Fordham Urban Law Journal

Volume 3 | Number 2 Article 1

1975

Tax Aspects of the Pension Reform Act of 1974

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TAX ASPECTS OF THE PENSION REFORM ACT OF 1974†

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† This article was originally presented, in substantially the same form, as a paper for the Annual Legal Section Meeting of the American Life Insurance Association on November 18, 1974, in San Francisco. For purposes of this article, some revisions were made in that paper to reflect later regulations and guidelines which were issued by the Internal Revenue Service through March 17, 1975.

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I. Introduction

The Employee Retirement Income Security Act of 1974[1] (commonly known as the Pension Reform Act and sometimes more lyrically cited as ERISA) has introduced a massive set of new rules for the private pension plan system. Many sections of the Pension Reform Act—such as those dealing with participation, vesting, funding, joint and survivor annuity payments, and the prohibitions against self-dealing—are treated in both the labor law and tax law provisions of the Act. This article will concentrate on highlighting those sections of the Act which are treated exclusively in the tax law provisions—namely those dealing with HR-10 and Subchapter S restrictions, individual retirement arrangements, maximum limitations on contributions and benefits, and the taxation of lump sum distributions.

II. New Rules for HR-10 Plans

A. Maximum Deductible Limits on Employer Contributions for Self-Employed Persons

Tax-qualified pension or profit-sharing plans which are adopted by employers who are self-employed[2] to benefit themselves and their employees are commonly referred to as "Keogh" or "HR-10"[3] plans. Traditionally, the annual amount of employer contributions which

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1. Pub. L. No. 93-406, 88 Stat. 829, *reprinted in* 8A U.S. CODE CONG. & AD. NEWS 1 (Pamphlet 1974) (codified in scattered sections of 5, 26, 29, 42 U.S.C.A.) [hereinafter cited as Act].
2. *E.g.*, sole proprietorships and partnerships.
3. HR-10 is commonly used to refer to the Self-Employed Individuals Tax Retirement Act of 1962, Pub. L. No. 87-792, 76 Stat. 809, *as amended*, Pub. L. No. 89-809, § 204, 80 Stat. 1577 (codified in scattered sections of 26 U.S.C.).

could be made to an HR-10 plan for the benefit of a self-employed participant was restricted to the lesser of $2,500 or 10% of the participant's earned income.[4] This limit was originally devised in 1962, but inflation has so seriously eroded its impact that many self-employed persons have chosen to form professional corporations in order to establish tax-qualified retirement plan benefits that are not subject to that limit.[5] Congress attempted to remedy this inequity in the retirement plan limits between corporate and self-employed employees by raising the deductible contribution limits applicable to HR-10 plans.[6]

General Rule: Effective for taxable years beginning after December 31, 1973,[7] the amount of annual deductible employer contributions to an HR-10 plan on behalf of a self-employed participant will be limited to the lesser of $7,500 or 15% of his earned income.[8] For example, if John Partner[9] earns $100,000 in a given year, his maximum deductible limit has now tripled from $2,500 (the lesser of $2,500 or $10,000) to $7,500 (the lesser of $7,500 or $15,000).[10]

Special Rules: The Pension Reform Act has preserved various

4. Self-Employed Individuals Tax Retirement Act of 1962, § 2, 76 Stat. 809, *as amended*, 26 U.S.C.A. § 404(e)(1) (Supp. 1975).

5. H.R. REP. No. 807, 93d Cong., 2d Sess. 112 (1974) [hereinafter cited as HOUSE REPORT 807]. This report was prepared by the House Ways and Means Committee on February 21, 1974, in connection with H.R. 12855, 93d Cong., 2d Sess. (1974) (an early version of the enacted Pension Reform Bill, H.R. 2).

6. *See also* text section V *infra* regarding the new limitations imposed on contributions and benefits under plans for corporate employees.

7. Act § 2001(i)(1).

8. *Id.* § 2001(a)(1), INT. REV. CODE OF 1954, ch. 1, § 404(e)(1) [hereinafter cited as Code].

9. See IRS Technical Information Rel. No. 1334, (Jan. 8, 1975), question H-3, in BNA PENSION REP. NO. 17, at R-2-3 (Jan. 13, 1975) [hereinafter cited as T.I.R. 1334] for an explanation of how the new $7,500-or-15% limit works in the case where the taxable years of the partners and of the partnership differ. The taxable year of the partnership (not the partner) governs the effective date of the availability of the $7,500-or-15% limit.

10. For the manner in which certain existing HR-10 plans are permitted to be revised to take retroactive advantage of the higher deductible limits, see text section II(M)(4) *infra*.

provisions for determining how the maximum deductible limit is to be calculated.

(1) If a self-employed person is covered under more than one HR-10 plan, the contributions made on his behalf under each plan must be aggregated in calculating the $7,500-or-15% limit.[11]
(2) Contributions made to an HR-10 plan on behalf of a self-employed person which are allocable (as determined by Treasury regulations) to the purchase of life, health, accident, or other insurance are not counted toward the $7,500-or-15% limit.[12]
(3) If an employer's contributions to an HR-10 plan are applied to pay premiums under one or more annuity, endowment, or life insurance contracts on the life of an "owner-employee" participant—namely, a self-employed person who is either a sole proprietor or a partner owning more than 10% of the capital or profits interest of the partnership—a three-year averaging rule is used to determine whether an annual employer contribution for the owner-employee exceeds the $7,500-or-15% deductible limit. The maximum amount of annual contribution for the owner-employee is based on the average of the amounts that were actually deductible under section 404 of the Internal Revenue Code ("or which would have been deductible if such section had been in effect"[13]) during the three taxable years prior to the year in which the last annuity, endowment, or life insurance contract was issued.[14] Although the exact meaning of the quoted language is somewhat unclear, it appears that this three-year averaging rule can be applied by using the $7,500-or-15% limit for 1973, 1974, and 1975 rather than the $2,500-or-10% limit for 1973 and the $7,500-or-15% limit for 1974 and 1975.

11. Act § 2001(a)(2), Code § 404(e)(2)(A).
12. Code § 404(e)(3).
13. Act § 2001(e)(3), Code § 401(e)(3).
14. *Id.*, Code § 401(e).

B. $100,000 Earned Income Base Limit for Self-Employed Persons

Effective (as a practical matter in most cases) for taxable years beginning after December 31, 1973,[15] the Pension Reform Act restricts the amount of annual earned income of a self-employed participant which can be taken into account under an HR-10 plan to $100,000.[16] When this $100,000 earned income base is coupled with the new $7,500-or-15% maximum deductible limitation, it becomes apparent that $7,500 is the maximum deductible contribution possible for a self-employed person earning over $100,000. For example, if a self-employed participant in fact earned $300,000, an employer contribution made on his behalf equal to $7,500 would constitute 7.5% of his earned income (7.5% x first $100,000 of earned income = $7,500) not 2.5% of his earned income (2.5% x full $300,000 of earned income = $7,500). In such a case, to avoid discrimination in favor of self-employed participants who are regarded as upper-level employees, it would be necessary for contributions to be made on behalf of common-law employee[17] participants at a rate at least equal to 7.5% of their annual compensation instead of 2.5%.[18]

It should be noted that a self-employed person is allowed only one $100,000 contribution base, no matter how many plans he establishes for a trade or business. For example, a self-employed person with $200,000 of earned income could not cover himself under two plans (each of which also covered half of his employees) and use up his $7,500 maximum deductible limit by contributing at a rate of 3.75% under both plans ($100,000 x 3.75% = $3,750 under Plan 1, and $100,000 x 3.75% = $3,750 under Plan 2, for a total contribution of $7,500), because contributions for each common-law employee are only made under one plan at the rate of 3.75% of his compensa-

15. Act § 2001(i)(2).

16. *Id.* § 2001(c), Code § 401(a)(17).

17. A common-law employee is any employee other than a self-employed person. For example, a nurse who is employed by a doctor doing business as a sole proprietorship would be a common-law employee of that proprietorship.

18. RESEARCH INSTITUTE OF AMERICA, INC., TAX COORDINATOR, SPECIAL STUDY: WHAT THE NEW PRIVATE PENSION REFORM LAW MEANS TO YOU 2 (Sept. 5, 1974).

tion. In that case, when the single $100,000 base is applied to the contributions made under both plans, the self-employed person has contributions at the rate of 7.5%. Therefore, to avoid discrimination, contributions for the common-law employees covered under each plan would also have to be made at the rate of 7.5%.[19]

The new $100,000 compensation base is effective for the first taxable year after 1973 in which the plan utilizes the new $7,500-or-15% maximum deductible limit for employer contributions. For example, if, during the 1974 taxable year, employer contributions were made to the plan for a self-employed participant in excess of the lesser of $2,500 or 10%, then the new $100,000 earned income base would also apply for the 1974 taxable year. If such contributions are not made until the 1975 taxable year, then the $100,000 earned income base will not come into play until the 1975 taxable year. In any event, the $100,000 earned income base will apply for taxable years beginning after December 31, 1975, regardless of the amount contributed.[20]

C. Minimum Deductible Limits on Employer Contributions for Self-Employed Persons

Effective for taxable years beginning after December 31, 1973,[21] the new minimum annual deductible limitation that may be superimposed on the $7,500-or-15% maximum annual deductible limitation is the lesser of $750 or 100% of the self-employed participant's earned income.[22] For example, if a self-employed plan participant's annual earned income were $3,000, the employer could contribute $750 to the HR-10 plan on his behalf and take a full deduction for that amount despite the fact that $750 represents 25% of the participant's earned income and thus exceeds the amount ordinarily deductible under the $7,500-or-15% maximum deductible limit.

The new minimum deductible limit should be helpful in the case

19. H.R. Rep. No. 779, 93d Cong., 2d Sess. 112 (1974) [hereinafter cited as House Report 779]. This report was prepared by the House Ways and Means Committee on February 5, 1974, in connection with H.R. 12481, 93d Cong., 2d Sess. (1974) (an early version of the enacted Pension Reform Bill, H.R. 2).

20. Act § 2001(i)(2).

21. *Id.* § 2001(i)(1).

22. *Id.* § 2001(a)(3), Code § 404(e)(4).

of a corporate employee who "moonlights" on the side as a self-employed person, or any other self-employed person whose earnings are relatively low, such as a housewife giving piano lessons on a part time basis. In fact, the \$750-or-100% minimum deductible limit was designed to:

> enable certain organizations of the self-employed, such as the Jockeys' Guild, to set up retirement plans for their members without having to confront complex record-keeping and administrative problems, and . . . [to] allow any self-employed individual who wishes to do so to save for his retirement, even though his earned income in a particular year is relatively low.[23]

However, the \$750-or-100% minimum deductible limit has some drawbacks. First, in the case of the self-employed person earning \$3,000 in the example given above, if a contribution on his behalf equal to 25% of his earned income were made to the HR-10 plan, then a contribution at least equal to 25% of the compensation of each of his common-law employees would also have to be made to the plan to avoid discrimination. Second, it may be that the new overall limitations on contributions to tax-qualified plans generally—which basically restrict the amount of annual plan contributions for a single employee to the lesser of \$25,000 or 25% of his compensation[24]—will override the minimum deductible limit so that no contribution can be made for a self-employed plan participant if it is greater than 25% of his earned income. For these reasons many HR-10 pension planners have decided to eschew the use of the \$750-or-100% minimum deductible limit. Since the minimum deductible limit does not appear mandatory, this seems to be the wisest course to follow until regulations clarify the interplay between the \$750-or-100% minimum deductible limit on contributions, and the discrimination requirements and contribution limitations generally.

D. New Rules for Defined Benefit HR-10 Plans

Effective for taxable years beginning after December 31, 1975,[25] Treasury regulations will be issued pursuant to the Pension Reform

23. HOUSE REPORT 779, at 112.

24. See text section V *infra* describing the new overall limitations on contributions and benefits contained in Act § 2004(a)(2), Code § 415.

25. Act § 2001(i)(3).

Act to prescribe special limits for defined benefit HR-10 plans.[26] These limits will allow self-employed persons to translate the \$7,500-or-15% limitations on maximum deductible employer contributions into approximately equivalent limitations on employer-financed benefits for those persons who prefer to use defined benefit retirement plans.[27] The Act specifically provides that a *trust* forming part of a defined benefit HR-10 plan which utilizes these new limitations on benefits will not be subject to the \$7,500-or-15% maximum deductible limit or to the \$750-or-100% minimum deductible limit on contributions.[28] Presumably, this will also be true of a non-trusted defined benefit HR-10 plan, for example, one funded by means of a group annuity contract.

General Rule: The benefit limitations will be expressed in terms of a ceiling on the annual amount of "basic benefit" at retirement that the plan can pay to a self-employed person. The term "basic benefit" is defined as the plan benefit (i) payable in the form of a straight life annuity, (ii) commencing at age 65 (or, if later, 5 years after the self-employed participant's current period of participation in the plan began), (iii) under a non-contributory plan, (iv) which provides no ancillary benefits.

The maximum amount of basic benefit that can be payable to a self-employed person cannot exceed the sum of the amount of annual retirement benefit accruing for each year of his participation in the plan under a specified benefit accrual formula. This formula multiplies the first \$50,000 of his earned income covered by the plan for each year by a percentage based on his age when he entered the plan. Table 1 sets forth the applicable percentages provided by the Act.[29]

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26. *Id.* § 2001(d)(2), Code § 401(j). The "term 'defined benefit plan' means any plan which is not a defined contribution plan." *Id.* § 1015, Code § 414(j). (To understand what this very enlightening definition means, see the definition of a "defined contribution plan" at note 324 *infra.*) Basically, a defined benefit plan means a plan where the employee's retirement benefit is defined in the plan, and whatever contributions are actuarially determined to be necessary to provide that benefit are then contributed by the employer. For example, a plan specifying an annual pension benefit equal to 50% of the employee's average annual salary during his last five years of service would be a defined benefit plan.

27. *Id.* § 2001(d), Code §§ 401(a)(18), (j)(1).

28. *Id.* § 2001(d)(2), Code § 401(j)(6).

29. The percentages in the Table are higher for younger entry ages to

Table 1

Age when self-employed person's current period of participation in the plan began:[30]	Applicable percentage used in his benefit accrual formula for each year of plan participation:
30 or less	6.5%
35	5.4%
40	4.4%
45	3.6%
50	3.0%
55	2.5%
60 or over	2.0%

To illustrate how the new benefit limits will work, assume that Dr. Brown, a self-employed person, entered a non-contributory defined benefit HR-10 plan at age 30 and participated in the plan for 5 years during which his annual earned income was $20,000. He left the plan at age 35, but rejoined at age 50 and continued his participation until his 65th birthday when he retired. From ages 50 through 54 his annual earned income was $30,000; from ages 55 through 59 his annual earned income was $40,000; and from ages 60 through 64 his annual earned income was $60,000. His maximum retirement benefit would be $24,500 per year paid in the form of a straight life annuity with no ancillary benefits. This $24,500 maximum basic benefit is calculated as illustrated in Table 2.[31]

reflect the fact that contributions made in the early years earn interest for a longer period prior to retirement than contributions made in later years. S. REP. No. 383, 93d Cong., 1st Sess. 124 (1973) [hereinafter cited as SENATE REPORT 383]. This report was prepared by the Senate Finance Committee on August 21, 1973, in connection with S. 1179, 93d Cong., 1st Sess. (1973) (an early version of the enacted Pension Reform Bill, H.R. 2).

30. Act § 2001(d)(2), Code § 401(j)(3)(A). In the case where a participant has an increase in compensation, his future yearly benefit accruals with respect to the increased amount of compensation will be calculated as if his participation in the plan began at the time of the increase. A similar rule will apply in the case where the plan is amended to increase the rate of benefit accruals. *Id.* § 2001(d)(2), Code § 401(j)(3)(B)(iii).

31. SENATE REPORT 383, at 124-25.

Table 2

Age	Annual Earned Income Covered by Plan up to $50,000	Applicable Benefit Accrual Rate (Percentage)	Annual Pension Benefit Accrued Per Year of Participation	No. of Years Benefit Was Accrued at Same Rate	Total Annual Pension Benefit Accrued
30-34	$20,000	6.5% (entry age 30)	$1,300	5	$6,500
50-54	$30,000	3.0% (entry age 50)	$ 900	5	$4,500
55-59	$40,000	3.0% (entry age 50)	$1,200	5	$6,000
60-64	$50,000	3.0% (entry age 50)	$1,500	5	$7,500
				TOTAL	$24,500

By way of contrast, assume that Dr. Brown's annual earned income was $60,000 from the time he first joined the non-contributory defined benefit HR-10 plan at age 45 until his retirement at age 65. During each of the 20 years of his participation in the plan he can accrue an annual retirement benefit of $1,800 (3.6% applicable to entry age 45 x first $50,000 of earned income covered by the plan = $1,800). So during the 20-year period until he reaches 65, he can build up a straight life annuity income with no ancilliary benefits of $36,000 per year ($1,800 x 20 = $36,000). In order to purchase this annuity income Dr. Brown must accumulate $343,000 by age 65.[32] To do this the annual plan contribution must be $9,800.[33] Obviously, in this case the defined benefit plan approach is better for Dr. Brown than the defined contribution plan approach, where his maximum annual contribution would be limited to $7,500 (the lesser of $7,500 or 15% of $60,000). And the younger Dr. Brown is when he enters the plan, the greater the advantages of the defined benefit approach.

Unfortunately, until explanatory regulations are issued, it is not

32. Compare the analysis on the same figures prepared by Lawrence Lieber, President of Consolidated Actuarial Services, Inc., who concluded that $367,000 is necessary to purchase an annuity of $36,000, so that $10,750 could be contributed each year. Andreder, *Win With Keogh*, BARRON'S, Oct. 7, 1974, at 24, cols. 4-5.

33. PRENTICE-HALL, CONCISE EXPLANATION OF PENSION REFORM LAW ¶ 101 (Spec. Pamphlet 1974).

entirely clear whether a deductible annual contribution for a self-employed person under a defined benefit HR-10 plan can exceed the $7,500-or-15% limit, and if so, by what amount. The Pension Reform Act merely provides that the $7,500-or-15% maximum deductible limit does not apply. However, the statute does not say what deductible limit does apply, except to provide that the regulations for defined benefit HR-10 plans must insure comparability of treatment of self-employed persons covered under defined contribution plans, defined benefit plans, or a combination of both plans.

It is important to remember that a defined benefit HR-10 plan is also subject to the new overall limitations on maximum pension benefits applicable to tax-qualified plans generally. These overall limitations[34] basically restrict an employee's annual pension to the lesser of $75,000 or 100% of his average annual compensation for his high-3 consecutive years.

Special Rules:

(1) Treasury regulations will prescribe the applicable percentages in the case of entry ages not listed in the statutory table, or plans that provide benefits other than a basic benefit.[35] Moreover, post-1973 changes in the prevailing interest and mortality rates may result in changes in the applicable percentages on or after January 1, 1978.[36]

(2) In the case of a defined benefit HR-10 plan covering self-employed persons who are owner-employees—such as sole proprietors or greater-than-10% partners—integration with Social Security will not be permitted.[37] No such restriction applies to a defined benefit HR-10 plan which merely covers self-employed persons who are 10%-or-less partners.

E. Excess Contributions Regarding Owner-Employees

Traditionally, an excess contribution made to an HR-10 plan on behalf of an owner-employee could result in disqualification[38] of the

34. *See* text section V *infra*.
35. Act § 2001 (d)(2), Code §§ 401(j)(3)(B)(i), (ii).
36. *Id.*, Code § 401(j)(3)(B)(iv).
37. *Id.*, Code § 401(j)(4).
38. Code § 401(e)(2)(A), 76 Stat. 815 (1962) (*Amended by* Act § 2001(e)(3)). *See* text accompanying note 41 *infra*.

plan as to the owner-employee if the amount of the excess contribution (and any net income attributable thereto) were not promptly repaid to the owner-employee within the prescribed time period. In addition, if it were determined that an excess contribution on behalf of an owner-employee had been willfully made to an HR-10 plan, the entire amount of the owner-employee's interest in that HR-10 plan (and all other HR-10 plans in which he was an owner-employee participant) had to be distributed to the owner-employee and no HR-10 plan could be qualified[39] as to him during the period of the five following taxable years. In either case, the amount required to be distributed to the owner-employee from the HR-10 plan because of an excess contribution was subject to certain income tax penalties under the so-called "110%" tax rule (which amounted to a tax of 10% of the marginal regular tax for the distribution).[40]

Effective for contributions made during taxable years beginning after December 31, 1975,[41] the Pension Reform Act repeals the existing approach which would disqualify an HR-10 plan as to an owner-employee for whom an excess contribution was made (and, in some cases, mandate the distribution of an owner-employee's entire interest in the plan).[42] Moreover, effective for correcting distributions made during taxable years beginning after December 31, 1975,[43] in order to cure excess contributions to an HR-10 plan for an owner-employee, the Pension Reform Act repeals the existing "110%" tax penalty rule[44] on such distributions received by the owner-employee, and substitutes a tax penalty equal to 10% of the amount so distributed to the owner-employee (prior to age 59½).[45]

39. Code § 401(e)(2)(E).

40. *Id.* § 72(m)(5)(B), 76 Stat. 821 (1962), *as amended*, Act §§ 2001(g)(1), Code § 72(m)(5)(C), 76 Stat. 821 (1962), *repealed by* Act § 2001(g)(2)(A). *See also* H.R. CONF. REP. No. 1280, 93d Cong., 2d Sess. 733 (1974) [hereinafter cited as CONFERENCE REPORT 1280 and referenced to pages in 8A U.S. CODE CONG. & AD. NEWS (Pamphlet 1974)].

41. Act § 2001(i)(4); T.I.R. 1334 (question H-5).

42. Act §§ 2001 (e)(2) (*repealing* Code § 401(d)(8), 76 Stat. 812 (1962)), 2001(e)(3) (*amending* Code § 401(e)(1)-(2), 76 Stat. 815 (1962)), 2001(e)(5) (*repealing* Code § 72(m)(5)(A)(iii), 76 Stat. 821 (1962)).

43. *Id.* § 2001(i)(5).

44. *Id.* §§ 2001(g)(1) (*amending* Code § 72(m)(5)(B), 76 Stat. 821 (1962)), 2001(g)(2)(A) (*repealing* Code §§ 72(m)(5)(C)-(E), 76 Stat. 821 (1962)).

45. *Id.* § 2001(g)(1), Code § 72(m)(5)(B).

The new approach toward excess contributions made to an HR-10 plan with respect to an owner-employee will be to impose a 6% excise tax on the amount of the excess contribution.[46] The excise tax is payable by the employer (*i.e.*, the sole proprietorship or the partnership) maintaining the HR-10 plan. No deduction is available to the employer for the amount of excise tax paid.[47]

Excess contributions with respect to owner-employees can arise in several ways:[48]

> (1) *Employer contributions for owner-employees under defined contributions plans*—the amount contributed to the plan by the employer on behalf of an owner-employee during the current taxable year (and any prior taxable year beginning after 1975) which has not been deductible (for the current taxable year or for any prior taxable year). For example, if a sole proprietor earning $80,000 in 1976 makes a $9,000 employer contribution on his own behalf to an HR-10 money purchase pension plan during that year, his maximum deduction for that contribution would be $7,500 (the lesser of $7,500 or 15% of $80,000). Therefore, $1,500 of that plan contribution would be characterized as an excess contribution;
>
> (2) *Employer contributions for owner-employees under defined benefit plans*—the amount contributed to the plan (when it is fully funded) by the employer on behalf of an owner-employee during the current taxable year (and any prior taxable year beginning after 1975) which has not been deductible (for the current taxable year or for any prior taxable year);[49]
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> (3) *Voluntary employee contributions made by owner-employees*—the amount actually contributed to the plan by the owner-employee (as an employee) during the current taxable year which exceeds the amount permitted to be contrib-

46. *Id.* § 2001(f)(1), Code § 4972. This approach was designed to cure the major abuse of overfunding, namely, the tax-free accumulation of earnings on excess contributions. HOUSE REPORT 779, at 115.

47. T.I.R. 1334 (question H-5).

48. Act § 2001(f)(1), Code §§ 4972(b)(2)-(4), (c). However, as explained in text section II(A)(2) *supra*, amounts properly allocable to the purchase of life, health, accident, or other insurance are not taken into account.

49. *See* text section II(D) *supra* concerning the new deductibility rules for defined benefit plans.

uted by the owner-employee (as an employee) during that year.[50] Basically, if an HR-10 plan covering employees other than owner-employees permitted those other employees to make voluntary employee contributions at the rate of 10% of their compensation, then the owner-employee participant would also be permitted to make voluntary employee contributions to the plan at the same rate, subject to a limit of the lesser of $2,500 or 10% of his earned income. Therefore, if an owner-employee covered under such a plan earned $40,000 in 1976, his maximum voluntary employee contribution would be $2,500 (the lesser of $2,500 or 10% of $40,000). If he contributed $3,500 in 1976 as an employee contribution, he would have an excess contribution of $1,000.

The excise tax on excess contributions applies for the year in which the excess contribution is made and for every subsequent taxable year when the excess contribution is still outstanding because it has not been eliminated. The excess contribution may be eliminated so as to stop the running of the excise tax by (i) refunding the excess amount through a correcting distribution (in which case the excise tax is eliminated for subsequent taxable years), or (ii) carrying over the excess payment and applying it against the amount allowed to be contributed to the plan in the next or a subsequent taxable year[51] (in which case the excise tax is eliminated in the taxable year in which the excess is used up by the carryover).

Whether an HR-10 plan is of the defined contribution or defined benefit type, a correcting distribution of an excess amount arising from voluntary contributions made by the owner-employee as an *employee* must be paid to the owner-employee himself.[52] Insofar as excess amounts arising from *employer* contributions are concerned, the payee of the correcting distribution will vary with the nature of the plan. In the case of a defined benefit plan, the excess amount must be paid to the employer.[53] In the case of a defined contribution profit-sharing plan, the excess amount can be paid either to the

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50. *See* text section II(G) *infra* which discusses limits on voluntary employee contributions by owner-employees.

51. CONFERENCE REPORT 1280, at 732.

52. ACT § 2001(f)(1), Code § 4972(b)(5)(A).

53. *Id.*, Code § 4972(b)(5)(B).

employer or to the employee;[54] but in the case of a defined contribution money purchase pension plan, the excess amount must be paid to the employer since the law generally prohibits a distribution to an employee from a money purchase pension plan until the employee attains retirement age.[55]

F. Premature Distributions to Owner-Employees Prior to Age 59½

Effective for distributions made during taxable years beginning after December 31, 1975,[56] a distribution made from an HR-10 plan to an owner-employee prior to age 59½ will be subject to an income tax penalty equal to 10% of the amount distributed, instead of the old "110%" income tax penalty rule which will then be repealed.[57] The new 10% income tax penalty is in addition to the amount of income tax otherwise payable on the early distribution. It is designed to discourage early distributions by raising[58] the penalty from the old "110%" rule which basically imposed an income tax penalty equal to 10% of the increase in income tax resulting from the inclusion of the early distribution in the recipient's gross income—for a total tax increase of 110%. Hopefully, the new 10% penalty will also simplify the computation of the tax.

These early distributions are known as premature distributions but the penalties for same are not applicable: (1) where the owner-employee receiving the distribution before age 59½ is totally disabled; or (2) where the amount received by the owner-employee before age 59½ represents a return of his voluntary employee contributions.[59]

The Pension Reform Act has not changed the existing rule that if a premature distribution is made to an owner-employee, no contributions can be made to the plan on his behalf for the five taxable

54. *Id.*, Code § 4972(b)(5)(C).

55. CONFERENCE REPORT 1280, at 732.

56. Act § 2001(i)(5); T.I.R. 1334 (question H-2).

57. Act §§ 2001(g)(1) (*amending* Code § 72(m)(5)(B), 76 Stat. 821 (1962)), 2001(g)(2)(A) (*repealing* Code §§ 72(m)(5)(C)-(E), 76 Stat. 821 (1962)).

58. T.I.R. 1334 (question H-2).

59. *See* text section II(H) *infra* respecting withdrawal of voluntary employee contributions.

years succeeding the taxable year in which the premature distribution was made.[60]

G. Voluntary Employee Contributions by Owner-Employees

The Pension Reform Act has not changed the basic rules which permit owner-employees to make voluntary employee contributions to certain HR-10 plans up to specified limits.

If only owner-employees are covered by an HR-10 plan, no voluntary employee contributions are permitted. If an HR-10 plan covers not only owner-employees but also other employees—such as common-law employees and/or 10%-or-less partners—and if these other employees are permitted to make voluntary employee contributions to the plan, then the owner-employee participants are also permitted to make voluntary employee contributions to the plan.[61] No voluntary employee contributions are deductible, whether made by an owner-employee,[62] a 10%-or-less partner, or a common-law employee.

Basically, owner-employees may make voluntary employee contributions to an HR-10 plan based on a percentage of their earned income which is equal to (or less than) the percentage of compensation used to determine the voluntary employee contributions allowed for other plan participants. For example, if common-law employees participating in the plan are permitted to contribute 8% of their salary to the plan in the form of voluntary employee contributions (even if they do not actually make any such contributions), then the owner-employee may similarly contribute voluntary employee contributions equal to 8% of his earned income.[63] However, a flat-dollar annual restriction is superimposed on the percentage requirement described above; in no event may an owner-employee make annual voluntary employee contributions in excess of the lesser of $2,500 or 10% of his earned income.[64]

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60. Code § 401(d)(5)(C).

61. Act § 2001(f)(1), Code § 4972(c)(3).

62. T.I.R. 1334 (question H-1).

63. Act § 2001(f)(1), Code § 4972(c)(3). The new $100,000 earned income base discussed in text section II(B) *supra* would also come into play here to restrict voluntary contributions to 8% of the first $100,000 of the owner-employee's earned income.

64. *Id.* § 2001(f)(1), Code §§ 4972(c)(1)-(2). Once again, the new

Suppose an HR-10 plan covered owner-employee, Dr. Smith, as well as his common-law employees who were permitted to contribute 8% of their salary to the plan as voluntary employee contributions. If Dr. Smith earned $150,000 in 1976, he would be permitted to make a voluntary employee contribution of $2,500 in 1976 calculated as follows:

Step 1: 8% x first $100,000 of earned income = $8,000;
Step 2: The lesser of $2,500 or 10% of the first $100,000 of earned income = $2,500;
Step 3: The amount determined in *Step 2* is smaller than the amount determined in *Step 1*, so that $2,500 is Dr. Smith's maximum voluntary employee contribution.

H. Withdrawal of Voluntary Employee Contributions by Owner-Employees Prior to Age 59½

Effective for distributions made after September 2, 1974,[65] an owner-employee may withdraw (prior to age 59½) the actual dollar amount of his voluntary employee contributions to an HR-10 plan without being subject to the tax on premature distributions.[66] Absent this amendment, such withdrawals made by an owner-employee, between September 2, 1974 and taxable years beginning after December 31, 1975, would be subject to the old "110%" tax penalty on premature distributions. Likewise, in taxable years beginning after December 31, 1975, a withdrawal by an owner-employee of his own voluntary employee contributions will not be subject to the new 10% tax penalty on premature distributions.[67]

I. Non-Bank Trustees for HR-10 Plans Covering Owner-Employees

Effective[68] for plan years beginning after December 31, 1975 in the

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$100,000 earned income base would come into play in calculating 10% of his earned income.

65. *Id.* § 2001(i)(6); T.I.R. 1334 (question H-1).

66. Act § 2001(h)(1), Code § 401(d)(4)(B); *id.* § 2001(h)(3), Code § 72(m)(5)(A)(i).

67. *See* text section II(F) *supra*.

68. An exception is made in the case of certain collectively bargained retirement plans. Act § 1017(c).

case of an HR-10 plan in existence on January 1, 1974,[69] and effective for plan years beginning after September 2, 1974 in the case of an HR-10 plan coming into existence after January 1, 1974,[70] a person other than a bank may be a trustee of an HR-10 plan which covers an owner-employee.[71] Traditionally, banks were the only acceptable trustees of HR-10 plans covering owner-employees.[72]

In order for a person other than a bank to be a trustee, he must demonstrate to the satisfaction of the Secretary of the Treasury or his delegate that the manner in which he will administer the trust assets will be consistent with the manner in which a bank trustee would administer the assets.[73] Seemingly, any person who can demonstrate fiscal responsibility will be acceptable as the trustee. However, a sole proprietor should not act as the sole trustee of the HR-10 plan in which he is the sole participant, to prevent merger of interests.[74]

The Pension Reform Act preserves the rule that the trustee re-

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69. *Id.* §§ 1017(b), 1024. For example, in the case of a plan in existence on January 1, 1974, the new trustee rules would be applicable as of the plan anniversary occurring in 1976, unless the plan irrevocably elects to comply sooner (as of a plan year beginning after September 2, 1974) with the participation, vesting, funding, and certain form-of-benefit requirements of the Pension Reform Act, in which case the new trustee rules should also apply sooner. *Id.* §§ 1017(b), (d), 1022(c), 1024. However, see Temporary Treasury Regulation section 420.0-1(a), which appears to indicate that a so-called "section 1017(d) election"—to comply sooner than necessary with certain provisions of the Pension Reform Act—does *not* apply to the new trustee rules set forth in subsection (c) of section 1022 of the Act, but merely to the new participation rules set forth in subsection (b) thereof. 40 Fed. Reg. 12075 (1975).

70. For example, in the case of a plan made effective during the period of January 2, 1974, and September 2, 1974, inclusive, the new trustee rules would apply in 1975 on the first plan anniversary. In the case of a plan made effective on or after September 3, 1974, the new trustee rules would apply on the date of the establishment of the plan. Act §§ 1017(a), 1024.

71. *Id.* § 1022(c), Code § 401(d)(1).

72. *See* Act § 1022(c), *amending* INT. REV. CODE OF 1954, ch. 1, § 401(d)(1), 76 Stat. 812 (1962). Since a bank trustee was not required if the HR-10 plan covered only non-owner-employee self-employed persons, such as 10%-or-less partners, this new rule has no application to such a plan.

73. Act § 1022(c)(1), Code § 401(d)(1).

74. *See* Rev. Rul. 253, 1966-2 CUM. BULL. 122.

quirements can be met even if a person (*e.g.*, the employer) other than the trustee administering the trust may be granted the power to control the investment of the trust funds either by directing investments or by disapproving proposed investments.[75] However, the person who is controlling the investments would obviously be characterized as a "fiduciary"[76] and therefore be subject to the fiduciary responsibilities[77] and self-dealing prohibitions[78] of the Pension Reform Act.

J. Custodians for Custodial Account HR-10 Plans Generally

Effective January 1, 1974,[79] a person other than a bank may be the custodian of a custodial account tax-qualified plan (whether HR-10 or corporate) which will then be treated as a tax-qualified *trust*.[80] Moreover, the custodian holding the assets of the account will be treated as the trustee thereof for the purposes of the trustee requirements of the Internal Revenue Code and the Pension Reform Act regarding prohibited transactions and trustee responsibilities. Formerly, only a bank could be a custodian of a custodial account plan, and the plan could only invest solely in mutual funds or solely in annuity, endowment, or life insurance contracts issued by an insurance company. These restrictions no longer apply.

In order for a person other than a bank to be a custodian, he must demonstrate to the satisfaction of the Secretary of the Treasury or his delegate that the manner in which he will hold the assets of the custodial account will be consistent with the manner in which a bank custodian would hold the assets.[81] Seemingly, any person who can demonstrate fiscal responsibility will be acceptable as a custodian.

Also effective January 1, 1974,[82] a tax-qualified annuity contract (whether used to fund an HR-10 or corporate plan) may be treated

75. Act § 1022(c)(1), Code § 401(d)(1).

76. *Id.* § 3(21)(A). However, in the case of a defined contribution plan where a participant (or his beneficiary) is granted the power to control the assets in his own individual account under the plan, see Code § 404(c).

77. *See* Code §§ 401-14.

78. *See* Act § 2003(a), Code § 4975.

79. *Id.* § 1022(d).

80. *Id.*, Code § 401(f).

81. *Id.*

82. Act § 1022(d).

as a tax-qualified *trust* and the person holding the annuity contract will be treated as the trustee thereof[83] for the purposes of the trustee requirements of the Internal Revenue Code and the Pension Reform Act regarding prohibited transactions and trustee responsibilities.

The new custodial account and annuity contract provisions are significant for two reasons. First, since many tax-qualified plans, whether HR-10 or corporate, frequently utilize a trusteed arrangement, a custodial account plan or an annuity contract plan can now serve the same purpose. Second, a tax-qualified profit-sharing plan, whether HR-10 or corporate, may now be funded solely by means of annuity contracts without the need for interposing a trust.[84] Similarly, a custodial account profit-sharing plan could be devised.

K. Which Common-Law Employees Must Be Included in HR-10 Plans Covering Owner-Employees?

Effective[85] for plan years beginning after December 31, 1975 in the case of an HR-10 plan in existence on January 1, 1974,[86] and effective for plan years beginning after September 2, 1974 in the case of an HR-10 plan coming into existence after January 1, 1974,[87] an HR-10 plan covering an owner-employee[88] must cover each employee having 3 or more "years of service"[89] except:

(1) any employee who is covered by a collective bargaining

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83. *Id.*, Code § 401(f).

84. The IRS has indicated that a non-trusteed profit-sharing plan funded solely with annuity contracts could qualify under Code § 401(a). T.I.R. 1334 (question M-4).

85. An exception is made in the case of certain collectively bargained retirement plans. Act § 1017(c).

86. *Id.* §§ 1017(b), (d), 1024. *See* Temp. Treas. Reg. § 420.0-(1)(a), 40 Fed. Reg. 12075 (1975). For an example of how this effective date rule works, see note 69 *supra*.

87. *Id.* §§ 1017(a), 1024. For examples of how this effective date rule works, see note 70 *supra*.

88. An HR-10 plan which does *not* cover an owner-employee is subject to the general participation requirements of the Pension Reform Act found in Code § 410. T.I.R. 1334 (question H-4). These requirements generally prohibit a tax-qualified retirement plan from excluding an employee from coverage (on account of additional age and service requirements), if he has attained age 25 and completed one "year of service."

89. Act § 1022(b)(2), Code § 401(d)(3)(A).

agreement satisfactory to the Secretary of Labor,[90] if there is evidence that retirement benefits were the subject of good faith bargaining;[91] and

(2) any employee who is a nonresident alien and who receives no earned income from the employer from United States sources.[92]

For the purposes of participation in an HR-10 plan covering an owner-employee (except in the case of seasonal or maritime industries), the term "year of service" means a 12-month period during which the employee has completed 1,000 hours of service.[93] Normally, the 12-month period will be measured from the date of commencement of employment, unless the employee has not completed 1,000 hours of service by his first anniversary of employment, in which case the 12-month period may (in accordance with regulations prescribed by the Secretary of Labor) be measured from the first day of the plan year in which he first completes 1,000 hours of service. The term "hour of service" will be defined by regulations prescribed by the Secretary of Labor.[94]

90. *Id.* §§ 1011, 1022(b)(2), Code §§ 401(d)(3)(B)(i), 410(b)(2)(A). See T.I.R. 1334 (question M-11) for the procedure that will be followed by the IRS and the Department of Labor for determining whether an agreement is a collective bargaining agreement for purposes of Code § 410(b)(2)(A) (regarding plan participation requirements).

91. If a statement to the effect that retirement benefits have been the subject of good faith bargaining is included in the application made to the IRS for an advance determination letter (regarding the qualified status of the plan), that statement will generally suffice in the absence of conflicting evidence brought to the attention of the IRS. T.I.R. 1334 (question P-8).

92. Act §§ 1011, 1022(b)(2), Code §§ 401(d)(3)(B)(ii), 410(b)(2)(C).

93. *Id.*, Code §§ 401(d)(3)(A), 410(a)(3).

94. The IRS indicates that until regulations are issued by the Secretary of Labor defining the term "hour of service," in order to obtain an advance determination letter or opinion letter from the Service (regarding the qualified status of a plan), the "plan must provide that an employee will be credited with one hour of service for each hour for which the employee is either (1) directly or indirectly compensated by the employer or (2) performing duties for the employer. In addition, an employee must be credited with hours of service for any customary period of work, based on a 40 hour week or pro-rata portion thereof, during which the employee is laid off for a temporary period (even if of indefinite duration), is on an employer-

This new 1,000 hours of service/3-year participation rule replaces the old participation rule that an HR-10 plan covering an owner-employee must cover each employee having a period of employment of 3 years (with employment measured by completion of at least 20 hours per week or 5 months per calendar year).[95]

The requirements relating to 1,000 hours of service arise from the participation standards of the Pension Reform Act applicable to tax-qualified plans generally, whether HR-10 or corporate. Those general standards also provide that once an employee has completed the applicable participation requirements, he must commence participation in the plan no later than:

(1) 6 months from the date of completion, or
(2) if earlier, the first day of the first plan year beginning after the date of completion,

unless he is no longer employed on that date.[96] In effect, this general timing-of-participation rule for tax-qualified plans permits a 6-month waiting period to build upon the years-of-service participation requirements. However, it appears that this 6-month waiting period will not be available for an HR-10 plan covering an owner-employee because section 401(d)(3) of the Internal Revenue Code, as amended by the Pension Reform Act, requires that such a plan "benefit . . . each employee having 3 or more years of service,"[97] and no provision is made for a 6-month waiting period. This view would be consistent with the manner in which the old 3-year (20 hours per week/5 months per year) participation requirement worked. In other words, employees still must be covered on the date of completion of 3 years of service.[98]

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approved leave of absence or sick or disability leave, is on jury or military duty, or is not working due to a labor-management dispute. As a condition for obtaining this advance determination or opinion, a plan must also provide that the above provisions shall be construed so as to resolve any ambiguities in favor of crediting employees with hours of service. Further, in order for such a plan to retain its qualified status, it must follow such construction in operation." T.I.R. 1334 (question P-9).

95. Act § 1022(b)(2), Code § 401(d)(3); T.I.R. 1334 (question P-1).
96. Act § 1011, Code § 410(a)(4); T.I.R. 1334 (question P-6).
97. Act § 1022(b)(2), Code § 401(d)(3)(A).
98. Note that in addition to the participation requirements for HR-10

Naturally, if an HR-10 plan's participation requirement for an owner-employee were set at only 2 years of service, the necessity of avoiding discrimination in favor of upper-level employees would mandate that the participation requirement for common-law employees could not be set any higher than 2 years of service. Similarly, if the HR-10 plan covered non-owner-employee self-employed persons (such as 10%-or-less partners), they too would be regarded as upper-level employees by comparison to common-law employees, and the participation requirement for the latter could not be made any stricter than the participation requirement for the former.

One interesting question raised by the Pension Reform Act is whether service rendered as a self-employed person can be counted under a subsequent corporate tax-qualified plan. Effective September 2, 1974,[99] in the case where a successor employer maintains the tax-qualified plan of a predecessor employer, an employee's service with the predecessor employer must be treated as service with the successor employer for all purposes under the successor employer's tax-qualified plan, including participation and vesting.[100] In the case where a successor employer does *not* maintain the plan of a predecessor employer, the Secretary of the Treasury or his delegate will determine the extent to which an employee's service with the predecessor must be counted as service with the successor for all purposes under the successor employer's tax-qualified plan.[101] Hopefully, these regulations will overturn the longstanding rule[102] and permit a sole proprietor—who later incorporates and establishes a corporate tax-qualified plan—to count his years of service as a self-employed person toward the participation requirements under the corporate plan, so long as the service of the common-law employees rendered to the sole proprietorship is also counted.

plans which appear in the tax law provisions of the Pension Reform Act and thus are discussed in detail in this article, the participation requirements contained in the labor law provisions of the Pension Reform Act will also apply to an HR-10 plan covering common-law employees. *Id.* §§ 3(2), 202; T.I.R. 1334 (question H-4).

99. Act § 1017(e).

100. *Id.* § 1015, Code § 414(a)(1).

101. *Id.*, Code § 414(a)(2).

102. Rev. Rul. 502, 1971-2 CUM. BULL. 199; Rev. Rul. 36, 1969-1 CUM. BULL. 128. *But cf.* Farley Funeral Home Inc. v. Commissioner, 62 T.C. 150 (1974), *acquiesced in result*, 1975 INT. REV. BULL. No. 4, at 5.

L. Timing-of-Contribution Rule for Deductibility

Generally effective for plan years beginning after December 31, 1975 in the case of plans in existence on January 1, 1974,[103] and effective for plan years beginning after September 2, 1974 in the case of plans coming into existence after January 1, 1974,[104] the Pension Reform Act has prescribed a new timing-of-contribution rule governing the deductibility of employer contributions to tax-qualified plans generally, whether HR-10 or corporate. The new rule provides that plan contributions made by an employer after the close of his taxable year but within the time prescribed by law for filing his tax return (including any extensions granted for the filing date), can be deemed to have been made on the last day of that taxable year and therefore can be deductible for that year.[105] Formerly, this "grace period" was only available to accrual basis taxpayers.[106] Now cash basis and accrual basis taxpayers can both take equal advantage of the leeway given. In the case of a partnership or a sole proprietorship, income tax returns generally must be filed by the 15th day of the fourth month following the close of the taxable year[107] (*i.e.*, April 15 for a taxpayer on a calendar year basis), and in the case of a corporation, income tax returns generally must be filed by the 15th day of the third month following the close of the taxable year[108] (*i.e.*,

103. Act §§ 1017(b), (d); *see* Temp. Treas. Reg. § 420.0-1(a), 40 Fed. Reg. 12075 (1975). For an example of how this effective date rule works, see note 69 *supra*.

104. Act § 1017(a). For examples of how this effective date rule works, see note 70 *supra*.

105. *Id.* § 1013(c)(2), Code § 404(a)(6). However, the new timing-of-contribution rule for funding purposes may be more restrictive since it only allows a "grace period" of 2½ months following the close of the plan year plus any funding extension (which may not exceed six months) granted by the Secretary of the Treasury or his delegate. *Id.* § 1013(a), Code § 412(c)(10). Hence, a sole proprietorship or partnership (taxpayer on a calendar year basis) maintaining a plan on a calendar year basis would have to make plan contributions for funding purposes no later than March 15 even though its income tax return was not due until April 15, unless it received a funding extension for paying the contributions.

106. Act § 1013(c)(2), *amending* INT. REV. CODE OF 1954, ch. 1, § 404(a)(6), 68A Stat. 138.

107. Code §§ 6012(a), 6031, 6072(a).

108. *Id.* § 6072(b).

March 15 in the case of a taxpayer on a calendar year basis).

For example, a sole proprietorship or partnership employer on a calendar year basis (which had an HR-10 plan in existence on January 1, 1974) could make a timely deductible employer contribution to the plan for the 1976 plan year as late as April 15, 1977.[109] If the

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109. The IRS has explained in detail how the new timing-of-contribution rule works in the case where the plan year and the taxable year of the employer maintaining the plan differ:

"Q. An employer, a cash basis taxpayer, whose taxable year is the calendar year, maintained a plan on January 1, 1974, whose plan year runs from July 1 to June 30. What is the first taxable year for which this employer can take a deduction for a contribution made after the end of the taxable year?

"A. IRC Section 404(a)(6) has been amended by ERISA to permit cash basis taxpayers the same privilege heretofore enjoyed by accrual basis taxpayers to deduct contributions made after the close of the taxable year but before the due date (including extensions) of the tax return for such year. Section 1017(b) of ERISA provides, in effect, that in the case of a plan in existence on January 1, 1974, IRC Section 404(a)(6), as so amended by ERISA, will become effective for plan years beginning after December 31, 1975. In the case posed by this question, the first plan year commencing after December 31, 1975, is the plan year running from July 1, 1976, to June 30, 1977; and, since this provision will be effective for the taxable year ending with or within such plan year, the first taxable year to which IRC Section 404(a)(6), as amended by ERISA, applies to this employer in the taxable year ending December 31, 1976. The taxpayer can, thus, make a contribution for its 1976 taxable year in 1977 if it is made prior to the time the 1976 return (including extensions) is due; but contributions for previous taxable years must be made prior to the end of the respective taxable years.

"If in this example the plan year were to have commenced on January 1, and the plan was in existence on January 1, 1974, the first plan year to which IRC Section 404(a)(6), as amended by ERISA, would apply would be the plan year beginning January 1, 1976, and the answer would be the same as in the case first posed.

"However, if the plan were to have been adopted and therefore in existence any time in 1974 later than January 1, then, notwithstanding that the plan provided that the first plan year began January 1, 1974, IRC Section 404(a)(6), as amended by ERISA, would first be applicable to the plan year beginning January 1, 1975; and, therefore, a contribution on account of the taxable year 1975 could be made in 1976 (if made prior to the due date (including extensions) of the 1975 return). Note that in the case of such a employer irrevocably opted to subject his plan to the general participation, vesting, funding, and certain form-of-benefit requirements of the Pension Reform Act for a plan year beginning after September 2, 1974 but prior to 1976,[110] then he could also utilize the new timing-of-contribution grace period rule for that earlier plan year.

Although the new timing-of-contribution rule applies generally to all tax-qualified plans, it was aimed primarily at helping plans of self-employed persons who may not be able to calculate the exact amount of their earned income until after the close of their taxable year.[111]

M. Other Rules

In addition to the provisions described in detail above, the Pension Reform Act contains other tax aspects which are applicable to self-employed persons. These include:

(1) *Tax treatment of "lump sum distributions"* from tax-qualified plans generally: providing for taxation, in part, as capital gains (based on pre-1974 participation in the plan) and, in part, as ordinary income with a 10-year averaging device (based on post-1973 participation in the plan).[112]

(2) *Overall limitations on contributions and benefits* under tax-qualified plans generally: providing for a "$75,000 limit"

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plan adopted after January 1, 1974, whose first plan year began January 1, 1974, the result is the same whether the adoption of the plan occurs before or after September 2, 1974 (the date of enactment of ERISA).

"If, however, a plan were to be adopted by a calender-year taxpayer in 1974 with its first plan year commencing after September 2, but before December 31, 1974, the amended rule of IRC Section 404(a)(6) would be applicable to the taxable year 1974; and, therefore, a contribution made on account of such taxable year could be made in 1975, in respect of the plan year commencing in 1974, and be deductible in 1974 if made before the due date (including extensions) of the 1974 return." T.I.R. 1334 (question M-14).

110. Act § 1017(d); IRS Technical Information Rel. No. 1336 (Jan. 13, 1975), in BNA PENSION REP. No. 18, at R-3 (Jan. 20, 1975).

111. CCH PENSION REFORM ACT OF 1974—LAW AND EXPLANATION ¶ 418 (Spec. Pamphlet 1974).

112. See text section VI *infra* for a more detailed discussion of these provisions.

on annual employer-financed benefits payable to an employee from a defined benefit plan, and a "$25,000 limit" on annual employer contributions (and other amounts) made for an employee to a defined contribution plan.[113]

(3) *Availability of individual retirement arrangements* as an alternative retirement program for self-employed persons: providing a limit of the lesser of $1,500 or 15% of earned income on deductible annual cash contributions thereto.[114]

(4) *"Safe haven" amendments to HR-10 plans:* Effective September 2, 1974,[115] IRS issued three Revenue Procedures setting forth their *interim* procedures for issuing opinion letters to sponsors of master and prototype tax-qualified plans, and for issuing determination letters to employers establishing individually-designed tax-qualified plans. Overall, these procedures apply to both HR-10 and corporate tax qualified plans.

In particular, Revenue Procedure 74-38[116] deals with individually-designed plans, whether HR-10 or corporate, while Revenue Procedure 74-39 deals with master and proto-type plans only of the HR-10 variety. The net effect of these Revenue Procedures was to give employers (with HR-10 plans made effective September 2, 1974 or earlier) a "safe haven." In other words, these employers were

113. See text section V *infra* for a more detailed discussion of these provisions.

114. See text section IV *infra* for a more detailed discussion of these provisions.

115. Rev. Proc. 74-38, 1974 INT. REV. BULL. No. 41, at 20; Rev. Proc. 74-39, 1974 INT. REV. BULL. No. 41, at 21; Rev. Proc. 74-40, 1974 INT. REV. BULL. No. 41, at 21.

116. Rev. Proc. 74-38 was modified by Rev. Proc. 75-5, 1975 INT. REV. BULL. No. 5, at 25. Rev. Proc. 74-38 had temporarily limited the issuance of IRS determination letters to those plans which would be subject to the law as in effect prior to the enactment of the Pension Reform Act. That limitation or "freeze" was necessary to enable the IRS to develop guidelines for determining whether plans meet the requirements of the Pension Reform Act. The IRS has now developed guidelines for determining whether certain defined contribution plans (see note 324 *infra* for the definition thereof) meet the requirements of the Pension Reform Act. Consequently, Rev. Proc. 75-5 catalogues the kinds of individually-designed defined contribution plans for which the IRS will now issue determination letters. However, the procedures of the Service contained in Rev. Proc. 75-5 are still provided on an interim basis.

given the opportunity to make early amendments to their plans solely to provide for the new (i) \$7,500-or-15% maximum deductible limit on employer contributions (or \$750-or-100% minimum deductible limit on employer contributions), and (ii) \$100,000 earned income base, but to defer making extensive amendments to their plans to comply with all of the other tax law provisions of the Pension Reform Act.[117] Similarly, sponsors were given a safe haven whereby they could make early amendments to their master or prototype HR-10 plans solely to incorporate those two provisions, but could defer making extensive amendments to their plans to comply with all of the other tax law provisions of the Pension Reform Act.[118]

Numerous sponsors of master and prototype HR-10 plans— such as banks and insurance companies—have made safe haven amendments to their plans. Unfortunately, these safe haven amendments to master and prototype plans are not available to employers whose plans are made effective after September 2, 1974 (and which therefore must comply with all of the other tax law provisions of the Pension Reform Act as of the plan date), because the IRS is not currently issuing opinion letters as to the form of master and proto-

117. The "safe haven" amendments of Rev. Proc. 74-38 are only available to two kinds of individually-designed plans: (1) so-called "pre-existing plans,"—namely, those adopted and put into effect by an employer on or before January 1, 1974—which must be amended extensively to comply with all of the tax law provisions of the Pension Reform Act for plan years beginning after December 31, 1975; and (2) so-called "new plans subject to prior law"—namely, those adopted and put into effect by an employer after January 1, 1974, whose first plan year begins on or before September 2, 1974—which must be amended extensively to comply with all of the tax law provisions of the Pension Reform Act for plan years beginning after September 2, 1974. For example, an individually-designed HR-10 plan adopted by an employer on November 1, 1974, and made retroactively effective to July 1, 1974, would have to comply extensively as of the plan year beginning on July 1, 1975. A similar rule applies in the case of employers who adopt master or prototype plans issued by sponsoring organizations. Rev. Proc. 74-39, §§ 3.04-05, 1974 INT. REV. BULL. No. 41, at 21.

118. If a sponsor makes this kind of "safe haven" amendment to its master or prototype HR-10 plan, the current IRS opinion letter approving the form of its plan will not be affected by that amendment, nor will the IRS issue a new opinion letter for the plan. *Id.* § 3.02. In fact, the IRS has imposed a temporary freeze on the issuance of any new opinion letters for master and prototype HR-10 plans. *Id.* § 3.03.

type plans which have been amended extensively to comply with all of the other tax law provisions of the Pension Reform Act. As a result, any such employer who desires to establish an HR-10 plan will probably have to resort to the use of an individually-designed plan rather than a master or prototype plan.[119]

III. New Rules for Tax-Qualified Plans of Subchapter S Corporations Covering Shareholder-Employees

A small business corporation which elects the option of being taxed under Subchapter S of the Internal Revenue Code as if it were a partnership is usually referred to as a "Subchapter S corporation" or a "tax option corporation." With the enactment of the Tax Reform Act of 1969,[120] certain limitations were placed on the tax-qualified pension and profit-sharing plans of Subchapter S corporations to recognize the fact that shareholder-employees of these corporations should be treated in somewhat the same manner as partners would be under an HR-10 plan.[121] Accordingly, section 1379 was added to the Internal Revenue Code. Among other things, section

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119. The employer could decide to adopt an HR-10 prototype plan now with the intention of later retroactively amending it (back to the plan date) to comply with all of the tax law requirements of the Pension Reform Act. Act § 1023, Code § 401(b). Such a retroactive amendment would have to be made before: (1) the time prescribed by law for filing the employer's tax return applicable to the first plan year (including any extensions he obtains for filing that tax return); or (2) if later, any extended deadline allowed by the Secretary of the Treasury or his delegate for the employer to make the retroactive plan amendment. However, this decision entails the risk that the sponsor may not be able to have a completely amended prototype plan (approved by the IRS as to form) ready on time for the employer to make his necessary retroactive plan amendment. It should be noted that section 1023, which took effect on September 2, 1974, should be a valuable tool to both corporate and HR-10 employers desiring to make retroactive amendments to their plans to correct defects which would otherwise result in disqualification.

120. Act of Dec. 30, 1969, Pub. L. No. 91-172, 83 Stat. 487 (codified in scattered sections of 26 U.S.C.A.).

121. Code § 1379.

1379(b) required that the amount contributed annually to a Subchapter S corporation's tax-qualified plan on behalf of a participant who was a shareholder-employee—namely, an employee who owned or was deemed to own more than 5% of the outstanding stock of the corporation—which exceeded the lesser of $2,500 or 10% of his compensation must be included in his gross income in the year in which the excess contribution was made.[122] However, the excess contribution was deductible under the usual rules for corporate tax-qualified retirement plans and could remain in the plan without tax penalty or disqualification of the plan.

A. Maximum Excludable Limits on Employer Contributions for Shareholder-Employees

Effective for taxable years beginning after December 31, 1973,[123] the amount of annual excludable employer contributions that can be made to a Subchapter S corporation's tax-qualified plan on behalf of a shareholder-employee participant will be limited to the lesser of $7,500 or 15% of his compensation.[124] Any amount contributed in excess of the excludable limit must be includible in the shareholder-employee's gross income in the year in which the excess amount is contributed. However, the amount so included in the shareholder-employee's gross income will be treated as an employee contribution for the purpose of determining his investment in the contract at the time he receives a distribution from the plan.

Note that the $750-or-100% minimum deductible limit on employer contributions for self-employed persons under HR-10 plans does *not* apply to shareholder-employees of Subchapter S corporations.

B. $100,000 Compensation Base Limit for Shareholder-Employees

Effective (as a practical matter in most cases) for taxable years beginning after December 31, 1973,[125] the Pension Reform Act restricts the amount of annual compensation of a shareholder-

122. *Id.* § 1379(b).
123. Act § 2001(i)(1).
124. *Id.* § 2001(b), Code §§ 1379(b)(1)(A)-(B).
125. *Id.* § 2001(i)(2).

employee which can be taken into account under a Subchapter S corporation's tax-qualified plan to $100,000.[126]

The new $100,000 compensation base is effective for the first taxable year after 1973 in which a shareholder-employee utilizes the new $7,500-or-15% maximum excludable limit for employer contributions. For example, if during the 1974 taxable year, excludable employer contributions on behalf of a shareholder-employee are made to the plan in excess of the lesser of $2,500 or 10% of his compensation, then the new $100,000 compensation base will also apply for the 1974 taxable year. If such contributions are not made until the 1975 taxable year, then the $100,000 compensation base will not come into play until the 1975 taxable year. In any event, the $100,000 compensation base will apply for taxable years beginning after December 31, 1975 regardless of the amount contributed.

C. New Rules for Defined Benefit Plans Covering Shareholder-Employees

Effective for taxable years beginning after December 31, 1975,[127] the Pension Reform Act prescribes new rules limiting the amount of "basic benefit" which can accrue for a shareholder-employee during each year of his participation in a defined benefit tax-qualified plan.[128] Although very similar to the rules for defined benefit plans for self-employed persons, the prohibition against integration does not apply in the case of shareholder-employees.[129]

IV. Individual Retirement Arrangements ("IRAs")

A. "Portability"—Tax-Free Rollovers From Tax-Qualified Plans to IRAs or Other Tax-Qualified Plans

Effective September 2, 1974,[130] the Pension Reform Act permits limited tax-free "portability" of an employee's interest from one tax-qualified plan to another tax-qualified plan. This tax-free transfer, known as a "rollover," can be made regardless of whether the paying or receiving plan is a trusteed pension, profit-sharing or

126. *Id.* § 2001(c), Code § 401(a)(17).
127. *Id.* § 2001(i)(3).
128. *Id.* §§ 2001(d)(1)-(2), Code §§ 401(a)(18), (j).
129. *See* text section II(D) *supra.*
130. Act § 2002(i)(3).

stock bonus plan qualified under section 401(a)[131] or a non-trusteed annuity plan qualified under section 403(a)[132] of the Internal Revenue Code. Portability may be effected directly from one tax-qualified plan to another, or indirectly by means of one of the new individual retirement arrangement ("IRA") devices introduced by the Pension Reform Act.[133] However, since IRAs cannot be established before taxable years beginning after December 31, 1974,[134] any rollovers made during 1974 would have to be made directly from one tax-qualified plan to another.[135]

General Rule: Suppose John Rich terminates service with Acme Company and goes to work for Baker Company. How would the new portability rules work? Basically, if Mr. Rich, an Acme employee, receives a lump sum distribution[136] from Acme's tax-qualified plan on account of his separation from service with Acme, and (within 60 days following his receipt of the distribution) he transfers all of the property received in that distribution (less the amount thereof consisting of his own employee contributions[137] to the Acme plan) to:

(i) an IRA account, annuity,[138] or bond; or
(ii) another tax-qualified plan (*i.e.* Baker Company's plan),

then the distribution to Mr. Rich is not includible in his gross income in the taxable year in which he receives the distribution from the Acme plan.

The new rollover provisions have been heralded as a great porta-

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131. Id. § 2002(g)(5), Code § 402(a)(5).
132. *Id.* § 2002(g)(6), Code § 403(a)(4).
133. *Id.* §§ 2002(b), (c), Code §§ 408-09.
134. *Id.* § 2002(i)(1).
135. *See* Proposed Treas. Reg. §§ 1.402(a)-3(d)(2), 1.403(a)-3(d)(2), 40 Fed. Reg. 7664 (1975).
136. Act §§ 2002(g)(5)-(6), Code §§ 402(a)(5)(A), 403(a)(4)(A). For an explanation of the meaning of a "lump sum distribution," see text section VI(C) *infra*.
137. *See* text of private letter signed by John E. Hurley, Acting Chief, Employee Plans, Technical Branch, Internal Revenue Service, *reproduced at* CCH PENSION PLAN GUIDE ¶ 84,510.
138. A rollover can only be made to an IRA annuity other than an IRA endowment policy. Act §§ 2002(g)(5)-(6), Code §§ 402(a)(5)(B)(i), 403(a)(4)(B)(i).

bility device for transfers between tax-qualified plans. The rollover provisions are designed:

> [t]o facilitate portability of pensions—or their transfer with the employee as he changes jobs— . . . [by providing] that money or property may be distributed from a tax-qualified plan . . . to the plan participant, on a tax-free basis, if the same money or property [less the amount he contributed to the plan] is reinvested by the participant within 60 days in a[n] . . . individual retirement [arrangement or] . . . transferred to another qualified plan . . . with the consent of the individual's new employer . . . .[139]

Special Rules: There are a number of factors which will diminish the value of the new rollover portability rules for tax-free transfers from one tax-qualified plan to another:

(1) Rollovers cannot be made from one tax-qualified plan to another if any part of the lump sum distribution from the paying plan is attributable to contributions made on behalf of the employee when he was a self-employed individual.[140]
(2) In order for the rollover to work, the paying plan must provide for lump sum distributions. Instead, many plans provide for deferred paid-up annuity benefits on termination of employment. In addition, the receiving plan must provide that rollover contributions can be paid into its plan.[141] Until many employers are sure of how their plans must operate under the new funding and record-keeping requirements of the Pension Reform Act, they may be unwilling to shoulder the burden of tracking rollover contributions for their employees.
(3) In the event that the rollover from one tax-qualified plan to another is made through an IRA account, annuity, or bond, the amount rolled over will not be subject to income tax, but rollovers through an IRA device cannot be made more frequently than once during a single 3-year period.[142] Consequently, in the case of an employee with a high rate of job turnover, his utilization of indirect rollovers, between tax-

139. CONFERENCE REPORT 1280, at 739.
140. Act §§ 2002(g)(5)-(6), Code §§ 402(a)(5), 403(a)(4).
141. Proposed Treas. Reg. §§ 1.402(a)-3(c)(2), 1.403(a)-3(c)(2), 40 Fed. Reg. 7663-64 (1975).
142. Act §§ 2002(g)(5)-(6), Code §§ 402(a)(5), 403(a)(4); *id.* § 2002(b), Code § 408(d)(3)(B).

qualified plans by means of IRA arrangements as conduits, will be restricted.

(4) The Pension Reform Act authorizes and directs the Pension Benefit Guaranty Corporation (PBGC), the new plan termination insurance corporation, to provide advice and assistance to individuals on the economic desirability of establishing IRA arrangements, particularly the desirability of establishing IRAs as a portability device for employees receiving lump sum distributions from tax-qualified plans upon termination of service.[143] It may be that it will take more than 60 days for a taxpayer to receive the requisite advice, thereby defeating the tax-free nature of the transfer.[144]

B. Who Can Make Deductible Contributions to IRAs?

Effective for taxable years beginning after December 31, 1974,[145] any individual (whether self-employed or a common-law employee) who has not reached age 70½ and who is not a participant in certain formal tax-supported retirement plans is eligible to take a tax deduction for limited cash amounts paid by him (or paid on his behalf) to an IRA arrangement.[146]

An individual will not be eligible for deductible IRA contributions in a given taxable year if, on *any* day during that taxable year,[147] he is:

(1) an *active* participant in a trusteed pension, profit-sharing or stock bonus plan qualified under section 401(a) of the Internal Revenue Code (whether HR-10 or corporate);

(2) an *active* participant in a non-trusteed annuity plan qualified under section 403(a) of the Internal Revenue Code (whether HR-10 or corporate);

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143. Act § 4009.

144. For additional aspects of the new rollover portability rules—in the case of a rollover from one IRA device to another or from an IRA device to a tax-qualified plan—see text sections IV(H)(3)-(4) *infra*.

145. Act § 2002(i)(1).

146. *Id.* § 2002(a)(1), Code §§ 219(a), (b)(2)-(3). The precise age limit for IRAs prohibits deductible contributions in the taxable year in which the individual reaches age 70½ and all later taxable years. *Id.* § 2002(a)(1), Code § 219(b)(3).

147. *Id.*, Code § 219(b)(2).

(3) an *active* participant in a bond purchase plan qualified under section 405(a) of the Internal Revenue Code (whether HR-10 or corporate);

(4) an *active* participant in a governmental retirement plan adopted for its employees by the United States, a state, any political subdivision of a state, or by any agency or instrumentality of one of those governmental units (whether or not the governmental plan is tax-qualified).[148] For example, the Federal Civil Service Retirement Plan would be such a governmental plan, but Social Security plans or Railroad Retirement plans would not;[149] or

(5) a participant in a tax-sheltered annuity contract plan adopted by a public school system or a section 501(c)(3) tax-exempt organization under section 403(b) of the Internal Revenue Code (whether or not the participant's rights in the contract are nonforfeitable), where amounts were actually contributed to the contract on his behalf by his employer.[150]

The Pension Reform Act does not define the term "active participant." However, it would appear that in order for an individual to be an active participant in a plan during any part of a given taxable year he must be a participant:

(1) who is actually accruing benefits under the plan[151] (*e.g.*, in a defined benefit pension plan),[152]

(2) for whom the employer is obligated to contribute to the plan on his behalf[153] (*e.g.*, in a money purchase pension plan),[154] or

(3) for whom the employer would have been obligated to con-

148. S. SIMMONS, INDIVIDUAL RETIREMENT ACCOUNTS, PENSION, PROFIT-SHARING, AND OTHER DEFERRED COMPENSATION PLANS 137, 140-41 (ALI-ABA ed. 1974).

149. HOUSE REPORT 807, at 129.

150. Act § 2002(a)(1), Code § 219(b)(2).

151. Proposed Treas. Reg. § 1.219-1(c)(1)(ii)(A)(1), 40 Fed. Reg. 7662 (1975).

152. HOUSE REPORT 807, at 128.

153. Proposed Treas. Reg. § 1.219-1(c)(1)(ii)(A)(2), 40 Fed. Reg. 7662 (1975).

154. HOUSE REPORT 807, at 128-29.

tribute to the plan on his behalf if any contributions had been made to the plan[155] (*e.g.*, in a profit-sharing plan, where no employer contributions are actually made under the plan due to a lack of profits),[156]

regardless of whether his benefits under the plan are nonforfeitable.[157] If, during the individual's taxable year, no contributions have been made to the plan and there has been a complete discontinuance of contributions under the plan, then he would not be considered to be an active participant in that plan.[158] In general, an individual would not be regarded as an active participant in a trusteed plan after his employer has completely terminated contributions under the plan albeit the trust continues in existence in order to provide benefits for the individual.[159] Finally, an individual would not generally be considered to be an active participant after he has separated from service,[160] with a vested interest in the plan.[161]

C. Maximum Deductible Limits on IRA Contributions

Effective for taxable years beginning after December 31, 1974,[162] an eligible individual may contribute to an IRA arrangement—and deduct annually—cash amounts equal to the lesser of $1,500 or 15% of his compensation, which is includible in his gross income.[163] In the case of a self-employed individual, his compensation would mean his earned income,[164] and in the case of a common-law employee, his

155. Proposed Treas. Reg. § 1.219-1(c)(1)(ii)(A)(3), 40 Fed. Reg. 7662 (1975).
156. HOUSE REPORT 807, at 129.
157. Proposed Treas. Reg. § 1.219-1(c)(1)(ii)(A), 40 Fed. Reg. 7662 (1975).
158. *Id.*
159. HOUSE REPORT 807, at 129.
160. Proposed Treas. Reg. § 1.219-1(c)(1)(ii)(B)(2), 40 Fed. Reg. 7663 (1975).
161. HOUSE REPORT 807, at 129. For a more complete description of whether an individual is an "active participant" in a tax-supported plan during any part of a given taxable year and therefore ineligible to make deductible IRA contributions, see Proposed Treas. Reg. § 1.219-1(c)(1)(ii)(B), 40 Fed. Reg. 7663 (1975).
162. Act § 2002(i)(1).
163. *Id.* § 2002(a)(1), Code § 219(b)(1).
164. *Id.*, Code § 219(c)(1).

compensation would mean his wages and salaries received as an employee.[165] In either case, compensation should be derived from the individual's personal services and not from his property, such as income in the form of interest or dividends.[166]

The IRA deduction is taken from an eligible individual's gross income, so it is available whether or not he itemizes his deductions.[167] The IRA deduction is also available to an eligible individual regardless of his marital status, the community property laws, or whether he files a joint return with his spouse.[168] Each eligible married individual is entitled to his own $1,500-or-15% deductible IRA contribution.[169]

An eligible individual can obtain a tax deduction for an IRA contribution by making the contribution in cash himself. Alternatively, an eligible individual can obtain a tax deduction for a cash IRA contribution made on his behalf by (i) his employer, or (ii) if he is a union member, by his labor union.[170]

Where an employer makes an IRA contribution on behalf of his employee, that contribution is automatically includible in the em-

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165. Goldberg, *What the Accountant Needs to Know About the New Individual Retirement Provisions*, 13 TAXATION FOR ACCOUNTANTS 196, 202 (1974).

166. HOUSE REPORT 807, at 127; Proposed Treas. Reg. § 1.219-1(c)(1)(i), 40 Fed. Reg. 7662 (1975).

167. Act § 2002(a)(2), Code § 62(10).

168. *Id.* § 2002(a)(1), Code § 219(c)(2).

169. *Id.*, Code §§ 219(b)(1), (c)(2); Proposed Treas. Reg. § 1.219-1(c)(2), 40 Fed. Reg. 7663 (1975). For example, if in a "Mom and Pop" candy store each of the owners has at least $10,000 of earned income per year, the wife and husband could contribute and deduct $1,500 *each* for a total IRA contribution of $3,000 per year. In the case of such small businesses, IRAs may prove to be more advantageous than HR-10 plans, because the latter must satisfy all of the requirements of tax-qualified plans, such as participation, vesting, and funding standards, and the nondiscriminatory coverage of all common-law employees with 3 "years of service." On the other hand, of course the maximum IRA contribution is only $1,500 per year, Act § 2002(a)(1), Code § 219(b)(1), compared to $7,500 per year under a defined contribution HR-10 plan. *Id.* § 2001(a), Code § 404(e).

170. Act § 2002(a)(1), Code § 219(a); *id.* § 2002(b), Code § 408(c). *See* text section IV(J) *infra* for the requirements necessary when a "group" IRA arrangement is established by an employer or by an association of employees such as a labor union.

ployee's gross income and then *may* be deductible from his gross income if it fits within the $1,500-or-15% maximum deductible limit.[171] For example, where an employer contributed $2,000 to an IRA arrangement on behalf of its employee, John Dough, during Dough's 1975 taxable year, the full $2,000 would be includible in Dough's gross income whether or not all or a portion of that $2,000 will be deductible by Dough. To determine whether all or a portion of the $2,000 contribution is deductible, it is necessary to see if any other IRA contributions were made by Dough himself or by others on his behalf during 1975. If not, then $1,500 would be deductible by Dough (assuming that it fits within the $1,500-or-15% limit, and that Dough is an eligible individual) and the $500 excess would not be deductible.[172]

Where an employer makes an IRA contribution on behalf of an employee, it appears that the employer will be able to deduct the amount thereof as an ordinary and necessary business expense.[173] Moreover, IRA contributions made by an employer can be exempt from the Federal Insurance Contributions Act (FICA) and Federal Unemployment Tax Act (FUTA) withholding tax provisions if it is reasonable for the employer to believe that the employee will be entitled to a deduction for the amount of those IRA contributions.[174]

> In this regard, generally it will be reasonable for an employer to make a lower [FICA and FUTA] withholding only when the amount contributed [by the employer] to the individual retirement account, etc., is based on periodic withholding from compensation otherwise paid the employee. Otherwise, the employer generally will not be able to reasonably estimate the amounts to be contributed to the account, etc., and will not be able to base his lower withholding on the estimate of such contributions.[175]

Note once again that no deduction is available for an IRA contribution made for an individual who has attained age 70½ in the taxable year in which the contribution is made.[176] Moreover, any

171. Act § 2002(a)(1), Code § 219(a); Proposed Treas. Reg. § 1.219-1(c)(3), 40 Fed. Reg. 7663 (1975).

172. *See* text section IV(G) *infra*.

173. Code § 162(a)(1); Proposed Treas. Reg. § 1.219-1(c)(3), 40 Fed. Reg. 7663 (1975).

174. Act § 2002(g)(7), Code § 3401(a)(12).

175. House Report 779, at 130.

176. Act § 2002(a)(1), Code § 219(b)(3).

contribution made to an IRA in taxable years *after* the taxable year in which the individual attains age 69½ will be treated as an "excess contribution."[177]

Finally, it should be mentioned that no deduction is allowed for a (cash and/or property) contribution to an IRA arrangement which represents a tax-free rollover of an individual's entire interest (less his employee contributions) from a tax-qualified plan to the IRA arrangement in question.[178] Similarly, no deduction is allowed for a (cash and/or property) contribution to an IRA arrangement which represents a tax-free rollover of all or a portion of the individual's interest from one IRA arrangement to another.[179]

D. Investment Vehicles for IRAs

Effective for taxable years beginning after December 31, 1974,[180] there are three kinds of investment arrangements that will qualify as IRAs:

(1) an individual retirement account,[181]
(2) an individual retirement annuity,[182] and
(3) an individual retirement bond which is not redeemed within 12 months from the date of issuance of the bond. (IRA bonds must be issued under the Second Liberty Bond Act.)[183]

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177. S. SIMMONS, *supra* note 148, at 147.

178. Act §§ 2002(a)(1), (g)(5)-(6), Code §§ 219(b)(4), 402(a)(5)(B)(i), 403(a)(4)(B)(i).

179. *Id.* §§ 2002(a)(1), (b), (c), Code §§ 219(b)(4), 408(d)(3)(A)(i), 409(b)(3)(C). For the general requirements applicable to rollovers from one IRA arrangement to another, see text section IV(H)(3) *infra*.

180. *Id.* § 2002(i)(1).

181. *Id.* §§ 2002(a)(1), (b), Code §§ 219(a)(1), 408(a).

182. *Id.*, Code §§ 219(a)(2), 408(b).

183. *Id.* §§ 2002(a)(1), (c), Code §§ 219(a)(3), 409. The Treasury Department has issued regulations which indicate, in detail, the rules applicable to IRA bonds, probably the most significant of which is that the investment yield on these bonds is 6% per annum compounded semiannually. Treas. Circular, Public Debt, Series No. 1-75, 40 Fed. Reg. 4240 (1975). *See also* Proposed Treas. Reg. § 1.409-1, 40 Fed. Reg. 7671 (1975) (concerning the income tax treatment and rollover rules for individual retirement bonds).

E. What is an IRA Account?

Effective for taxable years beginning after December 31, 1974,[184] an eligible individual may establish an "IRA account" by means of a trust or custodial account plan.[185] The trust or custodial account plan must be in writing, must be domestic (namely, created or organized in the United States), and must be for the exclusive benefit of the individual or his beneficiaries. In the case of a trust, the trustee must be a bank or another person who demonstrates to the satisfaction of the Secretary of the Treasury or his delegate that the manner in which he will administer the IRA trust assets will be consistent with the manner in which a bank trustee would administer the IRA trust assets.[186] In the case of a custodial account plan, the custodian must likewise be a bank or another person who demonstrates to the satisfaction of the Secretary of the Treasury or his delegate that the manner in which he will administer the IRA custodial account assets will be consistent with the manner in which a bank custodian would administer the IRA custodial account assets.[187] As in the case of HR-10 plans, it seems that any person who can demonstrate fiscal responsibility will be acceptable as the trustee or custodian.[188]

In order for the kind of trust or custodial account described above to qualify as an IRA account,[189] its written governing instrument

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184. Act § 2002(i)(1).

185. *Id.* § 2002(b), Code § 408(a). An individual is eligible to establish an IRA account either because he is eligible to make (or have made on his behalf) deductible contributions thereto, or because he is eligible to make a tax-free rollover thereto.

186. *Id.*, Code § 408(a)(2).

187. *Id.*, Code § 408(h); *see* text sections II(I), (J) *supra*.

188. The IRS has indicated that its regulations with respect to persons who may act as trustees or custodians of IRA accounts "will be issued early in 1975." IRS Technical Information Release No. 1335 (Jan. 10, 1975), in BNA PENSION REP. No. 18, at R-1 (Jan. 20, 1975). *But see* Proposed Treas. Reg. §§ 1.408-2(b)(2)(i), (ii), 40 Fed. Reg. 7668 (1975).

189. The IRS has indicated that it is not necessary for an *individual* to obtain a favorable determination letter from the IRS in order to obtain the benefits of an IRA arrangement (whether IRA account, IRA annuity or IRA bond). Rev. Proc. 75-6, 1975 INT. REV. BULL. No. 5, at 26. However, Rev. Proc. 75-6 also indicated that the Service will issue an opinion letter, if requested by a *sponsor*—who is a trade or professional association (but *not* an employee association), a bank, a federally insured credit union, a

must provide that the following requirements will be met:[190]

(1) No contribution will be accepted unless it is made in cash, except in the case of a tax-free rollover contribution made in property from a tax-qualified plan or from another IRA arrangement.

(2) No contribution will be accepted for an individual during a single taxable year in excess of $1,500, except in the case of a tax-free rollover contribution made from a tax-qualified plan or from another IRA arrangement.[191]

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savings and loan association, a regulated investment company, or a person who (under regulations) may act as a trustee or custodian—as to whether the prototype trust agreement or prototype custodial account agreement being sponsored meets the requirements of an IRA account under Code § 408(a). With reference to an employee association, see note 273 *infra*. A sponsor's request for an opinion letter should be submitted to the IRS National Office on IRS Form 5306 (*Application for Approval of Prototype Individual Retirement Account*). The request should include a copy of the proposed trust agreement or custodial account agreement, which must contain a procedure for amendments so that future changes in the Code, regulations or published rulings can be complied with on a group basis. Once a sponsor has obtained an IRS opinion letter approving his prototype as to form, individual taxpayers desiring to establish IRA accounts may do so by adopting the prototype as their own. Alternatively, individual taxpayers desiring to establish IRA accounts may do so by adopting either the Model Trust Agreement or Model Custodial Account Agreement, which have been devised by the IRS to meet the requirements of an IRA account under Code § 408(a). Individuals who wish to adopt such a Model Agreement should use either IRS Form 5305 (*Individual Retirement Trust Account*) or IRS Form 5305-A (*Individual Retirement Custodial Account*). Eligible individuals who adopt (1) previously approved prototype trust or custodial account agreements of sponsoring organizations, or (2) the IRS Model Trust or Custodial Account Agreement, will be treated as having arrangements that qualify as IRA accounts under Code § 408(a), and contributions thereto will be deductible subject to the limitations of Code § 219 so long as the terms and conditions of the trust or custodial account are followed. All of the forms mentioned in Rev. Proc. 75-6 were made available to the public on January 31, 1975.

190. Act § 2002(b), Code §§ 408(a)(1), (3)-(7).

191. *Id.*, Code § 408(a)(1). Nevertheless, if a contribution greater than $1,500 were made for an individual during a single taxable year, an excise tax would be charged. *Id.* § 2002(d), Code § 4973 (b). *See* text section

(3) No part of the trust funds (or assets of the custodial account) will be invested in life insurance policies.[192] By contrast, investments in annuity contracts[193] (on the life of the individual for whose benefit the account is established) are permitted. There is some uncertainty on this point,[194] although investments in endowment contracts[195] (on the life of the individual for whose benefit the account was established) appear to be permitted. If an endowment contract is permitted, the portion

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IV(G) *infra*.

192. Act § 2002(b), Code § 408(a)(3).

193. *Id.*, Code § 408(d)(2). Note that in Proposed Treas. Reg. § 1.408-2(b)(3), 40 Fed. Reg. 7668 (1975), the Internal Revenue Service indicated that if an IRA account invests in annuity contracts, those contracts may provide a death benefit which is not based on mortality assumptions.

194. Note that in Proposed Treas. Reg. § 1.408-3(a), 40 Fed. Reg. 7670 (1975), the IRS stated: "An individual retirement endowment contract may not be purchased under a trust which satisfies the requirements of [Code] section 408(a)." This prohibition appears to contravene the terms of the Pension Reform Act as well as other provisions set forth in the Proposed Regulation itself respecting the purchase of an endowment contract by an IRA account. For example, see Proposed Treas. Reg. § 1.408-1(b)(6), 40 Fed. Reg. 7667 (1975), which states: "Under [Code] section 408(e)(5), if all, or any portion, of the assets of an individual retirement account are used to purchase an endowment contract described in § 1.408-3(e) for the benefit of the individual for whose benefit the account is established, (i) the excess, if any, of the total amount of assets used to purchase such contract over the portion of the assets attributable to life insurance protection or waiver of premium upon disability shall be treated as a [tax-free] rollover contribution [from one IRA device to another] described in paragraph (b)(2)(i) of this section, and (ii) the portion of the assets attributable to life insurance protection or waiver of premium upon disability shall be treated as a [taxable] distribution described in paragraph (b)(1) of this section, except that the provisions of section 408(f) and paragraph (c)(1) of this section [regarding the 10% tax penalty on premature distributions] shall not apply to such amount."

195. *See* Act § 2002(b), Code § 408(e)(5). In view of the fact that rollovers between IRAs are only permitted once during a given 3-year period, it may be the case that if an IRA account is permitted to invest in an endowment contract, premiums under that contract will have to be paid at 3-year intervals. *Id.*, Code §§ 408(d)(3)(A)(i), (d)(3)(B), (e)(5)(A).

of each premium properly allocable to the cost of life[196] (and possibly health, accident, or other)[197] insurance protection will be taxable income to the employee when the premium is paid.[198] Regulations must be issued to clarify whether an endowment contract can be used under an IRA account,[199] and if so, what kind, and what portion of each premium is properly allocable to the cost of life (and possibly health, accident, or other)[200] insurance.

(4) The interest of the individual in his account balance under the trust (or custodial account) is nonforfeitable.

(5) The assets of the trust (or custodial account) will not be commingled with any other property, except in a common trust fund or common investment fund[201] composed solely of assets of other IRA accounts and of trusts forming part of tax-qualified retirement plans pursuant to section 401(a) of the Internal Revenue Code.[202] This prohibition against the commingling of IRA assets will not prohibit the trust (or custodial account) from investing in fixed-dollar annuity contracts,[203] or in the shares of a registered open-end investment company, such as an insurance company separate account,[204] or a mutual fund.[205]

(6) Distribution of the entire interest of the individual for whose benefit the trust (or custodial account) is established will be completed before the end of the taxable year in which he reaches age 70½.[206] Alternatively, distribution of the indi-

196. Proposed Treas. Reg. § 1.408-1(b)(6), 40 Fed. Reg. 7667 (1975).

197. Act § 2002(b), Code § 408(e)(5)(B).

198. *Id.*

199. *See id.*, Code § 408(b). *See also* Proposed Treas. Reg. § 1.408-3(e), 40 Fed. Reg. 76770 (1975).

200. Code § 408(e)(5).

201. *Id.*, Code § 408(a)(5).

202. *Id.*, Code § 408(e)(6). Banks frequently establish tax-exempt common trust funds composed solely of these underlying tax-exempt plan trusts. Now assets of underlying tax-exempt IRA accounts can be added to these common trust funds.

203. *Id.*, Code § 408(d)(2).

204. *Id.*

205. In fact, any annuity (or, if permitted, endowment contract) issued as part of an IRA account and any annuity or endowment contract used as an IRA annuity will qualify for favorable tax reserve treatment for the issuing insurance company. *Id.* § 2002(g)(9), Code § 805(d)(1)(E).

206. *Id.* § 2002(b), Code § 408(a)(6).

vidual's entire interest in the trust (or custodial account) will begin to be made by that time and will actually be distributed (according to Treasury regulations) over one of the following periods:

(i) the life of the individual;

(ii) the lives of the individual and his spouse;

(iii) a period no longer than the life expectancy of the individual; or

(iv) a period no longer than the life expectancy of the individual and his spouse.[207]

In addition, if the individual (or his surviving spouse) dies before the entire interest in the trust (or custodial account) has been distributed, then, within 5 years following death, the remaining interest generally must be distributed to his (or to his surviving spouse's) beneficiaries or used to purchase an immediate annuity for those beneficiaries.[208]

F. What is an IRA Annuity?

Effective for taxable years beginning after December 31, 1974,[209] an "individual retirement annuity" contract ("IRA annuity") can be issued on the life of an eligible individual who is then known as the "owner" of the contract.[210] An IRA annuity means an individual annuity contract, an individual joint and survivor annuity contract (on the life of the owner and his spouse),[211] or an individual endow-

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207. *Id.* In Proposed Treas. Reg. § 1.408-2(b)(6)(iii), 40 Fed. Reg. 7669 (1975), the Internal Revenue Service expanded upon the four acceptable time periods as follows: (i) the life of the individual, (ii) the joint life *and last survivor expectancy* of the individual and his spouse, (iii) a period certain no longer than the life expectancy of the individual, or (iv) a period certain no longer than the joint life *and last survivor* expectancy of the individual and his spouse.

208. Act § 2002(b), Code § 408(a)(7).

209. *Id.* § 2002(i)(1).

210. *Id.* § 2002(b), Code § 408(b). An individual is eligible to have an IRA annuity issued on his life either because he is eligible to make (or have made on his behalf) deductible contributions thereto or because he is eligible to make a tax-free rollover thereto.

211. CONFERENCE REPORT 1280, at 736.

ment contract (as defined in Treasury regulations and satisfying certain additional tests)[212] issued by an insurance company and meeting the following requirements:[213]

(1) the terms of the contract provide[214] that annual premiums under the contract will not exceed $1,500;[215]

(2) the terms of the contract provide[216] that any refund of premiums will be applied (before the end of the calendar year following the year of the refund) toward the payment of future

212. Act § 2002(b), Code § 408(b); Proposed Treas. Reg. § 1.408-3(e), 40 Fed. Reg. 7670 (1975). Note that Proposed Treas. Reg. § 1.408-3(e)(1)(ix), indicates that to qualify as an endowment contract within the meaning of Code § 408(b), the contract cannot provide any insurance other than life insurance and waiver of premiums on disability. *Cf.* Act § 2002(d), Code § 4973(a); Proposed Treas. Reg. § 54.4973-1(a)(2)(ii), 40 Fed. Reg. 7672 (1975).

213. The IRS has indicated that, if requested by a sponsoring insurance company, it will issue an opinion letter as to whether a specific prototype individual annuity contract or individual endowment contract meets the requirements of an IRA annuity under Code § 408(b). Rev. Proc. 75-6, 1975 INT. REV. BULL. No. 5, at 26. A sponsoring insurance company's request for an opinion letter should be submitted to the IRS National Office on Form 5306 (*Application for Approval of Prototype Individual Retirement Account*). The request should include a copy of the specimen annuity contract or specimen endowment contract, which must contain a procedure for amendments so that future changes in the Code, regulations or published rulings can be complied with on a group basis. Eligible individuals who purchase previously approved prototype individual annuity or individual endowment contracts will be treated as having arrangements that qualify as IRA annuities under Code § 408(b), and premiums paid thereunder will be deductible within the limitations of Code § 219, Rev. Proc. 75-6, *supra*.

214. Although the Pension Reform Act does not state that this $1,500 premium ceiling must appear as a provision in the contract itself, early legislative committee reports make clear that this was the congressional intent. *See* HOUSE REPORT 779, at 133; HOUSE REPORT 807, at 134.

215. Act § 2002(b), Code § 408(b)(2). Nevertheless, if a premium greater than $1,500 were paid for the owner during a single taxable year, an excise tax would be charged. *Id.* § 2002(d), Code § 4973(b). *See* text section IV(G) *infra*.

216. Although the Pension Reform Act does not state that this refund-of-premium provision must appear in the contract itself, early legislative committee reports make clear that this was the congressional intent. *See* HOUSE REPORT 779, at 133; HOUSE REPORT 807, at 134.

premiums or the purchase of additional benefits;[217]
(3) the terms of the contract provide[218] that the contract is not transferable by the owner;[219]
(4) the owner's rights in the contract are nonforfeitable,[220] without exception;[221]
(5) the terms of the contract provide[222] that distribution of the entire interest of the owner in the contract will be completed before the end of the taxable year in which he reaches age 70½.[223] Alternatively, the terms of the contract provide[224] that distribution of the owner's entire interest in the contract will begin to be made by that time and will actually be distributed (according to Treasury regulations) over one of the periods described in text section IV(E)(6) above regarding periodic distributions from IRA accounts.[225] The terms of the contract must also provide[226] that at death, the same requirements about dis-

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217. Act § 2002(b), Code § 408(b)(2).

218. Although the Pension Reform Act does not state that this nontransferability provision must appear in the contract itself, early legislative committee reports make clear that this was the congressional intent. *See* HOUSE REPORT 779, at 133; HOUSE REPORT 807, at 134.

219. Act § 2002(b), Code § 408(b)(1).

220. *Id.*, Code § 408(b)(5).

221. The Pension Reform Act does not state that this nonforfeitability requirement must appear as a provision in the contract itself. Neither do early legislative committee reports require a specific contractual provision, although these reports do say that the owner's interest must be nonforfeitable "without exception" to assure that payments under the contract will be used for retirement. *See* HOUSE REPORT 779, at 132; HOUSE REPORT 807, at 134. Therefore, it would be advisable to include a nonforfeitability provision in the contract itself.

222. Although the Pension Reform Act does not state that these distribution provisions must appear in the contract itself, early legislative committee reports make clear that this was the congressional intent. *See* HOUSE REPORT 779, at 133; HOUSE REPORT 807, at 134-35.

223. Act § 2002(b), Code § 408(b)(3).

224. *See* note 222 *supra*.

225. Act § 2002(b), Code § 408(b)(3). One way to satisfy this requirement would be to set the maturity date of the contract at age 70½. In the case of an endowment contract used as an IRA annuity, the statute mandates that the contract mature before the end of the taxable year in which the owner reaches age 70½. *Id.*, Code § 408(b).

226. *See* note 222 *supra*.

tributions within 5 years apply[227] as in the case of IRA accounts as explained in text section IV(E)(6) above;

(6) the terms of the contract prohibit the owner from using it as security for a loan.[228]

In the event that a group annuity contract can be used as the investment vehicle for the IRA annuity of more than one individual,[229] then the six requirements discussed above would apply only to each individual's own separate interest in the group annuity contract rather than to the group annuity contract as a whole.

On February 21, 1975, the IRS published substantive rules as to the requirements for qualifying IRA accounts and IRA annuities in the form of proposed regulations,[230] which will be made retroactively effective to January 1, 1975. Hopefully, when finalized, these substantive guidelines will clarify precise requirements for any annuity contract or endowment contract which is used as an IRA annuity or which (if possible) is used as an investment of an IRA account.

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227. Act § 2002(b), Code § 408(b)(4).

228. Proposed Treas. Reg. § 1.408-3(b)(6), 40 Fed. Reg. 7670 (1975), states that: "The [IRA annuity] contract must provide that the owner may not use such contract as security for a loan." By contrast, the Pension Reform Act contains no requirement at all that the terms of the IRA annuity itself must prohibit the contract from being used as security for a loan, although early legislative committee reports indicate that it was the congressional intent that such a no-loan provision appear in the contract itself. *See* HOUSE REPORT 779, at 133; HOUSE REPORT 807, at 134. Because of the penalty which attaches to using an IRA annuity to borrow money (see text accompanying note 264 *infra*) it would be advisable to include a no-loan provision in the contract itself. *But see* T.I.R. 1334 (question M-8), which indicates that the prohibited transaction rules now in Code § 4975 do not require a plan to include any particular provisions in order to obtain or retain its qualified status. These prohibited transaction rules generally apply not only to tax-qualified retirement plans (whether HR-10 or corporate) under Code §§ 401(a), 403(a), 405(a), but also to IRA accounts, annuities, and bonds under Code §§ 408(a), (b), 409. Act § 2003(a), Code § 4975(e)(1). Nevertheless, in the event that the pensioner borrows any money under or by use of the IRA contract, the automatic inclusion-in-income penalty described in the third exception in text section IV(I) *infra* comes into play. *Id.* § 2002(b), Code § 408(e)(3).

229. *See* text section IV(J) *infra*.

230. Proposed Treas. Reg. §§ 1.408-2, 1.408-3, 40 Fed. Reg. 7668-70 (1975).

(For example, must all of the policy provisions necessary for an IRA annuity contract also be incorporated in a contract issued as an investment of an IRA account, since the written instrument governing the account will contain much the same subject matter?)

G. Excess Contributions Regarding Individuals

Effective January 1, 1975,[231] the Pension Reform Act generally requires that an IRA contribution made by (or on behalf of) an individual in a given taxable year, which is greater than his $1,500-or-15% maximum deductible limit, will be subject to a 6% excise tax.[232] The excise tax is payable by the individual for whom the IRA arrangement is established[233] and he cannot take a tax deduction for the amount of excise tax paid.

The determination as to whether an excess contribution has been made to an IRA arrangement for an individual is made as of the close of his taxable year. However, in the case of an endowment contract which is used as an IRA annuity, one section of the Pension Reform Act provides that amounts properly allocable to the purchase of life,[234] health, accident, or other insurance[235] under the endowment contract are not taken into account in determining whether an excess contribution has been made, and accordingly, the 6% excise tax does not apply to these amounts.[236] On its face, this

231. Act § 2002(i)(2).

232. *Id.* § 2002(d), Code §§ 4973(a)-(b). However, the amount of the excise tax for any taxable year will not exceed 6% of the value (determined as of the close of the taxable year) of the IRA account, annuity, or bond in question. *Id.*, Code § 4973(a).

233. CONCISE EXPLANATION OF PENSION REFORM LAW, *supra* note 33, ¶ 126, at 24.

234. *See* Proposed Treas. Reg. § 54.4973-1(a)(2)(ii), 40 Fed. Reg. 7672 (1975), which addresses itself only to life insurance and not to health, accident, or other insurance under an endowment contract used as an IRA annuity.

235. Note that despite the provisions of the Pension Reform Act, it may be the case that an endowment contract used as an IRA annuity may not provide any insurance except life insurance and waiver of premiums upon disability. Proposed Treas. Reg. § 1.408-3(e)(1)(ix), 40 Fed. Reg. 7670 (1975). If so, then health, accident, and other insurance would not be permitted under such an endowment contract.

236. Act § 2002(d), Code § 4973(a).

"escape hatch" would seem to indicate that the specified annual premium for the endowment contract could exceed the $1,500-or-15% maximum deductible limit so long as the excess premium was properly allocable to the cost of life, health, accident, or other insurance[237] under the contract. But a separate section of the Pension Reform Act provides that in order for an endowment contract to be used as an IRA annuity, the specified annual premium for the individual under the endowment contract cannot exceed $1,500.[238] Consequently, when the two sections are read together, it appears that the escape hatch, from the 6% excise tax for the portion of premiums allocable to life, health, accident, or other insurance,[239] will only be useful where the individual's maximum deductible limit is 15% of his compensation rather than $1,500.[240]

The 6% excise tax on excess IRA contributions is cumulative, applying for the taxable year in which the excess contribution is made and for every subsequent taxable year when the excess contribution is still outstanding because it has not been eliminated.[241] In general, the excise tax can be eliminated by:[242]

(1) refunding the excess amount through a correcting distribution (in which case the excise tax is eliminated for subsequent taxable years), or

(2) carrying over the excess payment and applying it against the amount allowed to be contributed to the IRA arrangement

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237. *But see* note 234 *supra*.

238. Act § 2002(b), Code § 408(b).

239. *But see* note 234 *supra*.

240. For example, if Mr. White earned $8,000 during 1975, his maximum deductible contribution to an IRA annuity would be $1,200 (the lesser of $1,500 or 15% of $8,000). Suppose Mr. White had used an individual endowment contract as his IRA annuity and during 1975 he paid premiums totaling $1,500 (the specified annual premium under the contract) of which $300 was properly allocable to the purchase of life, health, accident, or other insurance under the contract. In this case, his maximum deduction would be $1,200. Although the $300 balance of premium would be in excess of his maximum deductible limit, no excise tax would be paid on that amount.

241. Act § 2002(d), Code § 4973(b); HOUSE REPORT 807, at 130.

242. Act § 2002(d), Code § 4973(b); *see* CONCISE EXPLANATION OF PENSION REFORM LAW, *supra* note 33, ¶ 126, at 24-25.

in the next or a subsequent taxable year (in which case the excise tax is eliminated in the taxable year in which the excess is used up by the carryover).

However, there is an "early bird" refund exception which eliminates the excise tax altogether—even for the taxable year in which the excess contribution was paid.[243] This exception provides that any excess contribution to an IRA arrangement:

(1) for which no tax deduction is taken by the individual for the year in which the excess contribution is made, and
(2) which is returned (together with net earnings thereon) to the individual before the date prescribed by law for filing his income tax return (including any extensions of the filing date) for the taxable year in which the excess contribution is made,

will be treated as if it were never made, so that the 6% excise tax penalty will not be imposed. In addition, the actual dollar amount of the excess contribution which is refunded by means of this early bird correcting distribution will not be includible in the individual's gross income, although, of course, the amount of any net income on the excess contribution[244] would be includible in the individual's gross income in the taxable year in which the refund is made.[245]

To illustrate how the 6% excise tax can be eliminated, assume that Jefferson Poor has $9,000 of compensation in 1975 and contributes $1,500 to his IRA account. Since his maximum deductible limit for 1975 is only $1,350 (the lesser of $1,500 or 15% of $9,000), he has an excess contribution of $150. If the $150 (plus any income earned by it) is not returned to Mr. Poor before the due date of his income tax return for 1975, he will owe an excise tax of $9 (6% of $150).

Assume that the excess contribution is not returned to Mr. Poor and he therefore pays the 6% excise tax for 1975. Assume further that in 1976, Mr. Poor's compensation is $10,000 and he makes a deductible contribution of $1,500 (the lesser of $1,500 or 15% of

243. Act §§ 2002(b), (d), Code §§ 408(d)(4), 4973(b).

244. See examples set forth in Proposed Treas. Reg. § 1.408-1(b)(3)(iii), 40 Fed. Reg. 7667 (1975) for an explanation of how to determine net income attributable to an excess contribution.

245. Act § 2002(b), Code § 408(d)(4).

$10,000). Since the $150 excess contribution from 1975 still remains in his IRA account, he is again subject to a $9 excise tax in 1976. However, Mr. Poor could eliminate the excise tax in 1976 by making a deductible contribution of only $1,350 for 1976, and using up the $150 excess contribution from 1975 by carrying it over and applying it against the $150 balance of Mr. Poor's $1,500 maximum deductible limit for 1976.[246]

If an excess contribution is eliminated by making an early bird refund before the due date of the individual's tax return for the year in which the excess contribution is made, the 10% income tax penalty for premature distributions from an IRA arrangement will not apply.[247] However, any correcting distribution of an excess contribution made after that time but before the individual reaches age 59½, will be subject to the 10% income tax penalty on premature distributions in addition to the ordinary income tax payable on the amount distributed.[248]

H. Premature Distributions to Individuals Prior to Age 59½

Effective for taxable years beginning after December 31, 1974,[249] a distribution made from an IRA arrangement to the individual prior to age 59½ will be subject to an income tax penalty equal to 10% of the amount distributed.[250] This 10% income tax penalty is in addition to the amount of income tax otherwise payable on the early distribution.

These early distributions are known as premature distributions but the penalties for same are not applicable in the case of:

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246. CCH PENSION REFORM ACT OF 1974—LAW AND EXPLANATION ¶ 508 (Spec. Pamphlet 1974).

247. Act § 2002(d), Code § 4973(b)(2). CCH PENSION REFORM ACT OF 1974—LAW AND EXPLANATION ¶ 508 (Spec. Pamphlet 1974). However, *see* Proposed Treas. Reg. § 1.408-1(b)(3), 40 Fed. Reg. 7667 (1975), which indicates that the amount of any net income attributable to an excess contribution, which is distributed to an individual as part of an early bird refund, may be subject to the 10% income tax penalty for premature distributions from IRAs. *See also* Proposed Treas. Reg. § 1.408-1(c)(1), 40 Fed. Reg. 7667 (1975).

248. Act § 2002(b), Code § 408(f).

249. *Id.* § 2002(i)(1).

250. *Id.* § 2002(b), Code § 408(f)(1).

(1) *Total Disability*—where the individual receiving the distribution before age 59½ is totally disabled;
(2) *Early Bird Refunds*—where the amount received by the individual before age 59½ is an early bird refund to eliminate an excess contribution (except with respect to the portion thereof representing net income attributable to the excess contribution);[251]
(3) *Rollovers Into IRAs*—where the entire amount received (including money and other property) by the individual before age 59½ is applied within 60 days following receipt as an income tax-free rollover to another IRA arrangement;[252] or
(4) *Rollovers Into Tax-Qualified Plans*—where the entire amount received (including money and other property) by the individual before age 59½ is applied within 60 days following receipt as an income tax-free rollover to a tax-qualified retirement plan.[253]

The following example may help to explain how a distribution made from an IRA arrangement to the individual before age 59½ can be rolled over to a tax-qualified plan without any tax penalty for a premature distribution. Assume that in 1975 Mr. Pewter (age 30), a common-law employee, terminates service with Sterling Bros., a partnership maintaining an HR-10 plan. Upon his termination of service, Mr. Pewter receives a lump sum distribution of his

251. *See* text accompanying notes 243-47 *supra*.
252. Act § 2002(b), Code § 408(d)(3)(A)(i). Note that in the case of a rollover from one IRA arrangement to another: (i) not more than one such rollover can be made during a given 3-year period; (ii) no rollover can be made from an IRA arrangement into an endowment contract; and (iii) it is not necessary for the entire amount of the individual's interest in the paying IRA arrangement to be distributed to him in order for a tax-free rollover to be made. *Id.*, Code §§ 408(d)(3)(A)(i), (B).
253. *Id.* § 2002(b), Code § 408(d)(3)(A)(ii). Note that in the case of a rollover from an IRA arrangement to a tax-qualified plan: (i) it is necessary for the entire amount of the individual's interest in the paying IRA arrangement to be distributed. In effect, a lump sum distribution must be made from the paying IRA arrangement; and (ii) the rollover to a later tax-qualified plan can only be made *from* a paying IRA arrangement if the IRA assets consist exclusively of funds attributable *to* a tax-free rollover to the IRA arrangement from an earlier tax-qualified plan with respect to a participant in that earlier plan who was not a self-employed individual. *Id.*

interest in the Sterling HR-10 plan and establishes an IRA account to which he makes a tax-free rollover of the Sterling distribution. Mr. Pewter does not put any other amounts in that IRA account. Instead, in 1976 he purchases a separate IRA annuity to which he makes deductible contributions up to the $1,500-or-15% limit during 1976 and 1977. In 1978, Mr. Pewter is hired by Gold, Inc., a corporation which maintains a tax-qualified plan. Mr. Pewter then takes a lump-sum distribution of his entire interest in the IRA account and makes a tax-free rollover of that distribution to the Gold plan. He cannot rollover his interest in the IRA annuity to the Gold plan, because the assets of the IRA annuity do not consist *exclusively* of amounts attributable to funds rolled over from a tax-qualified plan.[254]

Suppose, in the example given above, instead of a common-law employee like Mr. Pewter, a self-employed person like Mr. Sterling, a partner of Sterling Bros., had been involved. Any lump sum distribution which Mr. Sterling received from the Sterling HR-10 plan (*e.g.*, a lump sum distribution received prior to age 59½ on account of the occurrence of his total disability) could be rolled over to an IRA account. However, if Mr. Sterling later (but at a time prior to age 59½) were to recover and be hired by Gold, Inc., he could not make a tax-free rollover of his entire interest in the IRA account to the Gold plan. The rollover to the Gold plan would be prohibited by the fact that some of the funds in Mr. Sterling's IRA account arose from a tax-free rollover from the Sterling plan for a *self-employed* participant.

It is clear from Mr. Pewter's case that common-law employees who are contemplating rollovers between tax-qualified plans—by means of an IRA arrangement as a conduit—should be sure to keep the conduit IRA device segregated from any other IRA arrangement to which current deductible contributions are made. The solution is to establish two separate IRA arrangements; *e.g.*, an IRA account with a bank, and an IRA annuity contract with an insurance company.

254. For the same reason, if Mr. Pewter had made his deductible IRA contributions in 1976 and 1977 to the IRA account, he could not later make a tax-free rollover of the account to the Gold plan.

I. Income Tax-Exemption During IRA Accumulation Period

General Rules:

(1) *For IRA Accounts*—Effective for taxable years beginning after December 31, 1974,[255] the Pension Reform Act generally provides that an IRA account is exempt from taxation during the accumulation period.[256] In other words, the general rule is that the assets can accumulate income tax-free until they are distributed, at which time the amount distributed from the IRA account will be included in the gross income of the recipient (*i.e.*, the individual, his surviving spouse, or the beneficiary).[257] When amounts are distributed from an IRA account they are fully taxable because the basis of the recipient is zero. However, if an annuity contract is distributed from an IRA account, the full value of the contract is not includible in the recipient's gross income in the year in which it is distributed. Instead, the taxation rule for IRA annuities described below is applied.[258]

(2) *IRA Annuities*—Effective for taxable years beginning after December 31, 1974,[259] the Pension Reform Act generally provides that any amount paid out of an IRA annuity will be included in the gross income of the recipient (*i.e.*, the individual, his surviving spouse, or the beneficiary) in the taxable year when it is received.[260] In other words, the general rule is that the IRA annuity can accumulate income tax-free until pay-out at which time it is includible in the recipient's gross income under the rules applicable to annuities generally pursuant to section 72 of the Internal Revenue Code. However, the recipient's investment in the contract is zero, so that each payment will be fully taxable.

Exceptions to Tax-Exempt Accumulation Rules:

(1) *Total Loss of Exemption for IRA Account Due to Prohibited Transactions*—If the individual for whom an IRA account

255. Act § 2002(i)(1).
256. *Id.* § 2002(b), Code § 408(e)(1); Proposed Treas. Reg. § 1.408-2(a), 40 Fed. Reg. 7668 (1975).
257. Act § 2002(b), Code § 408(d)(1).
258. *Id.*, Code § 408(d)(2).
259. *Id.* § 2002(i)(1).
260. *Id.* § 2002(b), Code § 408(d)(1).

is established (or his beneficiary) engages in a "prohibited transaction" during a given taxable year, then the account ceases to be a tax-exempt IRA account as of the first day of that taxable year, and the individual is taxed as if a distribution had been made to him (in an amount equal to the fair market value of all of the assets in the account on the first day of that taxable year).[261] The prohibited transactions for IRAs are the same as those applicable to tax-qualified plans generally to prevent self-dealing.[262]

(2) *Partial Loss of Exemption for IRA Account Due to Pledging Account as Security*—If the individual for whom an IRA account is established uses the account (or any portion of the account) as security for a loan during a given taxable year, then the portion of the account so used will cease to be a part of a tax-exempt IRA account and the individual will be taxed on that portion as if a distribution had been made to him (in an amount equal to the portion of the account used as security).[263]

(3) *Total Loss of Exemption for IRA Annuity Due to Borrowing on the Contract*—If the individual for whom an IRA annuity is established uses the annuity contract to borrow any money during a given taxable year, then the contract ceases to be a tax-exempt IRA annuity as of the first day of that taxable year, and the individual is taxed as if a payment had been made to him (in an amount equal to the fair market value of

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261. *Id.* §§ 2002(b), 2003(a), Code §§ 408(e)(2), 4975(c)(1). However, if the trust with which the individual engages in a prohibited transaction is a "group" IRA trust established by an employer or by an employee association as described in text section IV(J) *infra*, then only the portion of that trust which is equal to the individual's own interest will be disqualified. "Thus, for example, if an employer establishes an individual retirement account for all of his employees and one employee whose interest is 10 percent of the entire account borrows money from the account only that 10 percent interest is disqualified." Proposed Treas. Reg. § 1.408-2(d)(2)(i), 40 Fed. Reg. 7669 (1975).

262. Act §§ 2002(b), 2003(a), Code §§ 408(e)(2)(A), 4975. Note that Code § 4975(c)(3) eliminates the 5% and 100% tax penalties on prohibited transactions, in the case where an IRA account ceases to be tax-exempt under Code § 408(e)(2)(A).

263. Act § 2002(b), Code § 408(e)(4); *see id.* § 2003(a), Code § 4975(c)(3).

the contract on the first day of that taxable year).[264]

(4) *50% Excise Tax on Deferred Distribution from IRA Accounts and Annuities*—Effective January 1, 1975,[265] if the amount distributed from an IRA account or annuity during a given taxable year is less than the minimum amount required to be distributed in that year because of the timing-of-distribution rules,[266] then an excise tax of 50% will be imposed in that taxable year on the amount which remained in the IRA account or annuity in that year but should properly have been distributed to the payee during that year. This excise tax is payable by the payee.[267]

Any amount which is required to be included in the individual's gross income because of a total or partial loss of exemption described in item (1), (2) or (3) above, will also be subject to an additional income tax penalty of 10%, if it is a premature distribution before age 59½.[268]

J. "Group" IRAs Can Be Established By Employers and Certain Employee Associations

Effective for taxable years beginning after December 31, 1974,[269] the Pension Reform Act provides that a *trusteed* IRA account can be established by:

(1) an employer for the exclusive benefit of his employees (including self-employed individuals) or their beneficiaries, or
(2) an association of employees[270] (including self-employed individuals) for the exclusive benefit of its members or their beneficiaries[271] (*e.g.*, a labor union could establish an IRA account for its members),

264. *Id.* § 2002(b), Code § 408(e)(3).
265. *Id.* § 2002(i)(2).
266. See text sections IV(E)(6), (F)(5) *supra* regarding commencement of distributions at attainment of age 70½. *See also* Proposed Treas. Reg. § 54.4974-1(c), 40 Fed. Reg. 7673 (1975), which sets forth examples of how the minimum amount required to be distributed is determined.
267. Act § 2002(e); Code § 4974.
268. House Report 807, at 136-37.
269. Act § 2002(i)(1).
270. The term "employee association" is defined in Proposed Treas. Reg. § 1.408-2(c)(4)(ii), 40 Fed. Reg. 7669 (1975).
271. A trust is for the exclusive benefit of employees or members even

provided that the trust not only satisfies the general requirements of an IRA account but also provides for a separate accounting[272] of the interest of each participating employee or member.[273] Hopefully, the regulations will extend this group IRA privilege to an IRA annuity using a group annuity contract.

K. Reports by IRA Trustees, Custodians, and Issuers

Effective for taxable years beginning after December 31, 1974,[274] the Pension Reform Act requires that the trustee (or, if applicable, the custodian) of an IRA account and the issuer of an IRA annuity (or of an endowment contract used as an IRA device) make certain reports concerning the account, annuity, or contract and contributions to and distributions from same.[275] These reports must be furnished to the Secretary of the Treasury (or his delegate) and to the individual(s) for whose benefit the account, annuity, or contract is maintained.[276]

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though it may maintain an account for former employees or members and employees who are temporarily on leave. Proposed Treas. Reg. § 1.408-2(c)(1), 40 Fed. Reg. 7669 (1975).

272. For a definition of "separate accounting," see Proposed Treas. Reg. § 1.408-2(c)(4)(i), 40 Fed. Reg. 7669 (1975).

273. Act § 2002(b), Code § 408(c). The IRS indicated that it would issue a determination letter, if requested by an employer or by an employee association, as to whether the individual retirement account established by it for the benefit of its employees or members meets the requirements of an IRA account under Code § 408(a). Rev. Proc. 75-6, 1975 INT. REV. BULL. No. 5, at 26. An employer or an employee association requesting such a determination letter should submit its request to the local IRS District Director (for the district in which the principal place of business of the employer or employee association is located) on IRS Form 5304 (*Application for Determination Individual Retirement Account Established by an Employer or Employee Association*). These determinations will be subject to post-review in the National Office of the IRS.

274. Act § 2002(i)(1).

275. *Id.* § 2002(b), Code § 408(i). Proposed Treas. Reg. 1.408-1(d), 40 Fed. Reg. 7668 (1975) specifies the time frame for these reports as well as the contents thereof in the case where an endowment contract is issued. The issuer of the endowment contract must provide the individual with information relating to the amount of the premium allocable to the retirement savings.

276. Act § 2002(b), Code § 408(i).

Effective January 1, 1975,[277] a penalty of $10 is set for each failure to file such a report unless reasonable cause can be shown for failure to file.[278]

L. Miscellaneous Considerations

The amounts distributed from IRA accounts and IRA annuities are generally taxed as described in the general rules in text section IV(I) above. In addition, an IRA account will be subject to tax on unrelated business income under section 511 of the Internal Revenue Code.[279] Moreover, it is important to note that for:

> purposes of the estate and gift taxes, the amounts in individual retirement accounts, individual retirement annuities, and qualified retirement bonds are not to be excluded from tax (secs. 2039(c) and 2517). This . . . is consistent with . . . [the House Ways and Means] committee's intention that the funds be used during the individual's retirement period.[280]

This should be taken into account if a participant in a tax-qualified plan is considering a tax-free rollover of his interest in the plan at retirement into an IRA arrangement. His interest in the IRA device at the time of death will not be excluded from his gross estate. By contrast, his interest in a tax-qualified plan at the time of death would be excluded (to the extent not attributable to his own plan contributions) pursuant to section 2039(c) of the Internal Revenue Code.

In recommending the IRA annuities, it is important to consider whether the individual will probably be joining one of the tax-supported plans listed in text section IV(B) above. If so, once he joined the plan he would no longer be eligible to make deductible contributions to the IRA annuity. Therefore, it might be wise to recommend to that individual a single premium deferred paid-up annuity, or a variable annuity contract where stipulated payments are not required at specified times.

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277. *Id.* § 2002(i)(2).
278. *Id.* § 2002(f), Code § 6693(a).
279. *Id.* § 2002(b), Code § 408(e)(1).
280. HOUSE REPORT 807, at 138.

V. Overall Limitations on Contributions and Benefits: The "$25,000 Limit" and the "$75,000 Limit"

A. Overview

Effective for years beginning after December 31, 1975,[281] the Pension Reform Act adds section 415 to the Internal Revenue Code to prescribe new overall limitations on *contributions* paid *to* defined contribution plans and on *benefits* paid *from* defined benefit plans, as well as composite limitations when a person is covered under both a defined contribution plan and a defined benefit plan.[282] In addition to the general effective date mentioned above, the Act has transitional effective date rules for persons covered under defined benefit plans before October 3, 1973,[283] and for persons covered under both defined benefit and defined contribution plans on September 2, 1974.[284]

281. Act § 2004(d)(1).

282. *Id.* § 2004(a)(2), Code § 415. To quote a very comprehensive article on the subject of these new overall limitations: "One of the most complex and intriguing changes brought about by the Pension Reform Act was the addition of new section 415 . . . . On its face, the basic thrust of section 415 is to limit the benefits from defined benefit plans to the lesser of $75,000 or 100 per cent of highest average compensation, and to limit contributions to defined contribution plans to the lesser of $25,000 or 25 per cent of annual compensation. Yet, to achieve this seemingly simple purpose the Congress has enacted a provision of nearly 3,000 words, about as many as were required for all of the original provisions of the United States Constitution . . . . Although the language of section 415 is neither as felicitous nor as memorable as the ringing phrases of the Constitution, it will provide tax and penision experts with a text which will require nearly as much scholarly exegesis and which is susceptible to nearly as many subtle disputations." Irish, *Intrigue: Limits on Benefits, Contributions Have Twin Goals*, 172 N.Y.L.J. 25 (Sept. 23, 1974) (footnotes omitted) [hereinafter cited as Irish].

283. Act § 2004(d)(2); *see* text section V(B)(8) *infra*. October 4, 1973 was the date upon which the House Ways and Means Committee tentatively agreed to accept the "$75,000 limit" on annual retirement benefits payable under a defined benefit plan. Apparently, this accounts for the use of October 3, 1973 as the cut-off date for the application of these transitional rules.

284. Act § 2004(a)(3). This transitional rule accelerates the effective date of the composite limitation to September 3, 1974. *See* text section V(D)(3) *infra*.

By their terms, the new limitations on contributions and benefits theoretically apply to:[285]

(1) trusteed, tax-qualified pension, profit-sharing and stock bonus plans under section 401(a) of the Internal Revenue Code (whether HR-10 or corporate);
(2) non-trusteed, tax-qualified annuity plans under section 403(a) of the Internal Revenue Code (whether HR-10 or corporate);
(3) tax-qualified bond purchase plans under section 405(a) of the Internal Revenue Code (whether HR-10 or corporate);
(4) tax-sheltered annuity contracts established by public school systems or section 501(c)(3) tax-exempt organizations under section 403(b) of the Internal Revenue Code;
(5) IRA accounts under section 408(a) of the Interal Revenue Code;
(6) IRA annuities under section 408(b) of the Internal Revenue Code; and
(7) IRA bonds under section 409 of the Internal Revenue Code,

in such a way that (with the exception of 403(b) annuity contracts) each will not qualify for favorable tax treatment under its appropriate section of the Code if the limitations are exceeded.[286] In the case of 403(b) annuities, the contract as a whole will not be disqualified from receiving favorable tax treatment under section 403(b) of the Code; rather, if the limitations (on benefits or contributions, whichever is appropriate) are exceeded, the income exclusion allowance otherwise permitted by that section will simply be reduced by the amount of the excess.[287]

As a practical matter, the new overall limitations on contributions and benefits would seem to have no real effect on IRAs,[288] HR-

285. Act § 2004(a)(2), Code §§ 415(a)(1)-(2).
286. *Id.* §§ 2004(a)(1)-(2), Code §§ 401(a)(16), 415(a)(1)-(2).
287. *Id.* § 2004(a)(2), Code §§ 415(a)(2)(F), (e)(5).
288. These are characterized as defined contribution plans in section 415 for the purposes of the new limitations thereof, but are otherwise subject to the more restrictive $1,500-or-15% limit on deductible contributions. *Id.*, Code § 415(e)(5).

10 plans,[289] or corporate tax-qualified plans of Subchapter S corporations benefiting shareholder-employees.[290] (Of course, where a self-employed person or shareholder employee is covered under both a defined benefit plan and a defined contribution plan, then the new composite limitations may come into play to restrict his aggregate retirement benefits.) With respect to section 403(b) annuities, which are automatically characterized as defined contribution plans in section 415 for the purposes of the new limitations thereof,[291] there are four special rules which modify the general terms of the new limitations on contributions and benefits and thus soften their impact.[292]

Consequently, the real impact of the new overall limitations on contributions and benefits will be felt by corporate tax-qualified plans generally.[293] This is consistent with one of the avowed purposes of these limitations, which was:

> to provide some limitations to prevent the accumulation of corporate pensions out of tax-sheltered dollars which are swollen completely out of propor-

289. These would otherwise be subject to the more restrictive \$7,500-or-15% limit on deductible contributions in defined contribution plans and equivalent limits on benefits in defined benefit plans.

290. These would otherwise be subject to the more restrictive \$7,500-or-15% limit on excludable contributions to defined contribution plans and equivalent limits on benefits in defined benefit plans.

291. Act § 2004(a)(2), Code § 415(e)(5). There is an exception in the case where the participant elects to abandon the traditional Code § 403(b) exclusion allowance. *Id.*, Code §§ 415(c)(4)(C)-(D),(e)(5); *id.* § 2004(c)(4), Code § 403(b)(2)(B).

292. First, *id.* § 2004(a)(2), Code §§ 415(a)(2), (e)(5); second, *id.*, Code §§ 415(c)(4)(A), (D); third, *id.*, Code §§ 415(c)(4)(B), (D); fourth, *id.*, Code §§ 415(c)(4)(C), (D).

293. Apparently, IRAs, HR-10 plans, Subchapter S tax-qualified plans and section 403(b) annuities were simply treated together with these regular corporate tax-qualified plans in an effort to bring uniformity to the statute. When the new overall limitations on contributions and benefits are coupled with the specific new IRA, HR-10, and Subchapter S limits, the effect is to eliminate some of the inequities of the old law for participants in different kinds of retirement programs. The purpose behind all of these limitations, as applied to these various tax-benefited retirement programs, is "to limit the size of the pension which is subsidized by the tax laws." HOUSE REPORT 779, at 111.

tion to the reasonable needs of individuals for a dignified level of retirement income.[294]

To help carry out this avowed purpose, the Pension Reform Act mandates disqualification of a tax-qualified plan where contributions made or benefits paid exceed the appropriate limits.[295] However, the Act specifically allows employers to maintain "excess benefit plans"[296] (whether funded or unfunded) solely for the purpose of providing contributions and benefits in excess of these limits. The additional benefits generated by these excess benefit plans are provided on a non-qualified basis.[297]

For ease of reference and because of their primary impact on corporate tax-qualified retirement plans, each of the overall limitations on contributions and benefits is described below in terms of those plans.

B. Defined Benefit Plan Limitations: "$75,000 Limit"

General Rule:

A corporate, tax-qualified defined benefit plan[298] must limit the maximum annual retirement benefit payable to an employee:

(1) who has completed 10 years of service with the employer maintaining the plan;[299]

(2) whose retirement income begins on or after age 55;[300]

(3) in the form of a straight life annuity[301] with no ancillary benefits;[302]

(4) under a non-contributory plan[303] to which no tax-free rollovers (from IRAs or other tax-qualified plans) were made,[304]

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294. HOUSE REPORT 779, at 115-16.

295. Act §§ 2004(a)(1)-(2), Code §§ 401(a)(16), 415(a)(1)-(2).

296. *Id.* § 3(36).

297. Klien & Moses, *New Pension Reform Act Requires Review of All Qualified and Nonqualified Plans*, 13 TAXATION FOR ACCOUNTANTS 196, 202 (1974).

298. *See* note 26 *supra*.

299. Act § 2004(a)(2), Code § 415(b)(5).

300. *Id.*, Code § 415(b)(2)(C).

301. *Id.*, Code § 415(b)(2)(A).

302. *Id.*

303. *Id.*

304. *Id.*

to an amount equal to the lesser of: $75,000 or 100% of the employee's average compensation for his "high 3 years."[305] This maximum annual retirement benefit limit is frequently referred to as the "$75,000 limit" or the "$75,000-or-100%" limit.

"High 3 years" means 3 or less[306] consecutive calendar years during which the employee was an "active participant" in the plan and had the greatest aggregate compensation from the employer. Although the term "active participant" is not defined, presumably it would have the same meaning as that discussed at text section IV(B) above regarding "active participants" in certain tax-supported plans who are ineligible for deductible IRA contributions.[307]

Special Rules:

(1) *Cost-of-Living Adjustment Rule*—The Secretary of the Treasury or his delegate will adjust the $75,000 amount (in the $75,000-or-100% limit formula) annually for increases in the cost of living.[308] Treasury regulations must be devised for these cost-of-living adjustments in a manner similar to the cost-of-living adjustments made for primary insurance amounts under the Social Security Act.[309] The calendar quarter beginning October 1, 1974 will be used as the base period for computing what increases have occurred in the cost of living.[310]

(2) *Short Term Employees*—If the employee has not completed 10 years of service with the employer, the $75,000-or-100% limit is reduced by multiplying it by a fraction, the numerator of which is the number of years (or part thereof) of service with the employer, and the denominator of which is 10.[311] A similar pro rata reduction applies in the case of an employee subject to the $10,000 de minimus rule referred to in text section V(B)(6) below.

305. *Id.*, Code § 415(b).

306. Presumably, a period shorter than 3 years could only be selected when the employee has less than 3 consecutive years of service. *Id.*, Code § 415(b)(3).

307. *See* text accompanying notes 151-61 *supra*.

308. Act § 2004(a)(2), Code § 415(d)(1).

309. *Id.*, Code § 415(d)(1); *see* Social Security Act § 215(i)(2)(A), 42 U.S.C. § 415(i)(2)(A) (Supp. II, 1972).

310. Act § 2004(a)(2), Code § 415(d)(2).

311. *Id.*, Code § 415(b)(5).

(3) *Retirement Before 55*—If the retirement income benefit under the plan begins before age 55, Treasury regulations will determine how the $75,000 amount (in the $75,000-or-100% limit formula) should be reduced to obtain the equivalent of a benefit beginning at age 55.[312]

(4) *Other Forms of Benefit*—If the retirement benefit under the plan is payable in any form other than a straight life annuity with no ancillary benefits (*e.g.*, payable as a life annuity with a 10-year period certain), Treasury regulations will determine how the benefit should be adjusted to obtain the equivalent of a straight life annuity with no ancillary benefits subject to the $75,000-or-100% limit.[313] However, no adjustment has to be made:[314]

(i) for an ancillary benefit, if that ancillary benefit is not directly related to retirement income benefits (perhaps, for example, pre-retirement life insurance coverage), or

(ii) where the retirement benefit is payable in the form of a joint and survivor annuity, with respect to the portion thereof which constitutes a "qualified joint and survivor annuity."[315]

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312. *Id.*, Code § 415(b)(2)(C). Note that no actuarial adjustment is made in the $75,000 amount (in the $75,000-or-100% limit formula) to increase benefits when the retirement income benefit begins after age 55.

313. *Id.*, Code § 415(b)(2)(B).

314. *Id.*; *see* Act § 1021(a), Code § 401(a)(11)(G)(iii).

315. For plan years beginning after December 31, 1975 (and in some cases, for earlier plan years), the Pension Reform Act generally requires that unless a participant in a tax-qualified plan opts out, his annuity retirement benefits must be paid in the form of a "qualified joint and survivor annuity." *Id.* §§ 1017(d), 1021(a), 1024, Code § 401(a)(11)(A), (G)(iii); *see* Temporary Treas. Reg. § 420.0-1(a), 40 Fed. Reg. 12075 (1975). This basically means that a joint and survivor annuity (which is the actuarial equivalent of the straight life annuity to which the retired participant would otherwise be entitled under the plan) will be paid with the result that the surviving spouse of the retired participant will receive an annuity at least equal to 50% but not greater than 100% of the amount of annuity payable during the joint lives of the retired participant and his spouse. Act § 1021(a), Code § 401(a)(11). For example, an annuity equal to $75,000 per year during the joint lives of the retired participant and his spouse, and upon his death an annuity equal to $75,000 per year to his

This joint and survivor provision has produced speculation about whether a corporate executive—who would otherwise be entitled to receive a retirement benefit in the form of a straight life annuity of $100,000 per year under the terms of the plan—can soften the impact of the $75,000 limit by taking this benefit in the form of a "qualified joint and survivor annuity" providing $75,000 per year during his life, and $75,000 per year after his death to his surviving spouse. A strict reading of the statute would appear to permit this. However, Treasury regulations may require that for the purposes of the $75,000 limit, the qualified joint and survivor annuity for the executive would have to be the actuarial equivalent of a $75,000 straight life annuity rather than the actuarial equivalent of a $100,000 straight life annuity.

(5) *Employee and Rollover Contributions*—If the employee has placed in the plan his own contributions or tax-free rollovers (from IRAs or other tax-qualified plans), Treasury regulations will determine how the $75,000-or-100% limit should be adjusted (increased).[316]

(6) *De Minimus Rule for $10,000 Annual Benefit*—Notwithstanding the $75,000-or-100% limit, an employee may receive a maximum annual retirement benefit up to $10,000 (from all defined benefit plans maintained by the employer) provided that the employee has never participated in a defined contribution plan maintained by the employer.[317]

In this way, it appears that an employee earning $9,000 each year will be able to receive an annual retirement benefit greater than 100% of his average compensation for his high 3 years. Apparently, for a retirement benefit as small as $10,000 a year,

surviving spouse, could constitute a "qualified joint and survivor annuity," because the amount of the payment to the spouse does not exceed 100% of the payment during the joint lives of the participant and his spouse. By contrast, if such an annuity provided $80,000 per year to the surviving spouse, the excess $5,000 could not constitute part of a "qualified joint and survivor annuity," and an adjustment would have to be made, *only* with respect to this excess, in order for the benefit to conform to the $75,000-or-100% limit.

316. Act § 2004(a)(2), Code § 415(b)(2)(B).

317. *Id.*, Code § 415(b)(4).

this rule will overturn Revenue Ruling 72-3[318] which basically indicated that a pension is essentially a substitute for earning power and therefore should not exceed 100% of compensation. If so, then this rule is designed to protect the "average working man."

(7) *Aggregation-of-Plans Rule*—If an employee is a participant in more than one defined benefit plan maintained by the same employer, the benefits under all of these plans will be aggregated in determining whether the employee's annual retirement benefit exceeds the $75,000-or-100% limit.[319]

(8) *Transitional Rules*—If an employee was an "active participant"[320] in a defined benefit plan on October 2, 1973 his annual retirement benefit will be deemed to be in compliance with the $75,000-or-100% limit so long as that benefit is no greater than:

(i) 100% of his annual rate of compensation on October 2, 1973, and

(ii) the annual benefit that would have been payable to him at retirement, if all of the terms of the plan as in effect on October 2, 1973 had remained in effect without change until his retirement, and no increases in compensation (above the annual rate of his compensation on October 2, 1973) were taken into account after October 2, 1973.[321]

A similar rule applies in the case of an "active participant" in a defined benefit plan who terminated his employment prior to October 2, 1973, except that his annual retirement benefit cannot exceed his vested accrued benefit as of the date of termination of employment.[322]

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318. Rev. Rul. 72-3, 1972-1 CUM. BULL. 105.

319. Act § 2004(a)(2), Code § 415(f). Regarding the aggregation rule for affiliated employers, see text section V(E) *infra*.

320. Although the term "active participant" is not defined, presumably it would have the same meaning as that discussed in text section IV(B) and accompanying notes 151-61 *supra*.

321. Act §§ 2004(d)(2)(A)-(B). For an example of how this transitional rule works in the case of an employee covered under both a defined benefit plan and a defined contribution plan, see note 336 *infra*.

322. *Id.* § 2004(d)(2)(C); Irish, *supra* note 282, at 38.

The primary beneficiaries of these "grandfather" or transitional rules presumably will be the retired employees whose present annual pensions exceed $75,000 but do not exceed 100% of their final salaries, and the active participants on October 2, 1973 whose projected annual pensions exceed $75,000 but do not exceed their salaries on October 2, 1973.[323]

C. Defined Contribution Plan Limitations: "$25,000 Limit"

General Rule:

A corporate tax-qualified defined contribution plan[324] must limit the maximum annual amount that can be credited to the account of an employee under the plan in the form of:

(1) all employer contributions;
(2) all forfeitures; and
(3) some employee contributions (namely, the smaller of: those employee contributions exceeding 6% of his compensation, and one-half of all his employee contributions),

to an amount equal to the lesser of: $25,000 or 25% of the employee's

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323. Irish, *supra* note 282, at 38.

324. A "defined contribution plan" means a plan which provides for an individual account for each participant and for benefits based solely on the amount contributed to the participant's account, together with any income, expenses, gains, losses, and forfeitures which may be allocated to that account. Act §§ 1015, 2004(a)(2), Code §§ 414(i), 415(k); *see id.* § 1015, Code § 414(k); T.I.R. 1334 (question M-6). For example, a profit-sharing plan or a money purchase pension plan would be a defined contribution plan. Note that a "target plan"—namely, a plan where the employer establishes a target retirement benefit, but where the employee's actual retirement benefit is based on the amount in his individual account—will be treated as a defined contribution plan for the purposes of the overall limitations on contributions and benefits under section 415 of the Code. CONFERENCE REPORT 1280, at 742. As such, the target plan will generally be subject to the $25,000-or-25% limit on "annual additions" rather than to the $75,000-or-100% limit on annual retirement benefits. However, if the target plan is a hybrid plan—namely, part target benefit and part defined benefit—then the plan will be treated as a defined contribution plan (subject to the $25,000-or-25% limit) only with respect to that portion of the employee's retirement benefit which is based upon the amount in his individual account under the plan. *Id.*

compensation from the employer maintaining the plan.[325] This maximum limlit on each "annual addition" is frequently referred to as the "$25,000 limit" or the "$25,000-or-25%" limit. The term "annual addition" means the sum for any year of the three account credit elements listed above.

Special Rules:

(1) *Cost-of-Living Adjustment Rule*—The Secretary of the Treasury or his delegate will adjust the $25,000 amount (in the $25,000-or-25% limit formula) annually for increases in the cost of living.[326] Treasury regulations must be devised for these cost-of-living adjustments in a manner similar to the cost-of-living adjustments made for primary insurance amounts under the Social Security Act.[327] The calendar quarter beginning October 1, 1974 will be used as the base period for computing what increases have occurred in the cost of living.[328]
(2) *Rollover Contributions*—If the employee places in the plan tax-free rollover contributions (from IRAs or other tax-qualified plans), these rollover contributions are not treated as employee contributions for the purposes of the $25,000-or-25% limit.[329]
(3) *Aggregation-of-Plans Rule*—If an employee is a participant in more than one defined contribution plan maintained by the same employer, the contributions under all of these plans will be aggregated in determining whether the employee's annual addition exceeds the $25,000-or-25% limit.[330]
(4) *No Transitional Rules*—Since the $25,000-or-25% limit on contributions to defined contribution plans is imposed on the amount of annual addition made to the plan during a given year, the limitations will have no retroactive effect on existing

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325. Act § 2004(a)(2), Code §§ 415(c)(1)-(3).
326. *Id.*, Code § 415(d)(1).
327. *Id.*, Code § 415(d)(1); *see* Social Security Act § 215(i)(2)(A), 42 U.S.C. § 415(i)(2)(A) (Supp. II, 1972).
328. Act § 2004(a)(2), Code § 415(d)(2).
329. *Id.*, Code § 415(c)(1).
330. *Id.*, Code § 415(f). Regarding the aggregation rule for affiliated employers, see text section V(E) *infra*.

plans. It is not necessary to aggregate the amount of contributions made for an employee during his career, so that participants who have had the benefit of very large annual additions to their accounts in the past will only be affected by the new limit on a prospective basis. As a result, there are no "grandfather" or transitional rules applicable to the $25,000-or-25% limit.[331]

D. Composite Limitations for Defined Benefit and Defined Contribution Plans: "140% Limit"

Where an employee is covered by both a corporate tax-qualified defined benefit plan and a corporate tax-qualified defined contribution plan maintained by the same employer, the contributions and benefits provided under both plans are subject to a composite limit determined under a somewhat complex formula. In effect, this formula provides that the sum of the employee's percentage of utilization of the "$75,000 limit" under the defined benefit plan, and his percentage of utilization of the "$25,000 limit" under the defined contribution plan, cannot exceed 140%. This composite limit is frequently referred to as the "140% limit" or the "1.4 fractional limit."[332]

The statute itself phrases the composite limit in terms of fractions rather than percentages. The maximum amount of benefits and contributions permitted for an employee who is covered under a defined benefit plan and a defined contribution plan cannot exceed 1.4 for any given year,[333] when 1.4 represents the sum of the employee's "defined benefit plan fraction" and "defined contribution plan fraction" for that year, each of which is determined according to the fractions in Formula 1:

Formula 1

$$\text{Defined benefit plan fraction}^{334} = \frac{\text{his actual projected annual retirement benefit under the plan (as of the close of the year)}}{\text{his possible projected annual retirement benefit under the plan (as of the close of the year) when the \$75,000-or-100\% limit is applied}}$$

331. Irish, *supra* note 282, at 38.

332. Act § 2004(a)(2), Code § 415(e). Regarding the aggregation rule for affiliated employers, see text section V(E) *infra*.

333. *Id.*, Code § 415(e)(1).

334. *Id.*, Code § 415(e)(2).

Defined contribution plan fraction[335] =

$$\frac{\text{the sum of the actual ``annual additions'' made to his account (as of the close of the plan year)}}{\text{the sum of the maximum possible amount of ``annual additions'' which could have been made to his account (for the current year and each prior year of service with the employer) when the \$25,000-or-25\% limit is applied.}}$$

It should be noted that the defined contribution plan *fraction*—unlike the $25,000-or-25% defined contribution plan *limit*—looks to the past to measure the relative level of contributions that have been made throughout the employee's career. For example, assume that John Better is hired by the Best Corporation in 1976. Mr. Better works for 10 years during which time he earns $20,000 per year and annual additions totaling $25,000 ($2,500 x 10 years = $25,000) are credited to his account under the Best profit-sharing plan. At the end of 1985, Mr. Better's defined contribution plan fraction would be .5 determined according to the fraction in Formula 2:

Formula 2

$$\frac{\text{\$25,000 (sum of actual annual additions)}}{\text{\$50,000 (sum of maximum possible annual additions 25\% of \$20,000 x 10 years = \$50,000)}}$$

If at the same time, annual pension benefits equal to 80% of Mr. Better's compensation for his high 3 years were projected for him under Best's defined benefit pension plan, Mr. Better's defined benefit plan fraction would be .8.[336] The sum of .5 (his defined contribu-

335. *Id.*, Code § 415(e)(3).

336. *Cf.* T.I.R. 1334 (question M-7). The IRS gave an example of how the transitional rule for the defined benefit plan limit discussed in text section V(B)(8) *supra* (regarding "active participants" whose projected annual benefits exceed the $75,000-or-100% limit, but do not exceed their salaries on October 2, 1973) will affect an employee's defined benefit plan *fraction* in the case where he is also covered under a defined contribution plan maintained by the same employer: "Q. On October 2, 1973, employee A was 40 years of age and participated in the defined benefit plan of X Corporation. At that time, the plan provided an annual benefit of 50% of a participant's average compensation for his high 3 years. On October 2, 1973, employee A's annual compensation from X Corporation was

tion plan fraction) and .8 (his defined benefit plan fraction) would equal 1.3 and therefore satisfy the 1.4 fractional limit.[337]

By contrast, if Mr. Better merely participated in the Best profit-sharing plan, the maximum amount of annual addition that could be made on his behalf during 1985 would be $5,000 (the lesser of $25,000 or 25% of $20,000).

There are some fairly intricate transitional rules available to soften the impact of this composite limit with respect to:

(1) defined contribution plans where sizable employer contributions and forfeitures were credited prior to 1976;[338]
(2) defined contribution plans where sizable employee contributions were made prior to 1976;[339] and
(3) any employee whose composite interest in his employer's defined contribution plan and defined benefit plan exceeded the 1.4 fractional limit on September 2, 1974.[340]

In effect, the third transitional rule permits an employee to continue to exceed the 1.4 fractional limit in the case where his composite interest in his employer's defined benefit plan and his employer's defined contribution plan exceeded the 1.4 fractional limit on September 2, 1974, provided that: no contributions are made to the defined contribution plan after September 2, 1974, and the defined benefit plan fraction is not increased (by amendment of the plan or

$200,000. Under ERISA Section 2004(d)(2), employee A's annual benefit is treated as not exceeding the [$75,000-or-100%] limitation applicable to defined benefit plans under IRC Section 415(b). If benefits under the [defined benefit] plan are not changed after October 2, 1973, what is the defined benefit fraction computed under IRC Section 415(e)(2) with respect to employee A, as of the time IRC Section 415 first applies to the plan? A. Under IRC Section 415(e)(2)(A), the numerator of the defined benefit fraction computed with respect to employee A is $100,000, the projected annual benefit provided for him under the plan. Under IRC Section 415(e)(2)(B), the denominator of the fraction is also $100,000, the maximum benefit allowable under IRC Section 415(b) (by reason of ERISA Section 2004(d)(2)). Consequently the defined benefit fraction computed with respect to employee A is 1." *Id.*

337. Irish, *supra* note 282, at 38.
338. Act § 2004(a)(2), Code § 415(e)(4)(A).
339. *Id.*, Code § 415(e)(4)(B).
340. *Id.* § 2004(a)(3).

otherwise) after September 2, 1974.[341] Because discontinuance of contributions to the defined contribution plan on and after September 3, 1974 is a prerequisite for the availability of this transitional rule, the rule accelerates the effective date of the imposition of the 1.4 fractional limit from plan years beginning after December 31, 1975 to September 3, 1974.

E. Employees of Affiliated Employers

Finally, it should be noted that one of the most important changes made by the Pension Reform Act requires that, for certain purposes, all employees of all corporations which are part of a "controlled group of corporations" (within the meaning of section 1563(a) of the Internal Revenue Code regarding "parent-subsidiary" and "brother-sister" corporations) must be treated as if they are employed by a single employer.[342] This aggregation rule applies in the case of the overall limitations on contributions and benefits, except that 50%, not 80%, is used as the yardstick for measuring "control."[343] For example, all of the defined benefit plans of these affiliated companies will be aggregated in determining whether an employee's aggregate annual pension benefit exceeds the $75,000-or-100% limit. A similiar aggregation rule would apply in the case of the $25,000-or-25% limit and the 140% composite limit.

VI. Taxation of Lump Sum Distributions From Tax-Qualified Plans

A. Overview

Effective for distributions made during taxable years beginning after December 31, 1973,[344] the Pension Reform Act provides that a lump sum distribution made with respect to an employee from a tax-qualified corporate or HR-10 plan may be taxed in part as capital gains, and in part as ordinary income under a special 10-year

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341. *Id.*

342. *Id.* § 1015, Code § 414(b). For a similar aggregation rule for unincorporated affiliated employers, see *id.* § 1015, Code § 414(c).

343. *Id.* § 2004(a)(2), Code §§ 415(g)-(h).

344. *Id.* § 2005(d).

forward averaging device.[345] These parts are determined on the basis of the length of the employee's pre-1974 and post-1973 "active participation" in the plan, respectively.

To the extent that self-employed plan participants can now avail themselves of capital gains tax treatment on the pre-1974 values of their lump sum distributions, the new taxation rules represent a major breakthrough. In addition, the new taxation rules liberalize the provisions of the Tax Reform Act of 1969, basically by extending the application of capital gains tax treatment to the portion of a lump sum distribution which represents employer contributions made after December 31, 1969 and before January 1, 1974. However, as a practical matter, employees joining tax-qualified plans on or after January 1, 1974, will have no opportunity to use capital gains tax treatment for any portion of their lump sum distributions. Instead only the special 10-year averaging rule may be available to them.

The specific provisions of the Pension Reform Act, which spell out how a lump sum distribution is taxed, are highly technical; therefore, only the highlights will be discussed in this article. Reference should be made to the Conference Committee Report—especially to the computation examples given therein[346]—for a more complete understanding of how the new tax rules will work in a given taxpayer's situation.

B. How Does the New Tax Treatment for Lump Sum Distributions Work?

In general, any "lump sum distribution"[347] made with respect to an employee (whether self-employed or common-law) from a tax-qualified person, profit-sharing, stock bonus or annuity plan (whether HR-10 or corporate) on or after January 1, 1974, will be taxed two separate ways. But first, any segment of the lump sum distribution which represents the amount actually contributed (or deemed to have been contributed) to the plan by the employee is

345. For the capital gains tax provisions, see *id.* § 2005(b)(1), Code § 402(a)(2); *id.* § 2005(b)(2), Code § 403(a)(2)(A)(iii). For the ordinary income tax provisions, see *id.* § 2005(a), Code § 402(e).

346. CONFERENCE REPORT 1280, at 749-52. Note the instructions to 1974 IRS Form 4972 (*Special 10-Year Averaging Method (For Total Distribution from Qualified Retirement Plans)*) which explain the lump sum distribution taxation rules in some detail.

347. *See* text section VI(C) *infra*.

subtracted out, because this amount is nontaxable as a return of basis.[348] The remainder constitutes the taxable segment of the lump sum distribution and so is referred to in the statute as the "total taxable amount."[349] It is the total taxable amount which is divided into two parts: the "capital gain portion" of the lump sum distribution and the "ordinary income portion" of the lump sum distribution.[350] The tax on each portion is computed separately; the total tax payable by the recipient with respect to the lump sum distribution equals the sum of the tax payable for the capital gain portion and the tax payable for the ordinary income portion.

(1) *Capital Gain Portion*—The capital gain portion of a lump sum distribution is equal to the total taxable amount of the distribution multiplied by the fraction in Formula 3:[351]

Formula 3

$$\frac{\text{"Years" of Employee's "Active Participation" in Plan Before 1974}}{\text{"Years" of Employee's "Active Participation" in Plan}}$$

If the employee had not participated in the plan before 1974, this fraction would be zero, so that no portion of the lump sum distribution would be subject to capital gains tax.[352]

(2) *Ordinary Income Portion*—The ordinary income portion of a lump sum distribution is equal to the total taxable amount of the distribution multiplied by the fraction in Formula 4:[353]

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348. Act § 2005(a), Code § 402(e)(4)(D). In the event that any part of the lump sum distribution consists of securities of the employer, then the net unrealized appreciation attributable thereto is also subtracted out to arrive at the "total taxable amount" of the distribution. Moreover, if any part of the lump sum distribution consists of the distribution of an annuity contract, the current actuarial value of that annuity contract is also subtracted out to arrive at the "total taxable amount" of the distribution. *But see* IRS Technical Information Release No. 1315 (Nov. 12, 1974), in BNA Pension Rep. No. 10, at A-4 (Nov. 18, 1974) [hereinafter cited as T.I.R. 1315)

349. Act § 2005(a), Code § 402(e)(4)(D).

350. *Id.* §§ 2005(a), (b)(1), (2), Code §§ 402(a)(2), (e)(4)(E), 403(a)(2)(A)(iii).

351. *Id.* §§ 2005(b)(1), (2), Code §§ 402(a)(2), 403(a)(2)(A)(iii).

352. Gelberg & Blitz, *Lump Sum Payouts Now Are Taxable 2 Separate Ways*, 172 N.Y.L.J. 30, 31 (Sept. 23, 1974) [hereinafter cited as Gelberg].

353. Act § 2005(a), Code § 402(e)(4)(E).

Formula 4

$$\frac{\text{"Years" of Employee's "Active Participation" in Plan After 1973}}{\text{"Years" of Employee's "Active Participation" in Plan}}$$

Another way to express the ordinary income portion of a lump sum distribution would be to say that the total taxable amount minus the capital gain portion equals the ordinary income portion of the distribution.[354] Accordingly, if the capital gain portion were zero (because the employee joined the plan after 1973), then the ordinary income portion would be synonomous with the total taxable amount of the lump sum distribution.

(3) *Calendar Years*—In the fractions used to determine the capital gain portion and the ordinary income portion of a lump sum distribution, the term "years" means calendar years, not plan years.[355] The Secretary of the Treasury will have to devise regulations to determine how fractional parts of calendar years will be treated.[356]

(4) *"Active Participation"*—In the fractions used to determine the capital gain portion and the ordinary income portion

354. Gelberg, *supra* note 352, at 31.

355. Act §§ 2005(a), (b)(1), (2), Code §§ 402(a)(2), (e)(4)(E), 403(a)(2)(A)(iii).

356. The IRS has issued instructions for the preparation of 1974 IRS Form 1099R (*Statement for Recipients of Lump Sum Distributions from Profit-Sharing and Retirement Plans*). T.I.R. 1315. These instructions translate the years-over-years fractions contained in the Pension Reform Act (for determining the capital gain portion and the ordinary income portion of a lump sum distribution) into the *months-over-months* fractions in Formula 5.

Formula 5

$$\text{(1)}\ \frac{\text{"Total Taxable Amount" x Months of "Active Participation" Before 1974}}{\text{Total Months Active Participation}} = \text{Capital Gain Portion}$$

$$\text{(2)}\ \frac{\text{"Total Taxable Amount" x Months of "Active Participation" After 1973}}{\text{Total Months of Active Participation}} = \text{Ordinary Income Portion}$$

of a lump sum distribution, the words "active participation" are used. Although the Pension Reform Act does not define the term "active participation," its meaning has been clarified by the IRS.[357]

(5) *How is the Capital Gain Portion Taxed?*—The capital gain portion of a lump sum distribution is taxed along with all other income of the recipient in the normal way,[358] except that the ordinary income portion of the distribution is excluded from the computation because it is deductible from the taxpayer's gross income.[359] For example, if the recipient of the lump sum distribution is married, he could use the tax schedule for married taxpayers filing a joint return, as well as the capital gains exclusion, itemized deductions, and personal exemptions.

(6) *How is the Ordinary Income Portion Taxed?*—The computation of the tax on the ordinary income portion of a lump sum distribution is made separate and apart from the computation of the tax on the capital gain portion of the distribution

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In addition, T.I.R. 1315 indicated that in computing months of "active participation" before 1974, any part of a calendar year in which an employee was an "active participant" under the plan will be counted as 12 months, whereas in computing months of "active participation" after 1973, any part of a calendar month in which an employee is an active participant under the plan will be counted as one month. In this way, fractional parts of calendar years are accounted for. *Id.*

357. The IRS has helped to explain the meaning of the term "active participation" by indicating that the number of months of "active participation" (see Formula 5, *supra* note 356) begins with the first month in which an employee became a participant under the plan and ends with the earliest of: (i) the month in which the employee receives a lump sum distribution under the plan; (ii) the month in which the employee separates from service; (iii) the month in which the employee dies; or (iv) in the case of a self-employed individual, the first month in which the employee becomes disabled within the meaning of Code § 72(m)(7). T.I.R. 1315. At least with respect to separation from service, the meaning of the term "active participation" as defined in T.I.R. 1315 is very similar to the meaning of the term "active participant" discussed in text accompanying notes 151-61 *supra*.

358. CONFERENCE REPORT 1280, at 750.

359. Act § 2005(a), Code § 402(e)(3).

and all other income of the taxpayer.[360] For this reason, the amount of tax payable by the recipient of a lump sum distribution on the ordinary income portion thereof is called the "separate tax."[361]

To arrive at the amount of separate tax payable by the taxpayer, a special 10-year forward averaging formula is used:

> [I]n order to give [to the recipient of a lump sum distribution] roughly the equivalent of what the tax would be were the individual [employee] to live 10 years after retirement and receive his interest in the plan over that [10-year] period.[362]

The special 10-year averaging formula begins with the total taxable amount—namely, the capital gain portion plus the ordinary income portion—of the lump sum distribution and goes through 5 steps to arrive at the amount of separate tax on the ordinary income portion alone.[363]

Step 1: From the total taxable amount of the lump sum distribution subtract an amount known as the "minimum distribution allowance."[364] (The remainder might be characterized as the "net total taxable amount.")

The minimum distribution allowance was inserted in the tax formula "to insure that the tax on relatively small lump sum distributions will generally be not more than it would . . . [have been] under . . . [the] law [prior to the enactment of the Pension Reform Act]."[365] The minimum distribution allowance is an amount equal to:

(i) $10,000 (or, if less, one-half of the total taxable amount of the lump sum distribution for the taxable year),

reduced (but not below zero) by

(ii) 20% of the excess, if any, of such total taxable amount over $20,000.[366]

360. *See* text section VI(B)(5) *supra*.
361. Act § 2005(a), Code § 402(e)(1)(A).
362. HOUSE REPORT 807, at 148.
363. Act § 2005(a), Code § 402(e)(1).
364. *Id.*, Code § 402(e)(1)(C).
365. HOUSE REPORT 779, at 146.
366. Act § 2005(a), Code § 402(e)(1)(D).

The minimum distribution allowance can never exceed $10,000.[367] Furthermore, for total taxable amounts over $20,000, the minimum distribution allowance decreases as the total taxable amount increases, so that when the total taxable amount reaches $70,000, the minimum distribution allowance decreases to zero and is phased out completely.[368] Consequently, when the total taxable amount of a lump sum distribution is $70,000 or greater, the taxpayer who is computing his tax will bypass *Step 1* and proceed directly to *Step 2*.
Step 2: Take 1/10 of the "net total taxable amount" determined under *Step 1*.[369] (The resulting amount might be characterized as "separate taxable income.")
Step 3: Compute the tax on the "separate taxable income" determined under *Step 2*, using the income tax schedule for single taxpayers, even when the taxpayer is actually married.[370] (The tax derived might be characterized as "preliminary separate tax.")
Step 4: Multiply the "preliminary separate tax" determined under *Step 3* by 10 to arrive at what the statute calls "initial separate tax."[371]
Step 5: Multiply the "initial separate tax" determined under *Step 4:* by the ordinary income portion divided by the total taxable amount to arrive at the amount of "separate tax" payable by the taxpayer on the ordinary income portion of the distribution.[372]

The example in Table 3 may help to demonstrate how the ordinary income portion of a lump sum distribution (without any annuity) is taxed:

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367. *Id.*, Code § 402(e)(1)(D)(i).
368. *Id.*, Code §§ 402(e)(1)(D)(i)-(ii).
369. *Id.*, Code § 402(e)(1)(C).
370. *Id.*
371. *Id.*
372. *Id.*, Code § 402(e)(1)(B).

Table 3

In 1974, Mr. Smith terminated his employment with the X Corporation and received a taxable $60,000 lump-sum distribution from its qualified plan. Mr. Smith received a Form 1099R from the payor of the plan which shows the ordinary income portion to be $12,000 and the capital gain portion to be $48,000.

Total taxable amount ($12,000 plus $48,000)		$60,000
Less minimum distribution allowance:		
Lesser of $10,000 or 1/2 of $60,000	$10,000	
Reduction ($60,000 less $20,000 multiplied by 20%)	8,000	2,000
Total taxable amount less minimum distribution allowance		$58,000
10% of $58,000		$ 5,800
Tax on $5,800 from tax rate Schedule X		$ 1,068
Tax on $5,800 multiplied by 10 ($1,068 multiplied by 10)		$10,680
Percentage of ordinary income portion to total taxable amount ($12,000 divided by $60,000)		20%
Tax on ordinary income portion of lump-sum distribution ($10,680 multiplied by 20%)		$ 2,136[373]

C. What is a "Lump Sum Distribution"?

General Rule:

In general, a distribution made to a taxpayer (during a single taxable year) of the entire amount standing to the credit of an employee (whether self-employed or common-law) in a "single" tax-qualified plan will be characterized as a "lump sum distribution"[374] if the distribution is made for one of the following reasons:

(1) on account of the employee's death (whether before or after termination of service);

(2) for any reason, after the employee reaches age 59½;

(3) solely in the case of a common-law employee, on account of his separation from service; or

(4) solely in the case of a self-employed employee, after he becomes totally disabled.

The distribution-after-age-59½ provision constitutes a change in the lump sum distribution rules for common-law employees. Prior to the Pension Reform Act, a common-law employee could not claim special tax treatment for a total distribution made to him after age

373. This Table appears as Example I in the instructions to 1974 IRS Form 4972 (*Special 10-Year Averaging Method (For Total Distribution from Qualified Retirement Plan)*).

374. Act § 2005(a), Code §§ 402(e)(4)(A), (F).

59½, unless he actually terminated his employment.[375]

Aside from the general description of a lump sum distribution given above, the Pension Reform Act contains a number of special rules regarding what constitutes a lump sum distribution, who can elect the special 10-year averaging tax treatment for a lump sum distribution, and what additional amounts must be taken into account in computing the actual tax on the lump sum distribution. Some of these rules are summarized below:

Special Rules:

(1) *Aggregation-of-Plans Rule*—To determine whether the entire amount standing to the credit of an employee in a "single" tax-qualified plan has been distributed, all trusts forming part of that plan, as well as all other plans of the same category which are maintained by his employer, must be aggregated. In other words, a pension plan will be aggregated with all other pension plans maintained by the employer. Similarly, a profit-sharing plan will be aggregated with all other profit-sharing plans maintained by the employer. However, a pension plan will not be aggregated with a profit-sharing plan, because these plans do not fit into the same category.[376]

For example, suppose Mr. Elliot were a participant in a pension plan and in a profit-sharing plan maintained by his employer, the Williston Company. In 1974, Mr. Elliot (age 60) took a distribution of the entire amount standing to his credit in the Williston profit-sharing plan, but made no withdrawal at all from its pension plan. If Williston maintained no other profit-sharing plan in which Mr. Elliot then had an interest, his profit-sharing plan withdrawal would constitute a lump sum distribution. It would not be necessary to aggregate Mr. Elliot's interest in the pension plan since it is a plan of a different category. (But compare the situation if Mr. Elliot were to withdraw his entire interest in both plans in the same taxable year.)[377]

375. Code §§ 402(a)(2), 403(a)(2)(A)-(B).

376. Act § 2005(a), Code § 402(e)(4)(C).

377. *See* text section VI(C)(2) *infra*.

(2) *Formal Election of Lump Sum Tax Treatment*—In general, no distribution will be treated as a lump sum distribution unless the taxpayer-recipient formally elects[378] to have the ordinary income portion of that distribution (and all other eligible distributions received during the same taxable year) taxed in accordance with the special 10-year averaging rule.[379] This provision seems to require that total distributions received by an employee from a pension plan and from a profit-sharing plan in the same taxable year be aggregated into one lump sum distribution.[380]

(3) *Who Can Elect Lump Sum Tax Treatment?*—Only an individual, an estate, or a trust may elect to have the special 10-year averaging rule apply to the ordinary income portion of a lump sum distribution of which it is the recipient.[381] Recipients who are corporations or partnerships cannot elect this tax treatment.[382]

(4) *Single-Election-After-Age-59½* Rule—Not more than one election to have the special 10-year averaging rule apply may be made "with respect to any individual" after he has attained age 59½.[383] The use of these quoted words has raised some question as to the meaning of this single election rule. Clearly, the rule means that no employee may elect the special 10-year averaging rule with respect to his own retirement benefits more than one time after he attains age 59½. Hopefully, it does not preclude an individual, after he attains age 59½, from making one election with respect to his own retirement benefits, and additional election(s) with respect to the retirement benefits of

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378. The Treasury Department issued temporary regulations spelling out the procedure whereby a taxpayer can (i) elect to have the ordinary income portion of the lump sum distribution of which he is the recipient taxed under the special 10-year averaging rule, and (ii) revoke that election. Temp. Treas. Reg. § 11.402(e)(4)(B)-1 (1975).

379. Act § 2005(a), Code § 402(e)(4)(B).

380. *See* Temp. Treas. Reg. § 11.402(e)(4)(B)-(1)(a) (1975).

381. Act § 2005(a), Code § 402(e)(4)(B).

382. Gelberg, *supra* note 352, at 31; *see* Temp. Treas. Reg. § 11.402(e)(4)(B)-(1)(b) (1975).

383. Act § 2005(a), Code § 402(e)(4)(B); *see* Temp. Treas. Reg. § 11.402(e)(4)(B)-(1) (1975), T.D. 7339, 1975 INT. REV. BULL. No. 5, at 11 (preamble).

other individuals which he receives as a beneficiary.[384]

(5) *Five-Year Participation Rule*—In the case where the employee himself is the recipient of a lump sum distribution, he may not elect to have the special 10-year averaging rule apply to the ordinary income portion, unless he has been a participant in the plan for at least five taxable years prior to the year in which the distribution is made.[385]

(6) *"Six-Year Look Back" Rule*—In computing the tax on the ordinary income portion of a lump sum distribution received by an individual in the current taxable year, all post-1973 lump sum distributions (and the current actuarial value of certain annuity contract distributions) which he received during the current year and during the five preceeding taxable years (from any tax-qualified plan, whether pension or profit-sharing) generally have to be taken into account.[386]

VII. Conclusion

It is not an exaggeration to say that the Pension Reform Act is "one of the most far reaching and comprehensive pieces of pension . . . legislation ever enacted . . . ."[387] Some have argued that the Act does not go far enough,[388] while others have contended that it will affect nearly every employee and self-employed person in the country.[389]

But whatever your persuasion, it seems clear that the tax aspects of the Pension Reform Act are pervasive, technical, and, in many instances, obscure. Clarifying regulations are urgently needed to

384. The Treasury Department has indicated that in Code § 402(e)(4)(B)—which provides that after an individual has attained the age of 59½, only one election may be made with respect to that individual—the word "individual" refers to the employee who participated in the plan. T.D. 7339, 1975 INT. REV. BULL. No. 5, at 11.

385. Act § 2005(a), Code § 402(e)(4)(H).

386. *Id.* § 2005(a), Code § 402(e)(2). This rule is sometimes referred to as the "five-year look back rule."

387. Gilling-Smith, *Employee Benefits: America Steps Forward*, Financial Times (London), Oct. 15, 1974, at 13, col. 6.

388. Marchi, *Reform Measure Still Leaves Many Unprotected*, 172 N.Y.L.J. 34 (Sept. 23, 1974).

389. *How New Pension Law Will Affect You*, U.S. NEWS & WORLD REPORT, Aug. 26, 1974, at 37.

refine numerous provisions of the Act that are open to differing interpretations.

Hopefully, this article has been able to shed some light on the dramatic improvement in the lot of the self-employed. Whether "do-it-yourself" IRA plans will really have an impact in the marketplace—in view of the $1,500 limit—remains to be seem.[390] Certainly the maximum limitations on contributions and benefits will require careful policing of executive pensions, since the penalty is plan disqualification.

In some respects, the Pension Reform Act has given with one hand and taken with the other in regard to the tax treatment of lump sum distributions. But overall, the intention was clear: to introduce an equitable and simplified method of computing the tax due on lump sum distributions while maintaining revenues at the present level.[391]

When viewed in all its glory—all 254 pages—the Pension Reform Act is a constructive and significant piece of legislation. Its passage should serve the cause of strengthening the private pension system. The tax incentives offered by the tax aspects of the Pension Reform Act will further that cause.[392]

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390. *See Labor Letter*, The Wall St. J., Sept. 24, 1974, at 1, col. 5, for conflicting opinions on this subject.

391. HOUSE REPORT 779, at 145.

392. For recent amendments to section 402 of the Internal Revenue Code, see the Tax Reduction Act of 1975, Pub. L. No. 94-12, CCH 1975 STAND. FED. TAX REP. No. 17 (Mar. 28, 1975).