and the assets would be drawn down in low-income or loss years when little or no tax would be due. It is the purpose of this bill to provide means for financing retirement; these penalties are designed to insure that retirement plans will not be used for other purposes.

O. Two or More Businesses

An owner-employee who controls more than one business would be required to group together all his business activities for the purpose of determining whether the nondiscrimination rules of present law are satisfied. He could not exceed the basic limitation on deductible contributions for his own behalf by splitting his activities among two or more businesses and establishing retirement plans in each, nor could he divide his businesses and set up a retirement plan in one business in which, for example, he is the only employee.

P. Annuity Treatment for Distributions

As under present law, retirement benefits when paid to individuals from qualified plans would be taxable as ordinary income. To the extent that they have been financed by nondeductible contributions made under a contributory pension plan, benefits would be taxable under existing rules which allow individuals to recover their capital invested in a retirement contract free of tax.

Q. Estate and Gift Tax Exemption

With respect to the estate and gift tax exemption in the case of retirement plan benefits, your committee's bill does not change present law as it applies to employees, including owner-employees of corporations. However, the bill does not extend these exemptions to the self-employed, insofar as contributions were made to the plan on behalf of the individual while he was a self-employed person. The estate and gift tax exclusion will continue to apply with respect to any employer contributions made while the individual was a true employee.

R. Lump Sum Distributions

Similarly, while your committee's bill does not extend to self-employed individuals capital gain treatment on certain lump-sum distributions from retirement plans, such treatment is not denied to employees of the self-employed nor to employees of corporations, including owner-employees. Under the bill, a self-employed individual will receive capital gain treatment on that portion of a lump-sum distribution which is attributable to employer contributions made on his behalf while he was an employee. Otherwise, a special averaging device, provides for the taxing of lump-sum distributions received by self-employed individuals after age 59½. Under the bill, the tax he will pay is limited to five times the increase in tax resulting from including 20 percent of the lump-sum distribution in taxable income. In this way some protection from the graduated rates of the individual income tax is given to the self-employed individual who receives a lump-sum distribution.

S. Prohibited Transactions

The bill tightens the prohibited transaction rules of present law with respect to trusts forming part of pension plans covering self-employed individuals or corporate owner-employees who control the business by means of a more than 50 percent ownership interest. In these situations since the owner-employee is, in effect, dealing with him-

self, your committee has provided that the owner-employee should not borrow from a trust he has established, should not buy from or sell property to that trust, and should not charge any fees for services he renders to the trust. It would be extremely difficult to police the large number of small trusts that may be established under this bill, and for this reason the prohibited transaction rules have been tightened.

T. Plan Requirements for Owner-Employee Plans

In summary, new retirement plans established by self-employed individuals or corporate owner-employees must meet the following requirements for qualification in addition to those which the law requires of all retirement plans:

(1) If it is a trusteed plan, the trustee must be a bank or similar institution with fiduciary powers.

(2) In the case of owner-employees, benefits may not be payable before the owner-employee reaches age 59½.

(3) In the case of profit-sharing and stock bonus plans, employees rights must be nonforfeitable and the plan must provide a definite formula for determining the amount of contributions for employees.

(4) No excess contributions may be made.

(5) The plan may not take account of social security contributions and benefits except where the contributions on behalf of employees are more than twice the amount contributed for owner-employees.

(6) Persons not covered by social security, in particular physicians and some ministers, may not make larger contributions on their own behalf because of this lack of social security coverage.

(7) If an owner-employee dies, his entire interest must within 5 years be distributed to his beneficiaries or used to provide immediate annuities for them.

(8) Excess contributions if made are required to be returned to the person who made them; and income earned by the plan which is attributable to the interest of an owner-employee with respect to whom an excess contribution was not timely returned is required to be taxed.

(9) For purposes of satisfying the rules relating to nondiscrimination of coverage two or more businesses controlled by owner-employees must be considered as a single business.

(10) Contributions on behalf of any owner-employee must be determined on the basis of his earned income from the trade or business with respect to which the retirement plan is established.

IV. MISCELLANEOUS PROVISIONS OF THE BILL

The bill adds three new paragraphs to section 401(a) of the Code; these have the effect of codifying certain regulations and administrative practices of the Internal Revenue Service. These three new paragraphs apply to all pension plans, not merely those which cover owner-employees. The first of these new paragraphs requires that, upon termination of the plan, the rights of all employees then covered by the plan must be nonforfeitable. The second new requirement makes employee benefits payable not later than the taxable year in

which the employee reaches age 70½, or retires, whichever is later. (In the case of an employee who is an owner-employee, as defined, benefits must be payable not later than the taxable year in which he reaches age 70½.) The third new requirement imposed upon all retirement plans makes it plain that forfeitures must not be used to increase the benefits any employee would otherwise receive under the plan.

The bill permits self-employed individuals and other owner-employees to qualify for the retirement-income credit on the basis of distributions from qualified retirement plans. However, it does not permit self-employed persons to qualify either for the $5,000 death-benefit exclusion or for the sick-pay exclusion. Those provisions were enacted for the benefit of employees as contrasted to the self-employed and, although owner-employees of corporations will continue to obtain these benefits under present law, it is not the purpose of this bill to treat self-employed individuals as employees except for retirement-plan purposes. However, the bill does allow a self-employed individual to exclude from his gross income under section 104 of the code amounts received through accident or health insurance for personal injuries or sickness, to the extent that such amounts are attributable to his own nondeductible contributions.

Where pension contributions take the form of the purchase of annuities, any loans against these contracts are treated as distributions and any repayments of such loans are treated as contributions. In addition, if any portion of a trust or of a contract is assigned or pledged, that portion is also treated as a distribution from the trust or under the plan. Without these rules, an owner-employee could, in effect, obtain premature access to a substantial portion of the pension funds being accumulated for his retirement.

The bill makes it plain that deductible contributions made to a retirement plan by a self-employed individual on his own behalf may not be used to increase a net operating loss, and that owners of unincorporated businesses which elect to be taxed as corporations may participate in qualified retirement plans only in their capacity as self-employed persons. The bill also makes it clear that amounts contributed to a qualified retirement plan by a self-employed individual which are deductible, are treated as deductions from gross income in computing adjusted gross income. Thus, a self-employed individual may take this deduction and still qualify for the standard deduction.

V. TECHNICAL EXPLANATION

SECTION 1. SHORT TITLE

The first section of the bill provides that the act may be cited as the "Self-Employed Individuals Tax Retirement Act of 1960".

SECTION 2. QUALIFICATION OF PLANS

Section 2 of the bill amends section 401 of the Internal Revenue Code of 1954 to provide that self-employed individuals may be covered under qualified pension, profit-sharing, and stock-bonus plans. In addition, section 2 amends section 401 to add additional requirements which must be met in order for a trust forming part of a plan covering employees who own more than 10 percent of the business to

qualify under section 401. There are also added to section 401 certain additional requirements which must be met by all qualified trusts and plans.

Section 401(a)

Section 401(a)(5) provides that a plan shall not be considered discriminatory merely because the contributions or benefits under the plan bear a uniform relationship to the "total compensation, or the basic or regular rate of compensation," of the employees covered under the plan. Paragraph (1) of section 2 of the bill amends section 401(a)(5) to provide that, for purposes of this rule, the total compensation of a self-employed individual is such individual's earned income (as defined in sec. 401(c)(2)(A)), and that the basic or regular rate of compensation of such an individual is that portion of his earned income which bears the same ratio to his total earned income as the basic or regular compensation of the employees covered under the plan bears to their total compensation. This ratio is to be computed in accordance with regulations prescribed by the Secretary or his delegate.

Section 401(a) sets forth the requirements which a pension, profit-sharing, or stock bonus trust must meet in order to constitute a qualified trust. Paragraph (2) of section 2 of the bill adds four additional requirements. In general, these additional requirements (other than the one included in the new sec. 401(a)(10)) are administrative rules which are applied by the Internal Revenue Service in determining whether a trust constitutes a qualified trust under section 401(a). The new paragraph (7) of section 401(a) provides that a trust will not qualify unless the plan of which it is a part provides that, upon its termination or upon complete discontinuance of contributions under the plan, the employees covered under the plan will be granted immediate vested rights to so much of their benefits under the plan as have accrued and have been funded at the time of the termination or discontinuance or, in the case of a money purchase plan, will be granted immediate vested rights to the amounts credited to their account as of the date of the termination or discontinuance. This provision is not to be applicable, however, to benefits or contributions which, pursuant to regulations prescribed by the Secretary or his delegate to preclude discrimination, may not be used for designated employees in the event of early termination of the plan. For example, this provision would not require vesting when certain officers or highly compensated employees are, at the inception of the plan, within a few years of retirement age and the granting of complete vested rights to such employees upon termination of the plan shortly after they reach retirement age would result in the plan being discriminatory in favor of such officers or highly compensated employees.

The new paragraph (8) of section 401(a) provides that a trust will not qualify unless, under the plan of which it is a part, the entire interest of each employee (A) either will be distributed to him not later than his taxable year in which he attains the age of 70½ years, or, in the case of an employee other than an owner-employee (as defined in sec. 401(c)(3)), in which he retires, whichever is the later, or (B) will be distributed, commencing not later than such taxable year, (i) over the life of such employee or over the lives of such employee and his spouse, or (ii) over the life expectancy of such employee or over the life expectancy of such employee and his spouse. For these

purposes, the Secretary or his delegate is to issue regulations prescribing the specific conditions under which these requirements will be considered to be met.

The new paragraph (9) of section 401(a) provides that a trust will not qualify unless the plan of which it is a part provides that forfeitures must not be applied to increase the benefits any employee would otherwise receive under the plan. Therefore, if the plan calls for future contributions, the forfeitures must be used to reduce such contributions.

Under present law, a qualified plan may contain as a condition of eligibility for coverage under the plan a period of employment not exceeding 5 years. The new paragraph (10) of section 401(a) provides that, in the case of certain plans, such 5-year period is reduced to a 3-year period. This new rule applies (1) to all plans covering self-employed individuals (regardless of their percent of ownership), (2) to all plans covering an owner (regardless of his percent of ownership) of a corporation described in section 401(c)(3)(D) or an association described in section 401(c)(3)(E), and (3) all other plans covering a more than 10 percent owner.

The new paragraph (11) of section 401(a) provides that a trust forming part of a plan covering an owner of more than 10 percent of the business must, in order to qualify under section 401, also meet the new requirements of section 401(d).

Section 401(c)

Paragraph (3) of section 2 of the bill adds a new subsection (c) to section 401(a), which contains certain definitions relating to self-employed individuals and owner-employees.

(1) *Definition of employee.*—Under the present law, a qualified pension, annuity, stock-bonus, or profit-sharing plan can cover only those individuals who are employees under common law. Paragraph (1) of the new subsection (c) defines the term "employee" to include, for any taxable year, a self-employed individual who has earned income (as defined in sec. 401(c)(2)(A)) for the taxable year.

(2) *Definition of "earned income".*—Paragraph (2) of the new subsection (c) contains a definition of "earned income." Subparagraph (A) provides that in the case of self-employed individuals, such term means the net earnings from self-employment (as defined in sec. 1402(a)) to the extent that such net earnings constitute earned income as defined in section 911(b), but such net earnings and earned income shall be determined with certain modifications. The first of these modifications provides that doctors and certain ministers, who are not subject to the tax on self-employment income, shall be treated, for this purpose, as being engaged in a trade or business from which net earnings from self-employment are derived. The second modification provides that certain salesmen described in section 3121(d)(3) who are not employees but who are not subject to the tax on self-employment income shall be similarly treated. The third modification provides that amounts which are not otherwise includible in gross income shall not be included in an individual's net earnings from self-employment.

Paragraph (6) of the new subsection (c) provides that, in applying section 911(b) for purposes of determining the "earned income" of a self-employed individual who is engaged in a trade or business in

which both personal services and capital are material income-producing factors and with respect to which the individual actually renders personal services on a full-time, or substantially full-time, basis, so much of his share of the net profits of such trade or business as does not exceed $2,500 shall be considered as earned income. Such paragraph (6) also provides that, in the case of any such individual who is engaged in more than one trade or business with respect to which he actually renders substantial personal services, if with respect to all such trades or businesses he actually renders personal services on a full-time, or substantially full-time, basis, there shall be considered as earned income with respect to the trades or businesses in which both personal services and capital are material income producing factors (A) so much of his share of the net profits of such trades or businesses as does not exceed $2,500 reduced by (B) his share of the net profits of any trade or business in which only personal services is a material income-producing factor. In a case when a self-employed individual is engaged in two or more trades or businesses in which both personal services and capital are material income-producing factors, the $2,500 must be allocated among such trades or businesses, but in no case shall the individual be considered to have earned income from a trade or business in excess of his share of the net profits of such trade or business. Section 911(b) provides that, in the case of a taxpayer engaged in a trade or business in which both personal services and capital are material income-producing factors, such individual's earned income from such trade or business shall not exceed 30 percent of his share of the net profits of such trade or business. Paragraph (6) provides that its provision shall not be construed to reduce the amount of an individual's earned income below that which he would be considered to have under section 911(b). The application of paragraph (6) may be illustrated by the case of an individual who is engaged on a full-time basis in a trade or business in which both personal services and capital are material income-producing factors and whose net profits from the trade or business for the taxable year are $8,000. Under section 911(b), such individual would be presumed to have received not more than $2,400 of earned income from such trade or business (30 percent × $8,000). However, under paragraph (6) such individual is considered to have received $2,500 of earned income from such trade or business. Paragraph (6) is applicable only for purposes of determining an individual's earned income as defined in section 401(c)(2)(A), and for no other purpose.

Subparagraph (B) of the new subsection (c)(2) provides that, in the case of an individual who is an employee, other than a self-employed individual, the term "earned income" means the compensation received by such individual from his employer.

(3) *Definition of "owner-employee".*—Certain of the provisions of the bill are applicable only to owner-employees or to plans covering owner-employees. Paragraph (3) of the new subsection (c) defines the term "owner-employee" to mean an employee who—

(A) Owns the entire interest in an unincorporated trade or business,

(B) In the case of a partnership, is a partner who owns more than 10 percent of either the capital interest or the profits interest in such partnership,

(C) In the case of a corporation (other than a corporation described in subparagraph (D) or (E)), is a shareholder who owns

more than 10 percent of the value of the outstanding stock of the corporation or who owns more than 10 percent of the total combined voting power of all classes of stock entitled to vote,

(D) In the case of a corporation with respect to which, for the taxable year, an election under section 1372 (relating to elections by small business corporations) is in effect, is a shareholder who owns more than 10 percent of the outstanding stock of the corporation, or

(E) In the case of an unincorporated association which is a corporation within the meaning of section 7701(a)(3) and which is engaged in a trade or business in which professional services is a material income-producing factor, is an individual who owns more than a 10-percent interest in such association.

(4) *Rules of constructive ownership.*—Paragraph (5) of the new subsection (c) provides rules of constructive ownership for determining who is n owner-employee and for determining in certain other situations an individual's ownership interest. Under such paragraph (5), an individual shall be treated as owning any interest in an unincorporated trade or business, and any stock in a corporation, which is owned, directly or indirectly, by his spouse and minor children. This rule is applicable whether or not such individual himself owns any interest in the trade or business or any stock in the corporation. In addition, when an individual owns any interest in an unincorporated trade or business or is an employee of such trade or business, or owns any stock in a corporation or is an employee of such corporation, he shall also be treated as owning any interest in such unincorporated trade or business, and any stock in such corporation, which is owned, directly or indirectly, by his ancestors or other lineal descendants. Paragraph (5) provides, however, that any interest or stock owned by any individual by reason of such paragraph shall not be treated as owned by him for the purpose of applying such paragraph in order to make any other individual the constructive owner of such interest or stock.

(5) *Definition of "employer".*—In order to qualify under section 401, a plan must be a plan of an employer. Paragraph (4) of the new subsection (c) provides that, for this purpose, an individual who owns the entire interest in an unincorporated trade or business shall be treated as his own employer. Similarly, a partnership shall be treated as the employer of its partners.

Section 401(d)

Paragraph (3) of section 2 of the bill adds a new subsection (d) to section 401, which sets forth additional requirements which must be met in order for a trust forming part of a stock bonus, pension, or profit-sharing plan covering owner-employees to qualify under section 401.

(1) *Trustee must be a bank.*—Paragraph (1) of the new subsection (d) provides that, in the case of a trust which is created on or after the date of the enactment of the bill, or which was created before such date but is not exempt as a qualified trust on the day before such date, the trustee must be a bank. However, paragraph (1) provides that a person (including the employer) other than a bank may be granted, under the trust instrument, the power to direct the investment of the trust funds. Paragraph (1) is not applicable to a trust created or organized outside the United States before the date of the enactment

of the bill if, under section 402(c), such trust is treated as exempt from taxation under section 501(a) on the day before such date. Such paragraph (1) defines the term "bank" to mean (A) a bank as defined in section 581, and (B) a corporation which under the laws of the State of its incorporation is subject to supervision and examination by the Commissioner of Banking or similar officer, and (C) in the case of a foreign trust, a bank or trust company, wherever incorporated, exercising fiduciary powers and subject to supervision and examination by governmental authority.

(2) *Time of distribution.*—Paragraph (2) of the new subsection (d) provides that, under the plan, no benefits may be paid to any owner-employee, except in the case of his disability (within the meaning of sec. 213(g)(3)), prior to his attaining age 59½.

(3) *Profit-sharing plans.*—Paragraph (2) of the new subsection (d) also provides that, in the case of a profit-sharing or stock-bonus plan covering an owner-employee—

(A) The employees' rights to or derived from the contributions under the plan must be nonforfeitable at the time such contributions are paid to or under the plan, and

(B) The plan provides a definite formula for determining contributions to be made to the trust by the employer on behalf of employees (other than owner-employees). Because of the limitations in section 404 on the amount that may be deducted for contributions on behalf of an owner-employee, the plan need not provide a definite formula for determining the contributions to be made on behalf of owner-employees, but the contributions actually made on behalf of the owner-employees must not be discriminatory when compared to those made for the other employees.

(4) *Excess contributions.*—Paragraph (3) of the new subsection (d) provides that the plan must not permit—

(A) Contributions to be made by an employer which is a corporation or a partnership on behalf of any owner-employee in excess of the amounts which may be deducted under section 404 for the taxable year;

(B) In the case of a plan which covers only owner-employees, contributions to be made in excess of those which are deductible under section 404 for the taxable year; and

(C) If a distribution under the plan is made to any owner-employee before such owner-employee attains the age of 59½ or becomes disabled, contributions to be made on behalf of such owner-employee for the 5 taxable years succeeding the taxable year in which such distribution is made. In the case of an early distribution to an owner-employee, contributions may not be made on behalf of such owner-employee for the 5-year period even though, under section 402(a)(2) or 403(a)(2), such early distribution was taxable at capital gains rates.

(5) *Integration with social security.*—Paragraph (4) of the new subsection (d) provides that, for purposes of determining whether the contributions or benefits under a plan covering owner-employees are discriminatory, there may be taken into account under the plan contributions or benefits under the social security system only for those taxable years in which the deductible contributions on behalf of the owner-employees do not exceed one-half of the vested contributions which are deductible in that year for all other employees. Thus, if the

contributions on behalf of owner-employees exceed one-half of such contributions on behalf of other employees, the contributions or benefits under a qualified plan must be nondiscriminatory without taking into consideration any contributions or benefits under the social security system. Paragraph (5) of the new subsection (d) provides that the plan must meet the nondiscriminatory requirements of section 401(a) (3) and (4) without taking into account for any purpose the fact that, by reason of section 211(c) (4) and (5) of the Social Security Act, as amended, the income of an owner-employee does not constitute net earnings from self-employment (as defined in sec. 211(a) of such act). Thus, a doctor who is not now covered by social security may not provide under a qualified plan higher contributions or benefits for himself than for his employees on the ground that he is required to contribute to the social security system on behalf of his employees.

(6) *Distributions after death.*—Under paragraph (6) of the new subsection (d), the plan must provide that, after the death of an owner-employee, his interest in the plan must be either distributed to his beneficiary within 5 years or used within that period to purchase an immediate annuity for his beneficiary.

(7) *Repayment of excess contributions.*—Paragraph (7) of the new subsection (d) provides that, under the plan—

(A) Any excess contribution (as defined in sec. 401(e)(1)), together with the income attributable thereto, is (except in the case of a willfully made excess contribution) to be repaid—

(i) If the excess contribution was made on behalf of an owner-employee, other than an owner-employee of a partnership, to the sole proprietor, corporation, or owner-employee who made the excess contribution, or

(ii) If the excess contribution was made on behalf of an owner-employee of a partnership, to such owner-employee;

(B) If for any taxable year the plan does not, by reason of section 401(e)(2)(A), meet (for purposes of sec. 404) the requirements of section 401(d) with respect to an owner-employee, the income for the taxable year attributable to the interest of such owner-employee under the plan is to be paid to such owner-employee; and

(C) The entire interest of an owner-employee is to be repaid to him when required by section 401(e)(2)(E) (relating to willful excess contributions).

(8) *More than one trade or business.*—Paragraph (8)(A) of the new subsection (d) provides that, if the plan covers an owner-employee who controls, or two or more owner-employees who together control, the trade or business with respect to which the plan is established, and who also control as an owner-employee or as owner-employees one or more other trades or businesses, such plan and the plans (if any) established by such other trades or businesses must constitute an overall plan which meets the nondiscrimination requirements of section 401(a) (3) and (4) with respect to the employees of all such trades or businesses. In determining whether the nondiscrimination rules of section 401(a) (3) and (4) are met with respect to the employees of more than one trade or business, the general rules of such section (including the reasonable classification provision of sec. 401(a)(3)(B)) shall be applicable.

Paragraph (8)(B) of the new subsection (d) provides that an owner-employee, or two or more owner-employees, shall be considered to

control a trade or business if such owner-employee, or such two or more owner-employees together—

(i) Own the entire interest in an unincorporated trade or business, or

(ii) In the case of a partnership, own more than 50 percent of either the capital interest or the profits interest in such partnership, or

(iii) In the case of a corporation (as defined in sec. 7701(a)(3)), own either more than 50 percent of the value of the outstanding stock of the corporation or more than 50 percent of the total combined voting power of all classes of stock entitled to vote.

For purposes of determining the ownership interest of an owner-employee, the rules of constructive ownership contained in section 401(c)(5) shall be applied. In addition, for purposes of determining his ownership interest, an owner-employee, or two or more owner-employees, shall be treated as owning any interest in a partnership, and any stock in a corporation, which is owned, directly or indirectly, by a partnership or by a corporation which such owner-employee, or such two or more owner-employees, are considered to control within the meaning of paragraph (8)(B). Thus, an owner-employee who controls a parent corporation will also be considered to control the subsidiaries controlled by such corporation.

(9) *Contributions limited to the earned income of the trade or business.*—Paragraph (9) of the new subsection (d) provides that, under the plan, contributions on behalf of any owner-employee may be made only with respect to the earned income of such owner-employee which is derived from the trade or business with respect to which the plan is established.

Section 401(e)

Paragraph (3) of section 2 of the bill adds a new subsection (e) to section 401, which contains a definition of "excess contribution" and which sets forth the consequences of making such an excess contribution.

(1) *Definition of "excess contribution."*—Paragraph (1) of the new subsection (e) defines the term "excess contribution" to mean—

(A) If, in the taxable year, contributions are made under the plan only on behalf of owner-employees, so much of any contribution made on behalf of any owner-employee as is not deductible under section 404 for the taxable year; or

(B) If, in the taxable year, contributions are made under the plan on behalf of both owner-employees and other employees—

(i) So much of any contribution made by an employer which is a corporation or a partnership on behalf of any owner-employee as is not deductible under section 404 for the taxable year;

(ii) So much of any nondeductible contribution as is made by an owner-employee at a rate which exceeds the rate of contributions permitted to be made by employees other than owner-employees; and

(iii) So much of any nondeductible contributions made by an owner-employee as exceeds the lesser of $2,500 or 10 percent of the earned income for such taxable year derived by such owner-employee from the trade or business with respect to which the plan is established; and

(C) Any contribution made on behalf of an owner-employee in any taxable year for which, under section 401(e)(2) (A) or (E), the plan does not (for purposes of sec. 404) meet the requirements of section 401(d) with respect to such owner-employee.

Such paragraph (1) provides, however, that the amount of any contribution which is allocable (determined in accordance with regulations prescribed by the Secretary or his delegate) to the purchase of life, accident, health, or other insurance shall not be taken into account in determining the amount of any contribution for purposes of determining whether such contribution is an excess contribution.

(2) *Effect of excess contribution.*—Paragraph (2)(A) of the new subsection (e) provides that, if an excess contribution (other than a willful excess contribution to which sec. 401(e)(2)(E) applies) is made on behalf of an owner-employee in any taxable year, the plan with respect to which such excess contribution is made shall, except as provided in section 401(e)(2) (C) and (D), be considered, for purposes of section 404, as not meeting the requirements of section 401(d) with respect to such owner-employee for the taxable year and for all succeeding taxable years. In any year when an otherwise exempt trust forming part of a plan is (pursuant to par. (2)(A)) considered, for purposes of section 404, as not meeting the requirements of section 401(d) with respect to an owner-employee, the earnings of such trust (including those attributable to the interest of the owner-employee with respect to whom the excess contribution was made) shall remain exempt from tax. However, the trust shall not be considered exempt for purposes of deducting any contributions made on behalf of the owner-employee with respect to whom the excess contribution was made.

Paragraph (2)(B) of the new subsection (e) provides that, for any taxable year for which a plan does not meet the requirements of section 401(d) with respect to an owner-employee by reason of paragraph (2)(A), such owner-employee shall currently include in his gross income the income for such year attributable to his interest in the plan.

Paragraph (2)(C) of the new subsection (e) provides that paragraph (2)(A) (and, consequently, paragraph (2)(B)) shall not apply to an excess contribution with respect to any taxable year if (on or before the close of the 6-month period beginning on the day on which the Secretary or his delegate sends by certified or registered mail, to the trust or insurance company to whom such excess contribution was paid, notice of the amount of such excess contribution) the amount of such excess contribution, and the income attributable thereto, is repaid—

(i) If the excess contribution was made on behalf of an owner-employee (other than an owner-employee of a partnership), to the sole proprietor, corporation, or owner-employee who made such excess contribution, or

(ii) If the excess contribution was made on behalf of an owner-employee of a partnership, to such owner-employee.

Such paragraph (2)(C) further provides that, if the contribution is an excess contribution by reason of exceeding the deduction limitations under section 404, the notice required to be sent by the Secretary or his delegate shall not be mailed prior to the time that the amount of the tax under chapter 1 of the Internal Revenue Code of the person to whom the excess contribution is to be repaid has been finally determined for the taxable year in which such excess contribution was made.

Paragraph (2)(D) of the new subsection (e) provides that, if an excess contribution, together with the income attributable thereto, is not repaid within the 6-month period, paragraph (2)(A) shall not apply to any taxable year beginning with the taxable year in which the trust or insurance company to whom such excess contribution was paid repays the amount of such excess contribution to the corporation, partner, sole proprietor, or owner-employee who made such excess contribution, and pays to the owner-employee with respect to whom the excess contribution was made the amount of income attributable to the interest of such owner-employee which, under paragraph (2)(B), is required to be included in such owner-employee's gross income for any prior taxable year.

(3) *Special rule if excess contribution was willfully made.*—Paragraph (2)(E) of the new subsection (e) provides that, if an excess contribution made on behalf of an owner-employee is determined to have been willfully made, then, instead of applying the provisions of section 401(e)(2) (A), (B), (C), and (D)—

(i) There shall be distributed to the owner-employee on whose behalf such excess contribution was willfully made his entire interest in all plans in which he is a participant as an owner-employee; and

(ii) Contributions may not be made on behalf of such owner-employee to any plan in which he is a participant as an owner-employee for the taxable year in which it is determined that such excess contribution was willfully made and for the 5 taxable years following such taxable year.

Thus, when it has been determined that an excess contribution has been willfully made to a plan on behalf of an owner-employee, such owner-employee's entire interest in all plans in which he is a participant as an owner-employee must be distributed to him and he may not participate in any plan with respect to which he is an owner-employee for the taxable year of the determination and for the 5 succeeding taxable years.

(4) *Statute of limitations.*—Paragraph (2)(F) of the new subsection (e) provides that, in any case in which a plan does not meet the requirements of section 401(d) with respect to an owner-employee by reason of paragraph (2)(A), the period for assessing any deficiency arising by reason of—

(i) The disallowance of any deduction under section 404 because such plan does not meet the requirements of section 401(d) with respect to an owner-employee on whose behalf an excess contribution was made, or

(ii) The inclusion, under paragraph (2)(B), in gross income of such owner-employee of the income attributable to his interest under a plan,

for the taxable year in which such excess contribution was made or for any succeeding taxable year shall not expire prior to 1 year after the close of the 6-month period referred to in paragraph (2)(C).

Section 3. Deductibility of Contributions to Plans

Section 3 of the bill amends section 404 of the Internal Revenue Code of 1954 to allow the deduction of contributions made on behalf of self-employed individuals who are covered under qualified pension, annuity, and profit-sharing plans. In addition, section 404 is amended to provide additional limitations on the amount that may be deducted with respect to contributions on behalf of both self-employed and corporate owner-employees.

Section 404(a)

(1) *Annuity plans.*—Section 404(a)(2) allows, within the applicable limitations, the deduction of employer contributions paid toward the purchase of retirement annuities if such purchase is a part of a plan which meets the requirements of section 401(a) (3), (4), (5), and (6), and if certain other conditions are met. Subsection (a)(1) of section 3 of the bill amends section 404(a)(2) to provide that the annuity plan must, in addition to meeting the present requirements, also meet the requirements in the new paragraphs (7), (8), (9), and (10) of section 401(a) and, if the plan covers owner-employees, the requirements of the new section 401(d)(2) (other than those which are applicable only to profit-sharing and stock bonus trusts), (3), (4), (5), (6), (7), (8), and (9). Thus, a qualified annuity plan is, in general, subject to the same requirements as is a qualified pension, profit-sharing, or stock-bonus trust.

(2) *Inclusion of self-employed.*—Subsection (a)(2) of section 3 of the bill adds a new paragraph (8) to section 404(a), which allows the deduction under section 404(a) of contributions to a qualified plan covering self-employed individuals. To accomplish this purpose, the new paragraph (8) provides that, for purposes of applying section 404 to a qualified pension, annuity, or profit-sharing plan covering self-employed individuals—

(A) The term "employee" is defined to include a self-employed individual who is an employee within the meaning of section 401(c)(1), and the employer of such a self-employed individual is defined to mean the person treated as his employer under section 401(c)(4);

(B) The term "earned income" has the meaning assigned to it by section 401(c)(2);

(C) The contributions to such a plan on behalf of a self-employed individual shall be considered to satisfy the conditions of section 162 or section 212 to the extent that such contributions do not exceed the earned income (as defined in sec. 401(c)(2)(A)) of such individual derived from the trade or business with respect to which such plan is established. However, contributions on behalf of self-employed individuals which are allocable (determined in accordance with regulations prescribed by the Secretary or his delegate) to the purchase of life, accident, health, or other insurance are not considered to satisfy the conditions of section 162 or section 212 and, therefore, are not deductible under section 404; and

(D) All references in section 404 to the term "compensation" shall, in the case of a self-employed individual, be considered a reference to the earned income (as defined in sec. 401(c)(2)(A)) of

such individual derived from the trade or business with respect to which the plan is established.

(3) *Plans covering owner-employees.*—Subsection (a)(2) of section (3) of the bill adds a new paragraph (9) to section 404(a), which provides special rules for computing the limitations on the amounts deductible for contributions under a qualified pension, annuity, profit-sharing, or stock-bonus plan covering owner-employees.

Subparagraph (A) of the new paragraph (9) provides that the limitations in paragraphs (1), (2), (3), and (7) of section 404(a) shall be computed, with respect to employees (other than owner-employees), as if such employees were the only employees covered under the plan. For example, if a qualified profit-sharing plan covers both owner-employees and other employees, the amount deductible under section 404(a)(3) with respect to contributions on behalf of such other employees is 15 percent of the compensation paid to such other employees if there are no carryovers for such year.

Subparagraph (B) of the new paragraph (9) provides that the limitations in paragraphs (1), (2), (3), and (7) of section 404(a) with respect to contributions under a qualified plan on behalf of owner-employees, shall be computed—

(i) As if such owner-employees are the only employees covered under the plan; and

(ii) Without regard to the carryover provisions contained in section 404(a)(1)(D), the second and third sentences of section 404(a)(3), and the second sentence of section 404(a)(7).

Subparagraph (C) of the new paragraph (9) provides that the amounts which are otherwise deductible under section 404(a) with respect to contributions on behalf of an owner-employee shall not exceed the additional limitations provided in section 404(e).

The new paragraph (9) further provides that, for purposes of section 404, the term "owner-employee" has the meaning assigned to it by section 401(c)(3) (determined with the application of the rules of constructive ownership contained in sec. 401(c)(5)).

Section 404(e)

Subsection (b) of section 3 of the bill adds to section 404 a new subsection (e), which provides additional limitations on amounts which may be deducted with respect to contributions on behalf of owner-employees.

(1) *Special limitations for self-employed and certain corporate owner-employees.*—Paragraph (1) of the new subsection (e) provides the additional limitations which are applicable in determining the amount that may be deducted with respect to contributions under a qualified plan on behalf of owner-employees either who are self-employed individuals or who are employees of corporations described in section 401(c)(3)(D) or of associations described in section 401(c)(3)(E). Under paragraph (1), the amounts deductible under section 404(a) in any taxable year with respect to contributions on behalf of such owner-employees shall, unless otherwise limited by paragraphs (3) and (4), not exceed whichever of the following amounts is the greater:

(A) $2,500, or 10 percent of the earned income derived by such owner-employee from the trade or business with respect to which the plan is established, whichever is the lesser; or

(B) An amount equal to such owner-employee's proportionate share of one-half of the amount deductible under section 404 for

such taxable year for contributions on behalf of employees (other than owner-employees) with respect to which the employees' rights are nonforfeitable at the time the contributions are made to or under the plan. For this purpose, such owner-employee's proportionate share shall be computed in accordance with regulations prescribed by the Secretary or his delegate. In computing the amount deductible under section 404 for a taxable year with respect to contributions on behalf of employees (other than owner-employees), there shall be included both the amount of the current contributions which are deductible in that year and the amount deductible in that year under the carryover provisions.

(2) *Special limitations for other corporate owner-employees.*—Paragraph (2) of the new subsection (e) provides the additional limitations which are applicable in determining the amount that may be deducted with respect to contributions under a qualified plan on behalf of owner-employees who are employees of corporations, other than corporations described in section 401(c)(3)(D) or associations described in section 401(c)(3)(E). Under paragraph (2), the amounts deductible under subsection (a) in any taxable year with respect to contributions on behalf of any such owner-employee shall, unless further limited by the provisions of paragraphs (3) and (4), not exceed whichever of the following amounts is the greater:

(A) $2,500, or 10 percent of the earned income derived by such owner-employee from the trade or business with respect to which the plan is established, whichever is the lesser; or

(B) An amount equal to such owner-employee's proportionate share (determined under regulations prescribed by the Secretary or his delegate) of the amount deductible under section 404 for such taxable year for contributions on behalf of employees (other than owner-employees) with respect to which the employees' rights are nonforfeitable at the time the contributions are made to or under the plan; or

(C) An amount, determined under regulations prescribed by the Secretary or his delegate, necessary (after taking into account amounts contributed or to be contributed to or under the plan and all other plans of the employer) to provide the cost of a straight life annuity commencing at the age of 64½ years, paying annually an amount equal to 20 percent of one-tenth of the compensation received by such owner-employee from the employer during the 10-year period immediately preceding the date of his retirement (or if earlier, his attaining the age of 64½ years), distributed as a level amount over the period beginning with the taxable year of the contribution and ending with the taxable year in which such owner-employee attains the age of 64½ years (or over the period required by sec. 404(a)(1)(B), if such period ends after the taxable year in which such owner-employee attains such age). For purposes of determining the cost of any such annuity with respect to any taxable year, the annual compensation to be received by such owner-employee from the employer in any year subsequent to such taxable year shall be assumed to be an amount equal to the average annual compensation received by such owner-employee from the employer during the 5-year period ending with such taxable year, or during so much of such 5-year period as such owner-employee has been an employee of the em-

ployer. Paragraph (2)(C) provides an alternative limitation for computing the contributions which may be deducted for any year. However, any funds which are properly accumulated in accordance with such limitation may be payable in the manner described in paragraph (2)(C) or in any other manner. For example, such funds may be distributed before the owner-employee attains the age of 64½ or may be distributed other than as a straight life annuity, such as in a lump-sum or as a joint and survivor annuity. If a plan is established when an owner-employee is age 64 and more than 50 percent of the remaining unfunded costs of the plan is attributable to the owner-employee alone, or to the owner-employee and not more than two other individuals, the costs of providing the owner-employee the benefits described in paragraph (2)(C) cannot be deducted over a period less than 5 years. Because under section 404(a)(9) contributions on behalf of owner-employees are deductible for the taxable year only if they are made in the year (or deemed to be made in the year under section 404(a)(6)), any contribution to provide the benefit described in paragraph (2)(C) in excess of the amount deductible for the year may be an excess contribution to which section 401(e) applies.

For purposes of the limitation described in paragraph (2)(B), the owner-employee's proportionate share and the amount deductible under section 404 for contributions on behalf of employees (other than owner-employees) shall be computed in the same manner as such share or amount is computed for purposes of the limitation in paragraph (1)(B) of the new subsection (e).

(3) *Limitations applicable to an owner-employee who controls the trade or business.*—Paragraph (3) of the new subsection (e) provides that the limitations in paragraphs (1)(A), (2)(A), and (2)(C) shall not apply with respect to contributions under a plan for any taxable year on behalf of an owner-employee who controls the trade or business with respect to which the plan is established, if contributions are made for such taxable year for any employee whose rights to or derived from such contributions are forfeitable at the time such contributions are made. For this purpose whether an owner-employee controls a trade or business is determined by applying the rules of section 401(d)(8)(B), including the rules of constructive ownership of section 401(c)(5). As a result of paragraph (3), an owner-employee who controls a trade or business is not entitled to deduct contributions on his own behalf under the 10 percent-$2,500 limitation or the limitation relating to a benefit of 20 percent of compensation, if for the taxable year he takes a deduction for contributions to a plan on behalf of employees and the employee's rights to such contributions are forfeitable at the time they are made. In such a case, the only limitation which such owner-employee can use is that contained in paragraph (1)(B) or (2)(B), both of which are based upon vested contributions made on behalf of his employees. If an owner-employee who controls a trade or business has no employees, paragraph (3) will not apply.

(4) *Overall limitiation.*—Paragraph (4) of the new subsection (e) provides that in any taxable year in which amounts are deductible under two or more plans (whether established with respect to the same trade or business or different trades or businesses) on behalf of an individual who is an owner-employee with respect to such plans, the aggregate amount deductible for such taxable year under such

plans with respect to contributions on behalf of such owner-employee shall not exceed whichever of the following amounts is the greater:

"(i) $2,500,

"(ii) The sum of the amounts so contributed under all such plans to the extent that, with respect to each such plan, the amount contributed does not exceed the amount described in paragraph (1)(B) or (2)(B), whichever is applicable, or

(iii) The sum of the amounts so contributed to all such plans to which paragraph (2) applies to the extent that, with respect to each plan to which paragraph (2) applies, the amount so contributed does not exceed the amount described in paragraph (2)(C).

The overall limitation in paragraph(4) has no application with respect to contributions made under a plan on behalf of an employee who is not an owner-employee of the trade or business with respect to which the plan is established, even though such employee may be covered as an owner-employee under a plan or plans established by other trades or businesses. The provisions of paragraph (4) may be illustrated by an example of an individual who is an owner-employee of a partnership and who is also an owner-employee of a corporation, other than a corporation described in section 401 (c)(3)(D) or an association described in section 401(c)(3)(E). Both the partnership and the corporation have qualified plans covering such owner-employee. In any taxable year when the total amount deductible under both plans with respect to contributions on behalf of such owner-employee does not exceed $2,500, it makes no difference under what limitations such amounts are deductible. However, the total amount deductible under both such plans with respect to contributions on behalf of such owner-employee may exceed $2,500 if the amount deductible by the partnership does not exceed the limitation described in paragraph (1)(B), and the amount deductible by the corporation does not exceed the amount described in paragraph (2)(B). Similarly, such owner-employee may exceed the basic $2,500 limitation in a taxable year, if the amount deductible under the plan established by the corporation in that year for contributions on his behalf does not exceed the limitation described in paragraph (2)(C). However, in that year, no amount would be deductible under the plan established by the partnership for contributions on his behalf.

Paragraph (4)(B) of the new subsection (e) provides that, in any case when paragraph (4)(A) reduces the amounts which are otherwise deductible under section 404 with respect to contributions made on behalf of an owner-employee under two or more plans, the portion of such reduced amount which is deductible under each plan shall be determined in accordance with regulations prescribed by the Secretary or his delegate.

(5) *Contribution allocable to insurance protection.*—Paragraph (5) of the new subsection (e) provides that the special limitations in section 404(e) are not applicable with respect to contributions which are allocable (determined under regulations prescribed by the Secretary or his delegate) to the purchase of life, accident, health, or other insurance.

(6) *Nondiscrimination requirements.*—Paragraph (6) of the new subsection (e) makes clear that nothing contained in the new section 404(e) shall be construed to allow the making of contributions or the distribution of benefits to, or with respect to, any owner-employee, if

such contributions or such benefits would be discriminatory within the meaning of section 401(a)(4). For example, the fact that a deduction may be allowed with respect to contributions on behalf of an owner-employee in an amount necessary to provide the 20 percent fixed benefit described in paragraph (2)(C) does not mean that such a benefit may be distributed to the owner-employee, if to do so would, because of an early termination of the plan, be considered discriminatory within the meaning of section 401(a)(4). In addition, even though contributions may meet the applicable limitations in the new section 404(e), a deduction may not be taken for such contributions unless they meet the applicable limitations of section 404(a) and are nondiscriminatory within the meaning of section 401(a)(4).

Section 404(f)

Subsection (b) of section 3 of the bill adds to section 404 a new subsection (f), which provides that, for purposes of section 404, any amount paid, directly or indirectly, by an owner-employee in repayment of any loan on an insurance policy which, under section 72(m)(4)(B), was treated as an amount received under a contract shall be treated as a contribution to which section 404 (including the limitations therein) applies on behalf of such owner-employee.

SECTION 4. TAXABILITY OF DISTRIBUTIONS

Section 4 of the bill amends section 72 of the Internal Revenue Code of 1954 to provide rules for the taxation of amounts distributed under qualified plans to self-employed individuals, owner-employees, or the beneficiaries of such individuals or employees.

Section 72(d)

Section 72(d) provides a special rule for the taxation of an annuity receivable by an employee when the aggregate amount receivable by the employee under the terms of the contract during the 3-year period beginning on the date on which the amount is first received under the contract as an annuity is equal to or greater than the consideration for the contract contributed by the employee. Subsection (a) of section 4 of the bill amends section 72(d)(2) to provide that, for purposes of section 72(d), any contribution which is made with respect to the contract while the employee is a self-employed individual and which is not allowed as a deduction under section 404 shall be treated as consideration for the contract contributed by the employee. This amendment merely makes clear that, as in the case of qualified plans established by corporations, a self-employed individual may not treat as consideration for the contract contributed by the employee any contributions under the plan for which deductions were allowed and which, consequently, are considered employer contributions. Moreover, under the new section 72(m)(2), contributions on behalf of a self-employed individual which are used to purchase life, accident, health, or other insurance are not, for purposes of section 72(d), included in the employee's basis for the contract.

Section 72(m)

Subsection (b) of section 4 of the bill adds to section 72 a new subsection (m), which provides special rules applicable to the taxation of employee annuities and distributions under employee plans.

(1) *Amounts received before annuity starting date.*—Paragraph (1) of the new subsection (m) provides that any amounts which are received under an annuity, endowment, or life insurance contract before the annuity starting date and which are not received as an annuity (within the meaning of sec. 72(e)(2)) shall be included in the recipient's gross income for the taxable year in which received to the extent that—

(A) Such amounts, plus all amounts theretofore received under the contract and includible in gross income under such paragraph (1), do not exceed

(B) The aggregate premiums or other consideration paid for the contract on behalf of an employee while such employee was an owner-employee (as defined in sec. 401(c)(3)) which were allowed as deductions under section 404 for the taxable year and all prior taxable years. For this purpose, the aggregate premiums or other consideration paid for the contract does not include any portion of such premiums or other consideration which is properly allocable (as determined under regulations prescribed by the Secretary or his delegate) to the cost of life, accident, health, or other insurance, even if such premiums were allowed as deductions under section 404.

Such paragraph (1) further provides that any amounts received under an annuity, endowment, or life insurance contract before the annuity starting date which are not received as an annuity and which are not includible in gross income under such paragraph (1) shall be subject to the provisions of subsection (e).

The provisions of paragraph (1) may be illustrated by the example of an employee who receives $8,000 as a distribution under a qualified pension plan before the annuity starting date. At the time of such distribution, $10,000 had been contributed and deducted under the plan on behalf of such employee while he was an employee (other than an owner-employee) and $5,000 had been contributed and deducted under the plan on behalf of such an employee while he was an owner-employee. In addition, such employee had contributed $2,000 on his own behalf under the plan. Of the $8,000, $5,000 (the amount contributed and deducted on behalf of the employee while he was an owner-employee) is includible in gross income under paragraph (1). Of the remaining $3,000, $1,000 (the amount in excess of the employee's contributions on his own behalf) is includible in gross income under section 72(e).

(2) *Computation of consideration paid by a self-employed individual.*—Paragraph (2) of the new subsection (m) provides that in computing—

(A) The aggregate amount of premiums or other consideration paid for the contract for purposes of section 72(c)(1)(A),

(B) The consideration for the contract contributed by the employee for purposes of section 72(d)(1), and

(C) The aggregate premiums or other consideration paid for purposes of section 72(e)(1)(B),

any amount allowed as a deduction with respect to the contract under section 404 while the employee was a self-employed individual shall be treated as consideration contributed by the employer. Such paragraph (2) further provides that the amounts described in paragraph (2) (A), (B), and (C) shall not include any portion of the premiums or other consideration for the contract paid while the employee was

an owner-employee which is allocable (as determined under regulations prescribed by the Secretary or his delegate) to the cost of life, accident, health, or other insurance.

Paragraph (2) merely makes it clear that there shall not be included in an employee's, or in his beneficiary's, basis for a contract any amount which was contributed by such employee under a qualified plan and which was allowed as a deduction under section 404. In addition, under paragraph (2), there shall not be included in the basis of any contract the amount of any premiums or other consideration paid to purchase for an employee while he was an owner-employee any life, accident, health, or other insurance. Present law shall be applied in determining whether an amount to which paragraph (2) does not apply should be included in the basis of a contract.

(3) *Life insurance contracts.*—Paragraph (3) of the new subsection (m) is applicable to any life insurance contract—

(i) Which is purchased as part of a qualified annuity plan described in section 403(a), or

(ii) Which is purchased by a qualified pension, profit-sharing, or stock-bonus trust, if the proceeds of such life insurance contract are payable directly or indirectly to a participant in such trust or to a beneficiary of such participant.

Paragraph (3)(B) provides that any contributions to such a qualified annuity plan or such a qualified trust allowed as a deduction under section 404, and any income of such a qualified trust, which are determined (in accordance with regulations prescribed by the Secretary or his delegate) to have been applied to purchase the life insurance protection under a life insurance contract to which paragraph (3) applies are includible in the gross income of the employee for whom such protection is purchased for the taxable year when such contributions, or such income, are so applied. In the case of the death of an employee insured under a life insurance contract to which paragraph (3) applies, an amount equal to the cash surrender value of such contract immediately before the death of the employee shall be treated as a payment under the qualified plan or trust, and the excess of the amount payable by reason of the death of the insured over such cash surrender value shall not be includible in gross income under section 72 and shall be treated as provided in section 101.

The provisions of paragraph (3) are rules presently contained in the regulations under the Internal Revenue Code of 1954.

(4) *Amounts constructively received*—Paragraph (4)(A) of the new subsection (m) provides that, if during any taxable year an owner-employee assigns (or agrees to assign) or pledges (or agrees to pledge) any portion of his interest in a qualified trust or any portion of the value of a contract purchased as part of a qualified annuity plan, such portion shall be treated as having been received in such taxable year by such owner-employee as a distribution from such trust or as an amount received under such contract. Paragraph (4)(B) provides that, if during any taxable year an owner-employee receives, directly or indirectly, any amount from an insurance company as a loan under a contract purchased by a qualified trust or purchased as a part of a qualified annuity plan, and issued by such insurance company, the amount of such loan shall be treated as an amount received under the insurance contract in such taxable year.

(5) *Penalty applicable to certain amounts received by owner-employees.*—Paragraph (5) of the new subsection (m) provides a penalty tax

on certain amounts received by an owner-employee under a qualified trust or annuity plan. Paragraph (5)(A) provides that the penalty tax is applicable—

(i) To amounts (other than any amount received by an individual in his capacity as a policyholder of an annuity, endowment, or life insurance contract which is in the nature of a dividend or similar distribution) which are received under a qualified pension, annuity, profit-sharing, or stock-bonus plan by an individual, who is, or has been, an owner-employee, before such individual attains the age of 59½, for any reason other than the individual's becoming disabled (within the meaning of sec. 213(g)(3)), but only to the extent that such amounts are attributable to the contributions paid on behalf of such individual (whether or not paid by him) while he was an owner-employee;

(ii) To amounts which are received under such a qualified plan at any time by an individual who is, or has been, an owner-employee, or by the successor of such individual, but only to the extent that such amounts are determined, under regulations prescribed by the Secretary or his delegate, to exceed the benefits provided for such individual under the plan formula; and

(iii) To amounts which are received by reason of the distribution under the provisions of section 401(e)(2)(E) (relating to willfully made excess contributions) by an individual who is, or has been, an owner-employee of his entire interest in all such qualified plans.

The penalty tax is applicable to such amounts even though, at the time they are received, the recipient is not an owner-employee. In the case of an early distribution described in paragraph (5)(A)(i), the penalty tax is applicable to only so much of the distribution as is attributable to contributions paid on behalf of the recipient while he was an owner-employee. However, the penalty tax is applicable to the entire amount, to the extent it exceeds the benefits under the plan formula, received by an employee (or by the successor of an employee) who is, or has been, an owner-employee, even though a portion of such amount may be attributable to contributions made on behalf of such employee while he was not an owner-employee.

Paragraph (5)(B) provides that, if the aggregate of the amounts to which the penalty tax is applicable received by any person in his taxable year equals or exceeds $2,500, the increase in his tax for that taxable year attributable to the receipt of such amounts shall not be less than 110 percent of the aggregate increase in taxes, for that taxable year and the 4 immediately preceding taxable years, which would have resulted if such amounts had been included in such person's gross income ratably over such taxable years. If deductions had been allowed under section 404 for contributions paid on behalf of such person while he is an owner-employee for a number of prior taxable years less than 4, paragraph (5)(B)(i) shall be applied by taking into account the number of taxable years immediately preceding the taxable year in which the amount was so received equal to such lesser number.

Under paragraph (5)(C), if the aggregate of the amounts to which the penalty tax is applicable received by a person in his taxable year is less than $2,500, the increase in tax attributable to the receipt of such amounts shall be 110 percent of the increase computed without regard to this penalty tax.

Paragraph (5)(D) provides that the penalty tax shall not apply to any amount which is taxed, under section 402(a)(2) or section 403 (a)(2), at capital gains rates. In general, therefore, the penalty tax is not applicable to an early distribution to an owner-employee of a corporation if such distribution represents a total distribution of his interest under the plan and is paid on account of his separation from service. The penalty tax would not, under similar circumstances, be applicable to amounts described in paragraph (5)(A)(ii). On the other hand, since a distribution required as a result of a determination that a willful excess contribution has been made on behalf of an owner-employee is not a distribution on account of separation from service or death, the penalty tax will, in all cases, be applicable to such a distribution.

Paragraph (5)(E) provides that the special rules in section 72(n)(3) shall be applied for purposes of computing the taxable income for taxable years to which paragraph (5) applies.

Paragraph (6) of the new subsection (m) provides that, for purposes of section 72, the term "owner-employee" has the meaning assigned to it by section 401(c)(3) (determined with the application of the rules of constructive ownership in sec. 401(c)(5)).

Section 72(n)

Subsection (b) of section 4 of the bill adds to section 72 a new subsection (n), which provides special tax treatment with respect to certain total distributions received under a qualified plan.

(1) Paragraph (1) of the new subsection (n) sets forth the distributions to which the special tax treatment in section 72 (n) applies. In the case of a qualified pension or profit-sharing trust, the special tax treatment is applicable to amounts distributed to a distributee, if such amounts represent the total distributions payable to the distributee with respect to an employee and if such amounts are paid to the distributee within 1 taxable year of the distributee—

(i) On account of the employee's death,

(ii) After the employee has attained the age of 59½ years, or

(iii) After the employee has become disabled (within the meaning of sec. 213(g)(3)).

In the case of a qualified annuity plan, the special tax treatment is applicable to amounts paid to a payee, if such amounts represent the total amounts payable to the payee with respect to an employee and if such amounts are paid to the payee within 1 taxable year of the payee—

(i) On account of the employee's death,

(ii) After the employee has attained the age of 59½ years, or

(iii) After the employee has become disabled (within the meaning of sec. 213(g)(3)).

For the special tax treatment to be applicable to a distributee or payee with respect to a distribution of an employee's interest in a qualified plan, it is not necessary that there also be distributed within the 1-year period any portion of the employee's interest which is payable to another payee or distributee. The special tax treatment is, under paragraph (1)(C), applicable only with respect to so much of any distribution or payment as is attributable to contributions made under a qualified plan on behalf of an employee while he is a self-employed individual. If an employee receives a distribution or payment of his own interest in a qualified plan or trust, the special tax

treatment is applicable to such distribution or payment only if contributions which were allowed as a deduction under section 404 have been made on behalf of such employee while he was a self-employed individual for 5 or more taxable years prior to the taxable year in which such distribution is paid. In addition, the special tax treatment is not applicable to amounts to which the penalty tax in section 72(m)(5) is applicable.

(2) Paragraph (2) of the new subsection (n) provides that, in any case when the special tax treatment applies, the tax attributable to the amounts to which the new subsection (n) applies for the taxable year for which such amounts are received shall not be greater than five 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.

(3) Paragraph (3) of the new subsection (n) provides that, notwithstanding section 63, and for purposes only of computing the tax under chapter 1 of the Internal Revenue Code of 1954 attributable to amounts to which the new subsection (n) or section 72(m)(5) (relating to the penalty tax in the case of certain distributions) applies and which are includible in gross income, the taxable income of the recipient for the taxable year of receipt (and for any other taxable year involved in the computation under sec. 72(m)(5)) shall be treated as being not less than the amount by which—

(A) The aggregate of such amounts so includible in gross income, exceeds

(B) The amount of the deductions allowed for such taxable year under section 151 (relating to deductions for personal exemptions).

In any case in which section 72(n)(3) results in an increase in taxable income for any taxable year, the resulting increase in the taxes imposed by section 1 or section 3 for such taxable year shall not be reduced by any credit under part IV of subchapter A of chapter 1 (other than sec. 31) of the Internal Revenue Code of 1954 which, but for this provision, would be allowable. Under paragraph (3), in no case is there subjected to tax under the penalty tax in section 72(m)(5) or the special tax treatment in section 72(n) amounts which represent a recipient's basis for a distribution.

Section 402(a)

Section 402(a)(2) provides that certain total distributions under qualified plans are taxable at capital gains rates. Subsection (c) of section 4 of the bill amends section 402(a)(2) to provide that the capital gains treatment is not applicable to distributions paid to any distributee to the extent such distributions are attributable to contributions made on behalf of an individual while he was a self-employed individual. In other words, in the case of an individual who was covered under a qualified plan both while he was an employee within the meaning of common law and while he was a self-employed individual, the capital gains treatment could only apply to that part of a distribution that is attributable to contributions made on his behalf while he was an employee within the meaning of common law.

Section 403(a)

Section 403(a) provides the tax treatment for distributions under qualified nontrusteed annuity plans. Subsection (d)(1) of section 4

of the bill amends section 403(a)(2)(A)(i) to provide that a qualified annuity plan must meet the new qualification requirements included by this bill in sections 401 (a) and (d).

Section 403(a)(2) provides capital gains treatment for certain total distributions. Subsection (d)(2) of section 4 of the bill amends section 403(a)(2)(A) to provide that the capital gains treatment shall not apply to amounts paid to any payee to the extent such amounts are attributable to contributions made on behalf of an individual while he was a self-employed individual. This amendment applies similar treatment to distributions under qualified annuity plans as the amendment made by subsection (c) of section 4 of the bill applies to distributions under qualified trusts.

Subsection (d)(3) of section 4 of the bill adds to section 403(a) a new paragraph (3) providing that, for purposes of section 403(a), the term "employee" includes a self-employed individual who is an employee within the meaning of section 401(c)(1), and the employer of such individual is the person treated as his employer under section 401(c)(4). This amendment merely makes clear that a self-employed individual can participate in a qualified annuity plan.

Section 5. Plans for Purchase of United States Bonds

Section 5 of the bill adds a new section 405 to the Internal Revenue Code of 1954 to provide for the establishment of qualified bond purchase plans. In general, participants in such a qualified bond purchase plan will be granted tax treatment similar to that granted to participants in qualified pension and profit-sharing plans.

Section 405(a)

Subsection (a) of the new section 405 provides that a plan of an employer for the purchase for and distribution to his employees or their beneficiaries of United States bonds described in section 405(b) shall constitute a qualified bond purchase plan if—

(1) The plan meets the requirements of section 401(a) (3), (4), (5), (6), (7), (8), (9), and (10) and, if applicable, the requirements of section 401(d) (2), (3), (4), (5), (6), (8), and (9); and

(2) Contributions under the plan are used solely to purchase for employees or their beneficiaries the United States bonds described in section 405(b).

A qualified bond purchase plan can be established by an employer for his employees without the creation of a trust but, if such a plan is established, only the special bonds can be purchased under the plan. A qualified trusteed plan can also purchase the special bonds together with other assets but, if a trusteed plan is established, the plan must qualify under section 401 as a pension or profit-sharing plan.

In general, a qualified bond purchase plan must meet the same qualification requirements as a qualified annuity plan. However, section 401(d)(7) is not applicable to a qualified bond purchase plan and, consequently, there is no limit on the amount of contributions in excess of those which are deductible that may be made under the plan.

Section 405(b)

Subsection (b)(1) of the new section 405 describes the special bond which can be purchased under a qualified bond purchase plan. Such

paragraph provides that such a bond is a bond issued under the Second Liberty Bond Act, as amended, which by its terms, or by regulations prescribed by the Secretary under the Second Liberty Bond Act—

(A) Provides for payment of interest or investment yield only upon redemption;

(B) May be purchased only in the name of an individual;

(C) Ceases to bear interest, or provide investment yield, not later than 5 years after the death of the individual in whose name it is purchased;

(D) May be redeemed before the death of the individual in whose name it is purchased only if such individual—

(i) Has attained the age of 59½ years, or

(ii) Has become disabled (within the meaning of sec. 213(g)(3));

(E) Is not transferable.

Subsection (b)(2) of the new section 405 provides that bonds purchased under a qualified bond purchase plan must be purchased in the name of the employee for whom it is purchased.

Section 405(c)

Subsection (c) of the new section 405 provides that contributions paid by an employer to or under a qualified bond purchase plan shall be deductible in an amount determined under section 404(a) in the same manner and to the same extent as if such contributions were made to a qualified trust described in section 401(a) which is exempt from tax under section 501. Thus, for contributions to a qualified bond purchase plan to be deductible under section 405(c), all of the requirements of section 404 must be met. For example, the contributions must meet the requirements of section 162 or 212, and must be made (or deemed to have been made under sec. 404(a)(6)) in a taxable year of an employer which ends with or within a year of the bond purchase plan for which it qualifies under section 405. If the amount of the contributions to the qualified bond purchase plan are determined by reference to the profits of the employer, as in the case of a qualified profit-sharing plan, the amount deductible with respect to such contributions is determined under section 404(a)(3), relating to qualified profit-sharing plans. Moreover, such a bond purchase plan shall be considered a profit-sharing plan for purposes of the provision in section 404(a)(3) relating to a situation when contributions are made to two or more profit-sharing trusts. In other cases, the amount deductible with respect to contributions to a qualified bond purchase plan will be determined under section 404(a)(1). If the qualified bond purchase plan covers owner-employees, the amount deductible with respect to contributions to the plan is subject to the further limitations of section 404(e) applicable to owner-employees. Similarly, in the case of a qualified bond purchase plan covering owner-employees, the special rules in section 404(a)(9) for computing the limitations with respect to deductions for contributions under the plan shall be applicable. Thus, the carryover provisions of section 404(a) are not applicable with respect to contributions made under a qualified bond purchase plan on behalf of owner-employees.

Section 405(d)

Subsection (d)(1) of the new section 405 provides that no amount is includible in the gross income of a distributee at the time a bond described in section 405(b) is distributed to him under a qualified bond purchase plan or from a qualified trust. Upon the redemption of such a bond, however, the proceeds are subject to taxation under chapter 1 of the Internal Revenue Code of 1954. In applying chapter 1, for purposes of determining the amount of tax due, the provisions of sections 72 and 1232 shall not be applied. In other words, the bonds described in section 405(b) received under a qualified bond purchase plan or from a qualified trust are not subject to tax until they are redeemed. In addition, upon redemption, no part of the proceeds will be taxable at capital gains rates under section 1232.

Subsection (d)(2) of the new section 405 provides rules for determining the basis of any bond received by a distributee under a qualified bond purchase plan. If the bond was purchased for an employee within the meaning of common law, the basis of such bond shall be an amount equal to the amount of the contributions made under the plan by the employee himself which were used to purchase the bond. If the bond was purchased for an employee at a time when he was a self-employed individual, the basis of such bond is an amount equal to the amount of the contributions used to purchase the bond which were made on behalf of such employee and which were not allowed as a deduction under section 405(c). Such subsection (d)(2) further provides that the basis of a bond described in section 405(b) which is received by a distributee from a qualified trust shall be determined under regulations prescribed by the Secretary or his delegate.

Section 405(e)

Subsection (e) of the new section 405 provides that the capital gains treatment of section 402(a)(2) shall not apply to any of the bonds described in section 405(b) and that, for purposes of applying section 402(a)(2) to amounts distributed by a qualified trust, any such bonds distributed to any distributee and any such bonds to the credit of any employee shall not be taken into account. In other words, for purposes of applying section 402(a)(2), a distribution under a qualified trust may be considered a total distribution of an employee's interest in such trust even though the trust retains bonds described in section 405(b). In the case of a distribution from a qualified trust which qualifies for the capital gains treatment of section 402(a)(2) and which includes both bonds of the type described in section 405(b) and other property, the capital gains treatment will be applicable to such other property. In no case, however, will the capital gains treatment be applicable to the proceeds received as a result of the redemption of any of the bonds described in section 405.

Section 405(f)

Subsection (f) of the new section 405 provides that, for purposes of section 405, the term "employee" includes an individual who is an employee within the meaning of section 401(c)(1), and the employer of such individual shall be the person treated as his employer under section 401(c)(4). Such subsection (f) has the effect of enabling the self-employed individual to participate in a qualified bond purchase plan to the same extent that he may participate in qualified pension, annuity and profit-sharing plans.

Section 405(g)

Subsection (g) of the new section 405 provides that, at the time of the purchase of any of the bonds described in section 405, proof of such purchase shall be furnished in such form as will enable the purchaser, and the employee in whose name such bond is purchased, to comply with the provisions of section 405.

Section 405(h)

Subsection (h) of the new section 405 provides that the Secretary or his delegate shall prescribe such regulations as may be necessary to carry out the provisions of section 405.

SECTION 6. PROHIBITED TRANSACTIONS

Section 6 of the bill amends section 503 of the Internal Revenue Code of 1954 to provide a special definition of the term "prohibited transaction" in the case of certain qualified employees' trusts covering owner-employees. This special definition is only applicable when the owner-employees covered by the qualified employees' trust, control the trade or business with respect to which the trust is established.

Section 6 of the bill adds to section 503 a new subsection (j) which provides that, in the case of a trust described in section 401(a) which is part of a plan covering owner-employees (as defined in sec. 401(c)(3)) who control the trade or business with respect to which the plan is established, the term "prohibited transaction" means, in addition to the transactions described in section 503(c), any transaction in which such trust, directly or indirectly—

(A) Lends any part of the corpus or income of the trust to;

(B) Pays any compensation for personal services rendered to the trust to;

(C) Makes any part of its services available on a preferential basis to; or

(D) Acquires for the trust any property from, or sells any property to;

any person described in section 503(c) or to any such owner-employee, a member of the family (as defined in sec. 267(c)(4)) of any such owner-employee, or a corporation controlled by such owner-employee through the ownership, directly or indirectly, of 50 percent or more of the total combined voting power of all classes of stock entitled to vote or 50 percent or more of the total value of shares of all classes of stock of the corporation.

For purposes of determining whether owner-employees covered under a qualified employees' trust control the trade or business with respect to which such trust is established, the rules in section 401(d)(8)(B), determined with the application of the rules of constructive ownership in section 401(c)(5), shall be applied.

Paragraph (2) of the new subsection (j) provides that, for purposes of the new definition of "prohibited transaction" in paragraph (1), the following rules shall apply with respect to a loan made before the date of the enactment of the bill which would be a prohibited transaction if made in a taxable year beginning after December 31, 1960:

(A) If any part of the loan is repayable prior to December 31, 1963, the renewal of such part of the loan for a period not extending beyond December 31, 1963, on the same terms, shall not be considered a prohibited transaction.

(B) If the loan is repayable on demand, the continuation of the loan beyond December 31, 1963, shall be considered a prohibited transaction.

SECTION 7. OTHER SPECIAL RULES, TECHNICAL CHANGES, AND ADMINISTRATIVE PROVISIONS

Section 7 of the bill provides certain technical amendments and administrative provisions.

Section 7(a) of the bill amends section 37 of the Internal Revenue Code of 1954, relating to the retirement income credit, to make clear that any distribution to a self-employed individual under a qualified pension, annuity, or profit-sharing plan, and that any income derived by any person from the bonds described in section 405(b) received under a qualified bond purchase plan or from a qualified trust, may qualify as retirement income for purposes of such credit.

Section 7(b) of the bill amends section 62 of the Internal Revenue Code of 1954, relating to the definition of "adjusted gross income", to provide that, in computing adjusted gross income, there shall be allowed, in the case of a self-employed individual, the deductions allowed under sections 404 and 405 for contributions on behalf of such an individual to a qualified pension, annuity, profit-sharing, or bond-purchase plan.

Section 7(c) of the bill amends section 101(b) of the Internal Revenue Code of 1954, relating to employees' death benefit. Paragraph (1) of section 7(c) amends section 101(b) so that the rule applicable to distributions under a qualified annuity plan will only apply if the annuity plan meets the new qualification requirements of section 401 (a) and (d) applicable to annuity plans.

Paragraph (2) of section 7(c) amends section 101(b) by adding a new paragraph (3), which provides that for purposes of section 101(b), the term "employee" does not include an individual who is an employee within the meaning of section 401(c)(1) (relating to self-employed individuals). Thus, if at the time of his death, a self-employed individual is a participant in a qualified pension, annuity, or profit-sharing plan and after his death a distribution is made to his beneficiary, the exclusion of section 101(b) is not applicable to any portion of such distribution even though such individual was at one time an employee of the trade or business and a portion of the distribution is attributable to contributions which were made while he was an employee. Similarly, the exclusion of section 101(b) is not applicable to any portion of a distribution from such a qualified plan on behalf of an individual who was retired at the time of his death and who at the time of his retirement participated in the plan as a self-employed individual.

Section 7(d) of the bill amends section 104(a) of the Internal Revenue Code of 1954, relating to compensation for injuries or sickness, to make clear that the exclusion of such section is not applicable to any benefits which are attributable to contributions to a qualified pension, annuity, profit-sharing, or bond purchase plan on behalf of an individual while he was a self-employed individual to the extent that such contributions were deductible under section 404 or 405.

Section 7(e) of the bill amends section 105 of the Internal Revenue Code of 1954, relating to amounts received under accident and health

plans, by adding a new subsection (g) which provides that, for purposes of section 105, the term "employee" does not include an individual who is an employee within the meaning of section 401(c)(1) (relating to self-employed individuals). For example, if at the time an individual commences to receive benefits described in section 105 from a qualified pension plan, he is covered under such plan as a self-employed individual, such benefits do not qualify for the exclusion of section 105.

Section 7(f) of the bill amends section 172(d)(4) of the Internal Revenue Code of 1954, relating to net operating loss deductions, to make clear that any deduction under section 404 or 405 attributable to contributions on behalf of a self-employed individual under a qualified employees' plan shall not be treated as attributable to the trade or business of such individual for purposes of section 172.

Section 7(g) of the bill makes conforming amendments to section 805 of the Internal Revenue Code of 1954, relating to pension plan reserves of life insurance companies.

Section 7(h) of the bill amends section 1361 of the Internal Revenue Code of 1954, relating to unincorporated business enterprises electing to be taxed as domestic corporations, to permit a partner or proprietor of such an unincorporated business to participate in a qualified pension, annuity, profit-sharing, or bond-purchase plan. However, for purposes of applying all the provisions relating to such qualified plans, such a partner or proprietor shall be considered a self-employed individual and will be considered an employee only to the extent he is so considered under section 401(c)(1).

Section 7(i) of the bill amends section 2039 of the Internal Revenue Code of 1954, relating to exemption from gross estate of annuities under certain trusts and plans. Paragraph (1) of section 7(i) amends section 2039(c)(2) to provide that the exclusion of the value of an annuity under a qualified annuity plan will be applicable only if the annuity plan meets the additional qualification requirements of sections 401 (a) and (d). Paragraph (2) of section 7(i) amends section 2039(c) by adding at the end thereof a new sentence which provides that, for purposes of section 2039(c), contributions or payments on behalf of the decedent while he was an employee within the meaning of section 401(c)(1) made under a qualified pension, annuity, or profit-sharing plan be considered to be contributions or payments made by the decedent. Accordingly, the estate tax exclusion of section 2039(c) is not applicable to the portion of a decedent's interest in a qualified plan which is attributable to contributions on behalf of an individual while he was a self-employed individual.

Section 7(j) of the bill amends section 2517 of the Internal Revenue Code of 1954, relating to exclusion from gift tax in case of certain annuities under qualified plans, in the same manner as section 7(i) of the bill *amends* the estate tax exclusion with respect to qualified plans.

Sections 7 (k) and (l) of the bill amend section 3306(b)(5) of the Internal Revenue Code of 1954 (relating to the Federal Unemployment Tax Act) and section 3401(a)(12) of such Code (relating to the withholding of income tax). These amendments make conforming changes and exclude from the definition of "wages" under such sections any payment made to, or on behalf of, an employee or his beneficiary, under or to a bond-purchase plan which, at the time of such payment, is a qualified bond-purchase plan described in section 405.

Section 7(m) of the bill amends the Internal Revenue Code of 1954 to add a new section 6047, giving the Secretary or his delegate authority to require the furnishing of additional information which is necessary to administer the new provisions in this bill.

SECTION 8. EFFECTIVE DATES

Section 8 of the bill provides the dates on which the amendments made by this bill will be applicable.

(*a*) *Trusts and plans of unincorporated employers.*—Under section 8 (a) and (d) of the bill, the amendments made by the bill are applicable for taxable years beginning after December 31, 1960, to all trusts or plans of an employer which is not a corporation. In other words, in the case of a trust or plan of such an employer, all the amendments made by the bill (including those in sec. 401(a) which apply to a trust or plan whether or not it covers an owner-employee) are effective for taxable years beginning after December 31, 1960, even though such trust or plan constituted a qualified trust or plan on December 31, 1960.

(*b*) *Trusts and plans of corporate employers which are qualified on December 31, 1960.*—Section 8(b) of the bill provides the dates on which the following sections of the bill are effective with respect to pension, annuity, stock bonus, and profit-sharing plans of corporate employers which are qualified plans on December 31, 1960:

(1) Section 2, relating to requirements for qualification,

(2) Section 3, relating to deductibility of contributions to qualified plans,

(3) Section 4, relating to taxability of distributions under qualified plans, and

(4) Section 6, relating to prohibited transactions.

Such sections 2, 3, 4, and 6 of the bill are generally applicable to such trusts or plans for taxable years beginning after December 31, 1963. However, if such a trust or plan should fail to qualify for a taxable year beginning on or before December 31, 1963, then such sections are applicable for the year in which the trust or plan so fails to qualify and all succeeding taxable years. In addition, even though a trust or plan established by a corporate employer is a qualified trust or plan on December 31, 1960, and retains such qualified status in succeeding years, the new paragraphs (7), (8), and (9) of section 401(a) (which are added by sec. 2(2) of the bill) are applicable to such a trust or plan with respect to taxable years beginning after December 31, 1960, except so much of paragraph (8) of section 401(a) as requires any distribution to an owner-employee before he retires. For purposes of applying the effective date rules in section 8(b) of the bill to foreign situs trusts, such trusts are considered to be qualified trusts if they are so considered under section 402(c), that is, if they would qualify for exemption under section 501(a) except for the fact that they are trusts created or organized outside the United States. The effective dates in section 8(b) of the bill apply to trusts and plans of all corporate employers (including corporations described in sec. 8(c)(3)(A) of the bill and associations described in sec. 8(c)(3)(B) of the bill).

(*c*) *Trusts and plans of corporate employers which are not qualified on December 31, 1960.*—Section 8(c) of the bill provides the date on which sections 2, 3, 4, and 6 of the bill are effective with respect to trusts or plans of corporate employers which are not qualified trusts

or plans (or which are not established) on December 31, 1960. In general, such sections are applicable to such trusts or plans for taxable years beginning after December 31, 1960. However, the following provisions of the bill which relate to the making of vested contributions for employees, are applicable to trusts and plans of corporations (other than corporations described in section 8(c)(3)(A) of the bill and associations described in section 8(c)(3)(B) of the bill) only with respect to taxable years beginning after December 31, 1963:

(A) Section 401(d)(2)(A), relating to the requirement that profit-sharing plans covering owner-employees must provide complete vested rights for all employees under the plan;

(B) So much of section 401(d)(4) (relating to integration of plans with social security) as relates to nonforfeitable contributions on behalf of employees;

(C) So much of section 404(e)(2)(B) (relating to an alternate limitation applicable to corporate owner-employees) as requires nonforfeitable contributions on behalf of employees; and

(D) Section 404(e)(3), relating to the inapplicability of certain limitations when some or all of the employees' contributions are forfeitable.

In other words, except in the case of a trust or plan of a corporation with respect to which an election under section 1372 is in effect or of an unincorporated association which is engaged in a trade or business in which professional services is a material income-producing factor, the vesting requirements included in the bill are not applicable to trusts or plans of corporate employees until taxable years beginning after December 31, 1963, even though such trusts or plans were established after December 31, 1960, or, if established before December 31, 1960, did not qualify on such date. In the case of a trust or plan of such a corporation with respect to which an election under section 1372 is in effect or of such an association, all vesting requirements are effective for taxable years beginning after December 31, 1960, if such trust or plan was established after December 31, 1960, or failed to qualify on such date.

The application of the effective date rules in section 8(c) of the bill may be illustrated by the case of a corporation (other than a corporation described in section 8(c)(3)(A) or an association described in section 8(c)(3)(B)) which establishes, after December 31, 1960, a profit-sharing plan covering owner-employees. In order to constitute a qualified plan, this profit-sharing plan would have to meet all the new requirements in section 401 (a) and (d) (except insofar as they require vested rights for employees) for all taxable years. Similarly, deductions for contributions under the plan on behalf of owner-employees would be subject to the special limitations in the new section 404(e) (applied without the vesting rules). The plan would, however, be subject to the vesting requirements in the bill only with respect to taxable years beginning after December 31, 1963. Thus, for taxable years beginning before January 1, 1964, the profit-sharing plan could qualify under section 401 although some or all of the contributions under the plan on behalf of employees were forfeitable at the time they are made. For taxable years beginning after December 31, 1963, however, the plan would qualify under section 401 only if, pursuant to section 401(d)(2)(A), the contributions under the plan on behalf of employees were vested at the time they are made.

Similarly, for taxable years beginning before January 1, 1964, contributions under the plan could, under section 401(d)(4), be integrated with the social security system for any year in which the deductible contributions on behalf of owner-employees do not exceed one-half of the amounts deductible for that year with respect to contributions (either forfeitable or nonforfeitable) on behalf of employees (other than owner-employees). On the other hand, in the case of a taxable year beginning after December 31, 1963, integration with the social security system would be permissible under section 401(d)(4) only if the deductible contributions on behalf of the owner-employees for that year do not exceed one-half of the amounts deductible for that year with respect to nonforfeitable contributions on behalf of employees (other than owner-employees). In addition, the limitations in section 404(e) would be applicable for all taxable years for purposes of determining the amount that may be deducted with respect to contributions under such plan on behalf of owner-employees. However, for a taxable year beginning before January 1, 1964, the limitation described in section 404(e)(2)(B) with respect to an owner-employee would be an amount equal to such owner-employee's proportionate share of the amount deductible under section 404 for such taxable year for contributions (whether or not vested) on behalf of employees (other than owner-employees).

(*d*) *Amendments made by sections 5 and 7 of the bill.*—Section 8(d) of the bill provides that the amendments made by section 5 of the bill (relating to qualified bond purchase plans) and section 7 of the bill (relating to other special rules, technical changes, and administrative provisions) are applicable with respect to taxable years beginning after December 31, 1960.

VI. CHANGES IN EXISTING LAW

In the opinion of the committee, it is necessary, in order to expedite the business of the Senate, to dispense with the requirements of subsection 4 of rule XXIX of the Standing Rules of the Senate (relating to the showing of changes in existing law made by the bill, as reported.)

MINORITY VIEWS ON H.R. 10

H.R. 10 should not be passed.

It would allow the self-employed a tax deduction of 10 percent up to $2,500 per year for funds set aside for a pension.

This privilege is asked for in the name of tax "equality." But we have found that under present pension plans very few receive a similar benefit. This bill would give the self-employed special privileges.

Under H.R. 10 the self-employed receive a tax deduction on the funds they set aside. Under almost all other plans, the individual pays the income tax on the money he sets aside.

If the benefits of the bill were extended to all citizens, as will inevitably be demanded with justice, and the principle applied to other equally deserving individuals, it would cost $3 billion per year in lost revenues.

This would convert the income tax from a tax on income to a tax on consumption. Savings would be exempt from taxation. The higher the income the higher both the absolute and proportional amounts of savings. Such a principle would throw an unfair burden of taxation on lower income groups or those who can afford either little or modest savings.

Because of the great tax favors for the beneficiaries from the bill, the Treasury has greatly underestimated the anticipated loss in revenues. More will use the bill than the Treasury estimates.

While everyone would like a tax deduction, this group has no special claim to a tax deduction of 10 percent of their income up to $2,500 per year when compared with other groups who pay taxes. This is especially true when the present personal exemption is only $600 per person.

The proper way to proceed would be to close existing loopholes in the pension laws rather than to attempt to extend or to universalize them.

The revenue lost by this bill would have to be paid for either by higher taxes on those who do not get the relief or by floating Government bonds in order to make up for the loss in revenue. This would add to the national debt.

As the bill is complex and would provide an entirely new principle of taxation, we believe that it should not be brought up at this late date in the session. If it is brought up, it should be considered very carefully, for a major principle of taxation is at stake.

PAUL H. DOUGLAS.
EUGENE J. MCCARTHY.
RUSSELL B. LONG.
ALBERT GORE.

INDIVIDUAL VIEWS OF SENATOR RUSSELL B. LONG AND SENATOR EUGENE J. McCARTHY

H.R. 10 has been advanced as a bill designed to remove inequities in present tax laws relating to pension and retirement plans. In the name of equity, H.R. 10 proposes to allow the self-employed to set aside out of earned income in any year approximately 10 percent of that income, up to a maximum of $2,500.

H.R. 10, however, does not establish equity between the self-employed and employees now included in other pension plans, and it creates new inequities.

1. It gives a more favorable treatment to a small group than that which is presently available to employees covered by private pension plans, a group which itself is a minority of our working force.
2. It makes no provision for the majority of our workers, some 42 million who are not covered by any pension plan, and in fact it increases the discrimination against them.
3. Among the self-employed themselves it provides tax treatment which is limited to those who invest their savings in pension or retirement programs.

H.R. 10 excludes from current taxation the entire amount of the contribution made by the self-employed in the year in which that contribution is made. In all other plans, including private pension plans qualifying under the Internal Revenue Code—civil service retirement, State and local governmental retirement programs, railroad retirement, and social security, the employee's contribution is taxed in the year in which it is made.

In private pension employee plans, vesting rights prior to retirement are very limited. Most employees obtain no rights to the pension income until retirement. It is absurd to say that an employee gets a tax advantage by deferring the receipt of income in which he does not have a vested interest.

The bill, H.R. 10, creates new inequities. In operation it will not apply equally to all self-employed persons. The benefits provided under the bill arise from financial investments for retirement from stocks and bonds, insurance policies, and annuities.

The farmer or the small businessman is interested in further investment in his business. Such investment, he expects, will help provide for his retirement. When he reaches retirement age he will have an investment from which he could receive income in rent or profits, or which he could sell in order to obtain money with which to make financial investments. In some respects this bill discourages reinvestment in small business. The farmer or the small businessman who wants to buy more plant and equipment will find that this kind of saving or investment is not eligible for favorable tax consideration. The person who wishes to provide for his old age by investing in a house is denied any such reduction.

Although there are approximately 7 million self-employed persons who are qualified to come under the provisions of H.R. 10, it is esti-

mated that only about 2 million will take advantage of its provisions. These 2 million would have the advantage of tax deductions estimated at as much as $250 million a year. Theoretically, this is a tax deferment, but experience with tax deferment proves rather conclusively that in most cases tax deferment results in tax reduction or tax avoidance.

H.R. 10 does nothing for approximately 42 million American workers who are not included in any pension program, private or governmental, other than social security. If H.R. 10 is passed, we must expect that those citizens of the United States who are not granted the same privilege will demand concessions in the name of equity and justice. The extension of the provisions of H.R. 10 to people now covered under these programs would result in an estimated additional revenue loss of $1,370 million a year, and the extension of this privilege to those not now included in any retirement program would bring the total revenue loss up to in excess of $3 billion a year.

If the Congress is to take action which leads to tax equity and uniformity, it should either close loopholes and eliminate special privileges in the pension field in order to achieve uniformity, or should undertake to achieve it by extending the advantages of H.R. 10 to everyone.

The bill continues a dangerous procedure which has been manifest in recent years. According to this procedure, decisions of the Congress are based upon arguments advanced by individual taxpayers or by organizations who argue that they are not getting the same benefits as other taxpayers in what are alleged to be identical situations. In most cases the situations in the first place are not identical. In the second step, the Congress accepts that when the situations are similar, the solution is to be found in giving the petitioning group something like the favorable treatment against which they protest, instead of removing or reducing the special advantages. The principle seems to be that if inequity is extended, justice is achieved, when, in fact, by multiplying and increasing the impact of special privilege, the burden of taxation is simply shifted to citizens who pay other taxes or as a result of forced deficit financing, shifted to the general public through inflation.

The bill reflects also a second dangerous trend in tax policy which, if allowed to continue, will make the general individual income tax no longer a tax on current income, but a tax on consumption, excluding from taxation that portion of current income which can be saved or set aside. The advantage of this practice to those in the high income brackets is obvious.

The Finance Committee amendments to H.R. 10 have modified some of the most glaring weaknesses of the House bill in that these amendments make some provision for employees of a self-employed proprietor or partner and will curb some of the abuses in the pension plans and provisions in very small corporations where the largest part of the benefits go to stockholder employees.

In the course of the years, the field of private corporate pension plans has been shown to be one in which there are glaring and inexcusable tax loopholes and special advantages. Treasury representatives pointed out many examples of inequity and tax favoritism in the corporate pension plans and made a number of proposals directed toward eliminating loopholes and tightening existing provisions of the

law. Perhaps the most significant ones were the Treasury recommendations that the highly discriminatory capital gains treatment, now available on lump-sum distribution under existing qualified pension plans, be eliminated, and also the Treasury suggestion that we look into the serious question of vesting rights in private pension plans. The committee rejected most of these recommendations either in whole or in part.

In the name of fiscal responsibility, efficient administration, equity, and justice, H.R. 10 should not be passed in its present form by this Congress.

RUSSELL B. LONG.
EUGENE J. MCCARTHY.

INDIVIDUAL VIEWS OF SENATOR PAUL H. DOUGLAS

I. SUMMARY

H.R. 10 would provide very great tax benefits to a relatively small group of people—namely, doctors, lawyers, and other self-employed people. Those who could take full advantage of this special-benefit legislation, moreover, are in little need of Government aid because they are among the most favorably situated people in the country. The bill would lose the Treasury several hundred million dollars a year if its benefits could be confined to just the self-employed individual. However, the loopholes it would create on behalf of the self-employed would be so great that simple justice would require giving similar benefits to others. If everyone were to get similar treatment, the revenue loss would exceed $3 billion.

The purpose of this bill is to exempt the savings of the self-employed person from income taxation. This objective is directly contrary to the basic principle of a good income tax which is based on the total income of the taxpayer, without reference to the source of the income or the way in which it is used. If the principle of this bill were universalized, it would change the character of the Federal individual income tax from an ability-to-pay tax on income to a tax on consumption. It would reduce progression in the income tax because savings would be exempt from taxation. Those who are in a position to save a large proportion of their incomes, the upper income groups, would benefit while the lower income groups would be required to assume a greater share of the total tax burden.

The bill would moreover introduce a very strong bias in favor of the limited types of personal investment of savings for retirement which it spells out. It would, therefore, substitute tax considerations for sound financial judgment in personal investment plans. The financial benefits provided by the bill are very great, much greater than generally appreciated.

If the bill passes, there is no just reason why its benefits should not be made available to all taxpayers. Indeed, the history of the loopholes in the Federal income tax offers persuasive evidence that the provisions of this bill would, before very long, be made universally applicable.

Instead of opening up a new loophole in the tax law, we should close the existing loopholes in the treatment of pension plans. This bill, however, makes a huge start toward expanding and worsening a loophole in the present law.

II. PROVISIONS OF THE BILL

The provisions of H.R. 10 have been detailed in the committee report. Briefly, the bill would permit self-employed persons (including owner-employees of corporations) to deduct from their taxable incomes amounts they set aside in restricted retirement funds. The deduction in any one year could not, in general, exceed 10 percent of the self-employed person's earnings from his employment or $2,500,

whichever is less. Upon retirement, the self-employed person would be taxable on amounts distributed from the fund; if these amounts are distributed in a lump sum, a type of averaging would be used in figuring the tax which would serve to keep the distribution from being taxed at a high marginal rate. The owner-employee would continue to enjoy capital gains treatment on lump-sum distributions, as he does under present law.

The self-employed person, in other words, would be granted the privilege of deferring the income tax on up to 10 percent of his earnings during his high income years. He would be taxable on his retirement income only at a lower rate, if at all, during his retirement.

The committee's bill includes some provisions aimed at eliminating abuses of the present law by owner-employees of corporations. These provisions should be separated from H.R. 10 and enacted. They would close some of the more flagrant loopholes now in the law, although more basic revision is necessary if the tax treatment of retirement plans is to be conformed to the principles of a good income tax.

III. ALLEGED JUSTIFICATION FOR H.R. 10

The proponents of this bill argue that its aim is only to provide the self-employed person with the same opportunities to defer taxes on income set aside for retirement which are now enjoyed by employees who are covered by pension plans financed in whole or in part by their employers. According to this argument, the self-employed person is discriminated against under present law because any of his income which he sets aside for his retirement is fully taxable. The employee, however, has contributions to a retirement fund set aside on his behalf by his employer; the employee does not take these contributions into his income at the time they are made, even though his employer claims a deduction for them. Instead, the employee is required to include in his income only the benefits he ultimately receives from the retirement fund, usually when his total income is lower and therefore taxable at a lower rate, or not taxable at all.

It is perfectly true that the present law does indeed make possible some duch discrimination. An employee who eventually does receive retirement benefits from a private retirement plan will have paid lower taxes on his earnings and retirement income than a self-employed person with the same amount of earnings and retirement income over the same period. The present law, in other words, does afford favorable tax treatment to the employee if he remains in a job covered by an employer-financed plan until his retirement and can, therefore, claim the retirement benefits his employer's contributions have built up on his behalf.

This is a large "if," however. As a matter of fact, private retirement plans can be financed at as low a cost as they are primarily because only a small proportion of the employees eventually receive these retirement benefits. Most lose out because they change jobs, or otherwise fail to obtain vested rights in the retirement fund. Most pension plans provide the employee with secure rights in retirement benefits only after he has completed an appreciable number of years of service with the employer, or has reached a certain age, or meets both of these conditions. In the vast proportion of cases, these vesting requirements are too severe for the majority of blue-collar

workers to obtain full pension benefits; executives, on the other hand, more easily meet these requirements.

These employer-financed plans, therefore, involve deductible contributions by the employer for many more employees than eventually draw benefits, because the employee does not have nonforfeitable rights in his employer's contributions to a retirement fund on his behalf. In 1959, for example, employer contributions to corporate pension funds (excluding those administered by insurance companies and unions and funds of nonprofit organizations) were $2.629 billion, and employee contributions were $354 million. In contrast with this total of $2.983 billion in contributions, benefits paid out were only $858 million, or only 28.8 percent of contributions. (Source: Securities and Exchange Commission, Statistical Series, release 1680, May 31, 1960, table 5.)

Constructive reform of the present law does not call for extending this favorable treatment, now given to a few other individuals. On the contrary, the proper way to remove the discrimination is by requiring the employee to include in his income his employer's contributions on his behalf to a private retirement fund, and to do so in the year in which the contribution is made. Upon retirement, the benefits received from the retirement plan would be taxable only to the extent that they exceeded the contributions. Moreover, the law should also be changed to permit the employer to deduct his contributions to a retirement plan on behalf of his employees only to the extent that these contributions are included in the employees' current income. Of course, to do this it would be necessary to give the employee a nonforfeitable right in his employer's contributions. Indeed, this full vesting of rights in the employee should, in my judgment, be made a condition for the qualification of pension trusts for tax exemption.

If this type of reform were undertaken, there would be no discrimination, even to the limited extent that now exists, between employees and the self-employed. Moreover, by requiring the vesting of nonforfeitable rights in the employees, the present deterrent to changing jobs arising from the fear of losing retirement benefits would be eliminated. Finally, constructive reform along these lines would expand the tax base and materially strengthen the income tax and the Federal Government's fiscal position.

H.R. 10, on the other hand, would extend the present tax favors to a group of favorably situated individuals. It would lose revenue, weaken the income tax and the Government's fiscal position.

IV. H.R. 10 WOULD DISCRIMINATE IN FAVOR OF THE SELF-EMPLOYED

The worst feature of the bill is that it would go far beyond eliminating the present tax differential between the employee and the self-employed. In fact, it would provide the self-employed person with tax benefits which very few, if any, employees are able to obtain.

The basic reason for this is that the self-employed individual would have a completely vested, nonforfeitable right in his contributions on his own behalf which virtually no employee has under present law or would have under H.R. 10. The self-employed person's retirement fund would go with him wherever he went. Moreover, subject only to a modest penalty, it would always be available to him; that is, the self-employed person could always withdraw sums from his re-

stricted retirement fund or deposit, if he were willing to pay a slight additional tax.

Practically no employee now enjoys similar rights under present law, even under so-called vested plans, nor would an equal privilege be provided the employee under H.R. 10. Neither the Internal Revenue Code nor the income tax regulations explicitly define an employee's "nonforfeitable" rights. In practice, however, even under the most liberal plans, the employee has no access to the contributions made on his behalf by his employer—on which tax is deferred—until he begins to receive retirement benefits. If he leaves his job before retirement, he may, under the more liberal plans, retain rights to retirement benefits when he reaches the specified retirement age. He cannot, however, withdraw the contributions made on his behalf by his employer, as the self-employed individual could under H.R. 10.

Moreover, most retirement plans specify a number of conditions, such as length of employment, as well as age, which the employee must meet to be eligible for retirement benefits, even when rights are vested in him. No such condition would apply to the self-employed person under H.R. 10, even though the bill would allow the full tax benefits to the self-employed person only if he met the specified conditions. Nevertheless, he would have unlimited access to his retirement funds at any age and at any time, subject only to a modest tax penalty if he withdrew the funds prior to reaching the age of 59½.

This fundamental inequity of H.R. 10 was recognized even by the Treasury Department, although tardily and halfheartedly. This recognition was expressed by the Treasury, unfortunately, very late in the legislative progress of H.R. 10. For example, in his letter of February 16, 1959, to the chairman of the Committee on Ways and Means, Mr. David A. Lindsay, assistant to the Secretary of the Treasury, expressed the Department's objection to the bill as based on the revenue loss it would entail, rather than on the grounds that it would open a new and large loophole for a privileged group. It was only after the bill had passed the House and was presented to the Committee on Finance that the Treasury's opposition to the bill took on a more concrete form in the spelling out of an alternative proposal. Even then, and recognizing the shortage of time and the large volume of other business facing the committee, the Treasury did not come up with a draft of their alternative proposal in the statutory form which was necessary if the committee were to handle the bill expeditiously.

What is even more discouraging is that the Treasury's alternative proposal will not effectively deal with the basic discrimination in favor of the self-employed, as compared with the employee, which H.R. 10 would introduce into the law. For all of the elaborate rules which the committee's and the Treasury's staff were able to put together, the basic tax preference for the self-employed individual remains in the bill, because it is inherent in the whole approach and tenor of the bill. All that the modifications would do, in fact, is to limit some of the more flagrant abuses in the present law and which would otherwise be possible in H.R. 10. Even so, so long as the bill takes the form of extending the present law's provisions for deductible allowances for retirement to the self-employed, the self-employed will be favored in comparison with the employee.

It is also discouraging that only under the pressure of the additional revenue loss involved in H.R. 10 would the Treasury call to the

attention of the committee a flagrant abuse of existing law, the opportunity which the present statute affords owner-employees of corporations to derive extraordinary pension benefits at the Treasury's expense. Individuals who own substantial amounts of stock in companies in which they also serve as officers have set up liberal pension plans primarily for their own benefit. By virtue of their ownership of the company, the company's contributions to the pension plan on their behalf give them significantly more secure rights in the pension benefits than are enjoyed by other employees who do not have an ownership link to the company. Cases were brought to the committee's attention in which owner-employees were covered under the plans of numerous companies, in each of which they owned substantial interests. The amount of the tax benefits involved in such arrangements is so great as to set up a very strong inducement for partnerships and other noncorporate associations to elect to be treated as corporations, under subchapter S of the Internal Revenue Code, for the primary purpose of providing tax-favored pension arrangements for the owners of these businesses.

It is regrettable that the Treasury has not sought to close this loophole long ago. Instead, it offers proposals for its correction only in connection with H.R. 10 which would extend similar tax favors to self-employed persons who are reluctant, for various reasons, to take advantage of subchapter S. Had the Treasury sought and fought for corrective legislation to deal with the corporate owner-employee situation long ago, specifically in connection with the Revenue Act of 1954, the pressure for new gimmicks, such as the subchapter S provisions and H.R. 10, would have been substantially less and very likely of minor consequence.

Since H.R. 10, or a similar bill, has been actively before the Congress for several years past, one would have thought that the Treasury Department would, long since, have prepared a full analysis of the bill and would have had ready its alternative proposals. The Treasury's performance in connection with H.R. 10, however, suggests that its efforts to forestall this unjust revenue-losing measure have been halfhearted, at best.

This failure to act in the past is further evidence of the administration's disinclination to face up to the need for constructive tax reform by removing the special privileges now in the law until extension of those privileges to new groups of taxpayers threatens to become too expensive in an election year when a favorable budget picture is desired for political reasons.

The specific proposals in the committee's bill for curbing the tax favors now enjoyed by corporate owner-employees will go a long way toward improving the situation in this area. They should be separated from H.R. 10 and enacted promptly.

V. H.R. 10'S TAX BENEFITS

We find it hard to believe that H.R. 10 would have progressed legislatively as far as it has had the magnitude of the tax benefits been fully appreciated.

The major force behind this bill has come from doctors, lawyers, and accountants. These professions are among the most honorable and, deservedly, well rewarded, in our country. In 1955, for example, the average annual income of all doctors was $18,122 and of family

physicians, $15,000. In 1954, the average annual income of lawyers was $10,258. In 1958, the average annual income of senior accountants was between $8,000 and $10,000. Today these averages are even higher.

These amounts are averages, which means that a substantial number of the individuals in these professions have incomes in excess of these amounts. For example, in 1957 almost a third of the tax returns filed by proprietorships in the field of medical and other health services showed net profits from the business of more than $20,000. H.R. 10, in other words, has been promoted by and on behalf of individuals whose economic and financial position is very favorable compared to taxpayers as a whole. Certainly they are much better off than most employees covered by pension plans.

The extraordinary financial and tax benefits in H.R. 10 may be illustrated in the case of a self-employed person with net earnings of, say, $20,000 a year. If he invests 10 percent of his earnings each year for, say, 20 years in a restricted retirement fund, he will have claimed tax deductions totaling $40,000 while he has built up a retirement fund amounting, with accumulated interest, exempt from current tax, at, say, 3 percent, to $55,353. But this latter amount is only part of the savings he will have been able to accumulate. Each of his annual deductions of $2,000 will have reduced his tax by $940 (assuming he has no other income, is married with two children, and his itemized personal expenses are 10 percent of his net earnings). In other words, each year's deposit of $2,000 into a restricted retirement fund, involving no relinquishment of the $2,000 nor even any risks in its investment, increases his *aftertax income* by $940 or *47 percent* of his annual investment. Any other type of investment providing the same aftertax return in a year would have to yield 88.7 percent before tax. Therefore, this taxpayer not only accumulates the $55,353 in the retirement deposit but, in addition, $940 a year plus the aftertax interest earnings on this sum from the tax reduction which H.R. 10 saving affords him. After 20 years, the accumulated sum of the $940 annual increase in aftertax income, with interest at 3 percent, would amount to $23,220. By the time the 20 years were up, in other words, the taxpayer would have accumulated $78,570 on an investment of $40,000. In some other form of saving to which the H.R. 10 privileges did not apply, he would have to obtain an annual yield of 12.1 percent, before income tax, on his $2,000 annual investment to build up an equal amount.

For eligible individuals with higher earnings during their years of self-employment, the effective rate of return afforded on restricted retirement funds under H.R. 10 would be even greater. The astonishing thing to us is that with such large earnings on the virtually riskless investments specified in H.R. 10, the Treasury, in estimating the revenue loss this bill would involve, could assume that any eligible individual would not take full advantage of the deduction each year. It is clear that a much larger percentage of the self-employed would take advantage of the privilege than the Treasury assumes.

For the self-employed person, favorable tax treatment is also provided for lump-sum withdrawals from the retirement fund after age 60. Instead of computing the tax in the ordinary way, the self-employed beneficiary of H.R. 10 would have a form of averaging which moderates the effect of the graduation of tax rates. His tax would be determined

by dividing the amount received by five, computing the tax on that amount, and multiplying the result by five.

For example, suppose the amount the self-employed person receives as a lump-sum payment from his retirement fund is $100,000 (over and above his personal exemptions and deductions). If the tax were computed in the ordinary way, it would amount to $67,320 (on a separate return). Under the method provided in H.R. 10, however, the tax would be $36,300. This saves him $31,020, or 46.1 percent of what his tax ordinarily would be. In other words, not only would the self-employed person have the benefit, under H.R. 10, of deferring tax on a substantial amount of his earnings during his high-income, high-tax-rate years, he also gets a much reduced tax when he draws out his retirement funds.

The corporation owner-employer is treated even more favorably under present law, and his preferential tax position is protected under H.R. 10. The owner-employee receives capital gains treatment on lump-sum distributions from his retirement fund; that is, his benefits are taxable at a maximum rate of 25 percent. His tax on a $100,000 lump-sum distribution does not exceed $25,000. This is $42,320, or 62.9 percent less than it would be if these retirement benefits received ordinary income tax treatment.

Tax favors of this magnitude, if they are to be dispensed at all, should have some overwhelming public purpose behind them. H.R. 10 amounts to a highly regressive, concealed, indirect subsidy for the self-employed. If the subsidy were to be offered openly, and for some important public purpose, one can imagine the horrified screams about Government intervention which would come from the professional societies.

VI. EXTENSION OF BENEFITS OF H.R. 10 TO OTHER TAXPAYERS

Constructive reform of the tax law regarding provision for retirement, as already indicated, calls for eliminating the undue benefits in the present law, rather than extending them, greatly magnified, to certain favored individuals. Our first efforts, when H.R. 10 reached the Finance Committee, was to offer a substitute which would have required (1) vesting nonforfeitable rights in the employee as a condition for qualification of employer's pension plans, (2) the inclusion by the employee in his current taxable income of amounts contributed on his behalf by his employer to a private retirement plan, and (3) allowing the employer to deduct such contributions only to the extent they were included in the employee's income currently. This type of change in the law would eliminate any tax bias between the self-employed and the employee.

The committee chose, however, to accept the Treasury's proposals which would extent the benefits of present law to self-employed persons. Despite efforts to eliminate the more flagrant abuses of the House version of the bill, the Finance Committee's version nevertheless would provide very substantial tax and financial advantages to the eligible self-employed person which would not be available to other taxpayers.

If H.R. 10 is to be enacted, simple justice demands that its benefits be made available to all taxpayers, not merely a select few.

If H.R. 10 is to be enacted, every taxpayer, not just the self-employed, should be given the right to set aside tax-free up to 10 percent of his earnings.

It might be objected that many employees are now covered by pension plans. As pointed out above, however, few if any of these employees enjoy the nonforfeitable, vested rights in the contributions to retirement plans made on their behalf which would be given the self-employed individual under the provisions of H.R. 10.

To the extent that an employee in fact does have such nonforfeitable rights, the deductible contribution to a restricted retirement fund which he would be allowed to make under this proposal each year would be reduced by the amount of the contribution on his behalf in which his rights are nonforfeitable. For example, an employee enjoying nonforfeitable rights in an employer-financed retirement plan in which the employer's annual contribution on his behalf is, say, 7 percent of the employee's earnings, would be permitted to deduct amounts he sets aside on his own account in a restricted retirement fund but only up to 3 percent of his covered earnings. The employee would also be able to deduct his own contributions under contributory plans, again only up to a total of 10 percent of net earnings.

Universalizing the applicability of H.R. 10 in this way would admittedly be extremely expensive in terms of the revenue loss it would entail. Contrary to widespread impression, very few employees have nonforfeitable rights in pension plans which even remotely approximate those which would be conveyed by H.R. 10 to the self-employed person. Therefore, virtually all taxpayers, including those now covered under public and private retirement plans, would be eligible to claim the full 10 percent deduction provided under the terms of H.R. 10.

A breakdown of the estimated revenue loss if H.R. 10 were made available to all taxpayers is as follows:

Yearly revenue losses if the principle in H.R. 10 were applied to:	*Millions*
Social security	$880
Railroad retirement	52
Federal, State, and local government plans	312
Corporate pension plans, employee contributions	130
Total	1,372
Those not now under plans	1,628
Total	3,000

These revenue estimates assume that taxpayers in the first bracket would take advantage of the objective only to the extent of 15 percent of the total deductions which would be available to them if they took full advantage of H.R. 10 and those in the top bracket would use the deduction provision up to two-thirds of the amount that would be allowed them. As we have already indicated this assumption is undoubtedly very conservative in view of the very strong financial incentives that are offered by the H.R. 10 type of saving provision.

H.R. 10 would provide deductions only for savings set aside for retirement purposes. As a matter of public policy it is questionable whether this saving motive deserves any greater encouragement than any of the other objectives to which people direct their savings. For example, if H.R. 10 is to be passed, why shouldn't its provisions be extended to cover personal savings invested in housing and various

forms of consumer durable items, in providing advanced education and training for one's children, and other worthwhile purposes?

The legislative history of H.R. 10 demonstrates a well-established principle in the field of income taxation. It is well known that there are two ways to eliminate a tax differential or inequity. One is to withdraw the benefits which the unfair differential provides from those who presently enjoy it; it is only in this way that the integrity of the income tax and its revenue productivity can be assured. The other way is to extend the benefits to other taxpayers. This method, however, leads to extension of the loophole to more and more groups of taxpayers until virtually all are able to take advantage of the tax benefits. While this method assuredly eliminates much of the inequity, it does so at the expense of the strength of the income tax. Yet this is the logical conclusion.

It may not be possible, this late in the session, for the Finance Committee or the Ways and Means Committee in the House to undertake a really constructive reform of the tax treatment of income set aside for retirement. This reform should get a very high priority under the next administration and Congress. In the interim, sound fiscal and tax policy demand the defeat of H.R. 10.

PAUL H. DOUGLAS

INDIVIDUAL VIEWS OF SENATOR ALBERT GORE

H.R. 10, I believe, is falacious both in principle and in premise.

The bill provides a deduction from earned taxable income of self-employed individuals for personal investment made by the individual for his own personal benefit. This is not only erroneous in principle but the extent and amount of the deduction (ostensibly limited to $2,500 per year but, under certain circumstances, much more) would be unjustly disproportionate to that enjoyed by ordinary taxpayers. The personal exemption for the average citizen would remain at $600 but for the self-employed it would be $3,100 (more under certain circumstances), provided $2,500 is invested in a retirement plan.

H.R. 10 is advanced on the premise that one inequity justifies another. Admittedly, this has appeal. But if Congress followed such a course of action, it would bring about more, not less, injustice in tax law.

It is quite understandable that some self-employed citizens and many others look with envy at the tax advantages of their friends and neighbors who happen to be officers or employees of certain corporations. A quick glance at some of the tax advantages provided by law for corporate pension and profit-sharing plans will explain why this is true.

The law permits corporations fully to deduct from taxable income their contributions to qualified pension plans. Some corporations have pension plans only for their salaried employees. Others have plans for all employees but many of these have separate and less generous plans for hourly employees.

Moreover, the corporate contribution to the pension plan of which an employee is, or may become, a beneficiary, is not currently taxable as income to the employee-beneficiary. Such benefits only become taxable income to the employee when an actual distribution is made to him. If the pension plan generally serves the purpose of providing an annuity for retirement and an orderly annual distribution is made to the employee from such a pension plan, then it becomes taxable income to the employee-beneficiary as received. So long as these benefits are within reasonable limits, they serve a useful social purpose and it is proper for the Government to encourage employers to assist in providing reasonable security for their employees during retirement.

There are many devices, however, by which the so-called corporate pension plan and profit-sharing plan become tax avoidance devices for high salaried officers rather than a means of serving the laudatory social purpose of reasonable retirement security. For instance, some corporate officials are beneficiaries of several different corporate pension plans. Under certain circumstances, an employee-beneficiary may receive a lump-sum distribution of the amount credited to him and is subject only to capital gains tax treatment, thereby converting what otherwise might be ordinary income into a form of income bearing a much lower tax rate.

For example, the committee was informed by the Treasury that there are instances in which lump-sum distributions in excess of $800,000 have been made to a corporation executive from sums set aside for his benefit. Under existing law, distribution of these large sums is accorded the 25-percent capital gains tax rate. In reality, such "income" bears no relationship whatever to capital gains in the ordinary meaning of that term. Rather, such a distribution reflects an accumulation of ordinary income, whose distribution has been deferred. On top of this, the same individual may still be the beneficiary of several other pension plans. I fail to find any justification either as a matter of equity or as a matter of public policy, to support such favored tax treatment for those in a position to take advantage.

Capital gains treatment is by no means the only device by which a corporate official or employee may avoid payment of ordinary income tax on the money he receives from a pension plan provided for his benefit by tax-free corporate contributions. For instance, these proceeds can be passed on to grandchildren, or any other person, endowment, or a trust without the corporation ever having paid any tax on the contribution, without the named beneficiary ever paying any income tax whatever and without payment of either gift or estate tax.

The law, as I have said, provides no limit to the number of pension plans and profit-sharing plans—all with tax-free corporate contributions—of which an individual may be a beneficiary.

There are other devices, unrelated to pension and profit-sharing plans, by which tax avoidance may be achieved. One such device is the restricted stock-option plan, a wholly risk-free procedure under which certain employees are granted an option to purchase at a specified price stock in the corporation with which they are affiliated. If they exercise their option and dispose of the stock at an increased price, the profit is accorded capital gains treatment. In addition, by the organization and liquidation of corporations, and other means, the well-informed, or the well-advised, find additional ways to turn ordinary income into capital gains by the process of "running it through some corporations."

It is said that these and other devices are required as "incentives" to attract capable corporate management because otherwise corporate executives would quit work rather than pay taxes. However this may be, it is in part because of the various mechanisms by which income is actually taxed at less than the prescribed progressive rates that such high rates are required to provide revenue for essential Government services.

It is also said that qualified pension plans represent a tax advantage that has been won by organized labor and it is implied that H.R. 10 would only extend to the self-employed the same tax treatment granted to union labor. About the justification for qualified pension and profit-sharing plans as a matter of public policy, I will have more to say later. I say in passing that if the committee bill provided no greater benefit to certain of the self-employed than that which is available to the average union member who is a beneficiary of a corporate pension plan, there would not be nearly so great a clamor for the enactment of H.R. 10.

Under existing law there is no effective limit to the amount which may be credited for the benefit of corporation officer or employee, so long as the plan is "nondiscriminatory," according to the rather loose

provisions by which discrimination is measured. In the smaller, closely held corporations, or in what is known as the owner-manager corporation, which has only a handful of employees other than the executives or managers who usually, in large measure, own the corporation, that part of the cost of establishing a pension or profit-sharing plan which is attributable to the benefits accruing to the nonexecutive employees may be but a small price to pay to gain the tax advantages arising from the much larger deductions made for the benefit of the executives.

It is obvious that the availability of such tax advantages encourages the organization of a multiplicity of corporations having the same ownership. After deducting the expenses of the corporation, including salaries paid to its executives, a further deduction is taken for sums set aside for pensions or corporate "employees." If a sufficient number of corporations is organized, no single corporation has remaining a sufficient amount of "taxable" income to subject it to a corporate surtax rate, if, indeed, it has any substantial taxable income at all.

As I have already indicated, existing law places no limit on the amount which a corporation can deduct for contributions for pension and profit-sharing plans for the benefit of its high-salaried executives. Many corporations have obtained approval of pension plans authorizing deductions for contributions to provide pensions amounting to more than 50 percent of the employee's salary during his peak earning years. These tax-free accumulations, as already pointed out, may later be drawn as annuities, as lump-sum distribution, or left to survivors or trusts.

I feel strongly that justice requires that these loopholes of tax favoritism be closed or at the very least brought within reasonable limits. The Treasury made numerous recommendations in this regard but the Finance Committee rejected all of them in whole or in part.

I wish to emphasize that in my view it is entirely appropriate for the Government to encourage employers to contribute toward reasonable security of employees during the years of their retirement. At the present time some 19 million employees are included, at least to some degree, in pension and profit-sharing plans with assets of about $40 billion. These pension plans are for the most part established by employer contributions, although employee contributions account for approximately 15 percent of current contributions. There are some 48,000 qualified plans in existence and the Treasury is now receiving requests for rulings on about 7,000 new plans every year.

Unfortunately, many, if not most, plans now in effect do not provide for definite and early vesting of employee rights. Therefore, most employees are only ostensibly covered by existing plans and may never receive any benefits at all. There is a need not only for tightening the provisions which permit abuses, but also for general improvement and extension of the coverage of such plans, including vesting requirements.

This is true because only about one-fourth of the 70 million people in our civilian labor force are potentially eligible for benefits from existing corporate pension plans, and, as I have said, many of those will never realize any benefit. There is need also for improvement in the social security program covering both employees and self-employed.

For the Government to encourage employers to contribute to the security of their employees in their later, nonproductive years, is one thing; to grant tax deductions to individuals for investments made for their own personal benefit is quite another thing. This distinction is conveniently overlooked by the proponents of H.R. 10, which provides such a tax deduction for specified types of savings or investment.

If the principle of allowing a tax deduction for savings is followed to its logical conclusion, the burden of the income tax will fall upon that which is not saved but spent. The result would be a tax, not on income, but on spending or consumption. H.R. 10 deals with a principle, therefore, which would become a precedent of far-reaching and potentially dangerous proportions.

If legislation should be enacted to provide tax deduction for investment in a retirement insurance policy for those who are able to invest in such a policy, then why should it not provide similar tax deduction for investment in a health and accident policy, or in an educational policy for one's children, or for meeting mortgage payments on the family home? Why should this tax favor be exclusively for the benefit of those who can afford such an investment after meeting all other equally worthy and desirable obligations? This illustrates not only the fiscal danger of the principle of H.R. 10, but the inequity which it would provide.

The provisions of the bill which are designed to condition and limit the circumstances under which the deduction would be available are loosely drawn and easily evaded. For example, the committee amended the bill to provide that a self-employed individual might take the deduction only if he makes provision for a nondiscriminatory pension plan for his own employees. The theory of this amendment constitutes an improvement in the bill. However, employees do not have to be covered until they have been employed for 3 years. Taxpayers with a rapid turnover of employees could, therefore, avoid this condition. Moreover, this condition could be evaded entirely by a self-employed individual by the process of "leasing" his secretaries or his clerks from an agency created to provide that service.

The bill undertakes to limit the amount of the deduction in any one year to the lesser of 10 percent of earned income, or $2,500, with an overall cumulative limit of $50,000. Actually, the bill contains no effective limit at all because it would permit one individual who had multiple, separate activities from which he earns income to claim the deduction with respect to each. The bill as reported by the committee still contains this loophole within a loophole. I offered an amendment in committee which would have provided that in no event could one individual deduct more than $5,000 in a single taxable year with a cumulative limit of $100,000, exactly twice the ostensible limits in the bill, but this amendment was rejected.

If the benefits proposed by H.R. 10 are to be extended to one class of taxpayers, they ought to be extended to all. If we are to give special treatment to doctors, for example, then why not to teachers and preachers, clerks and laborers? Yet H.R. 10 provides no relief for the millions of taxpayers who are neither eligible to take advantage of its provisions nor covered by an employee pension plan.

Uniformity and fairness in applicability of tax laws must be our goal. One way to achieve this goal is to remove provisions for special benefit from the law. Another is to extend similar benefits to all other citizens. Unless we achieve the one, then the other is, or in justice should be, inevitable.

ALBERT GORE.