

DEFINITION OF EARNED INCOME FOR PENSION PLANS OF SELF-EMPLOYED INDIVIDUALS

OCTOBER 8, 1968.—Ordered to be printed

Mr. LONG of Louisiana, from the Committee on Finance, submitted
the following

REPORT

[To accompany H.R. 18253]

The Committee on Finance, to which was referred the bill (H.R. 18253) to amend the effective date of the 1966 change in the definition of earned income for purposes of pension plans of self-employed individuals, having considered the same, reports favorably thereon without amendment and recommends that the bill do pass.

I. SUMMARY

H.R. 18253 would make clear that the new definition of earned income for purposes of pension plans for self-employed individuals (sec. 204(c) of Public Law 89-809) applies to taxable years beginning after December 31, 1967. It would also provide that, in applying the 3-year averaging provisions (sec. 401(e)(3) of the code) in determining whether excessive contributions have been made to such plans, the new definition (which no longer limits "earned income" to 30 percent of the total income where capital is a material income-producing factor) is to be applied as though in effect for years beginning before January 1, 1968.

The Treasury Department has indicated that it has no objections to the bill's enactment.

II. GENERAL STATEMENT

When H.R. 10 was enacted in 1962, it permitted contributions each year to self-employed pension plans in amounts up to the lesser of \$2,500 or 10 percent of the owner-employee's "earned income" from the business. However, where capital was a material income-producing

factor, not more than 30 percent of the income from the business could be treated as "earned income" for purposes of this provision.

Since such plans can accumulate income without paying income taxes on the earnings of the invested funds, the 1962 act penalized contributions to the plans in excess of the amount generally permitted to be contributed. To avoid hardship in certain limited circumstances, those penalties are not imposed, however, where the contributions are in the form of premiums for annuity, endowment, or life insurance policies and are not greater than the average annual permissible contribution by the owner-employee for the 3 years immediately preceding the year in which the last policy contract was entered into.

The provisions relating to self-employed pension plans were liberalized in a number of respects in 1966—among them was elimination of the 30-percent limitation described above. This change was made prospective only. One effect of this prospective repeal of the 30-percent limitation has been that, for 3 years after this change, those who apply the averaging provisions described above have to continue to include in that average up to 3 years as to which the 30-percent limitation continues to apply. For those individuals, then, the effect of the 30-percent limit has not fully been repealed, in determining the maximum permissible contribution, until 1971. The committee agrees with the House that Congress did not intend that there be a 3-year waiting period before the repeal of the 30-percent limit became fully effective.

For the reasons indicated above this bill permits those who apply the averaging provisions to compute their averages for taxable years beginning after December 31, 1967, without regard to the now-repealed 30-percent limitation. This is accomplished by providing that for purposes of making the computations under the 3-year averaging provision the 30-percent limitation is treated as repealed for years before 1968.

The bill also removes any uncertainty as to the effective date of the repeal of the 30-percent limitation by providing that it applies to taxable years beginning after December 31, 1967.

III. CHANGES IN EXISTING LAW

In compliance with subsection (4) of rule XXIX of the Standing Rules of the Senate, changes in existing law made by the bill, as reported, are shown as follows (new matter is printed in *italic*, existing law in which no change is proposed is shown in *roman*):

SECTION 204¹ OF PUBLIC LAW 89-809

SEC. 204. REMOVAL OF SPECIAL LIMITATIONS WITH RESPECT TO DEDUCTIBILITY OF CONTRIBUTIONS TO PENSION PLANS BY SELF-EMPLOYED INDIVIDUALS.

(a) **REMOVAL OF SPECIAL LIMITATIONS.**—Paragraph (10) of section 404(a) (relating to special limitation on amount allowed as deduction for self-employed individuals for contributions to certain pension, etc., plans) is repealed.

(b) **CONFORMING AMENDMENTS.**—

(1) Each of the following provisions of section 401 is amended by striking out "(determined without regard to section 404(a)(10))" each place it appears:

- (A) Subsection (a)(10)(A)(ii).
- (B) Subparagraphs (A) and (B) of subsection (d)(5).
- (C) Subparagraph (A) of subsection (d)(6).
- (D) Subparagraphs (A) and (B)(i) of subsection (e)(1).
- (E) Subparagraphs (B) and (C) and the last sentence of subsection (e)(3).

(2) Subparagraph (A) of section 404(e)(2) is amended by striking out "(determined without regard to subsection (a)(10))".

(3) Paragraph (1) and subparagraph (B) of paragraph (2) of section 404(e) are each amended by striking out "(determined without regard to paragraph (10) thereof)".

(c) DEFINITION OF EARNED INCOME.—Section 401(c)(2) (relating to definition of earned income for certain pension and profit-sharing plans) is amended by striking out subparagraphs (A) and (B) and inserting in lieu thereof the following:

"(A) IN GENERAL.—The term 'earned income' means the net earnings from self-employment (as defined in section 1402(a)), but such net earnings shall be determined—

"(i) only with respect to a trade or business in which personal services of the taxpayer are a material income-producing factor,

"(ii) without regard to paragraphs (4) and (5) of section 1402(c),

"(iii) in the case of any individual who is treated as an employee under sections 3121(d)(3)(A), (C), or (D), without regard to paragraph (2) of section 1402(c), and

"(iv) without regard to items which are not included in gross income for purposes of this chapter, and the deductions properly allocable to or chargeable against such items.

For purposes of this subparagraph, section 1402, as in effect for a taxable year ending on December 31, 1962, shall be treated as having been in effect for all taxable years ending before such date."

(d) EFFECTIVE DATE.—The amendments made by subsections (a) and (b) shall apply with respect to taxable years beginning after December 31, 1967. *The amendment made by subsection (c) shall apply with respect to taxable years beginning after December 31, 1967, and in the case of a taxpayer who applies the averaging provisions of section 401(c)(3) of the Internal Revenue Code of 1954 for a taxable year beginning after December 31, 1967, the computation of the amount deductible under section 404 of such Code for any prior taxable year which began before January 1, 1968, shall be made, for purposes of such averaging provisions, as if the amendment made by subsection (c) were applicable to such prior taxable year.*

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