The Self-Employed Individuals Retirement Act of 1962
COMMENTS

THE SELF-EMPLOYED INDIVIDUALS RETIREMENT ACT OF 1962

Pension and profit-sharing programs have always been limited to salaried employees, and, therefore, the tax advantages afforded such plans were, for the most part, unavailable to the self-employed professional man. Furthermore, the possibility of incorporating and thereby becoming a salaried employee was often precluded by either state law or ethical considerations. To circumvent this inequitable treatment, a group of physicians, unable to incorporate under state law, relied on the test in *Morrissey v. Commissioner*, i.e., that which resembles a corporation will be taxed as one, and formed an association with many corporate attributes. They thus sought to qualify their pension trust for the more desirable corporate tax treatment. Because the relationship between the association and its members was that of employer-employee, the United States Court of Appeals for the Ninth Circuit, in *United States v. Kintner*, upheld the validity of this plan.

Initially, the Treasury Department refused to follow this decision but it later retreated and made the propriety of a Kintner association dependent upon local law. Therefore, since it was unlawful in those states which had adopted the Uniform Partnership Act for professional men to form an association to achieve the necessary attributes of corporate status, the favorable aspects of the Kintner rule were frustrated.

To alleviate this situation, twenty states enacted legislation permitting professional men to incorporate, and thereby enabled these individuals to receive deferred compensation from a pension or profit-sharing plan. Even in states which prohibit professional corporations, however, it might still be possible to bring a professional association within the rationale of Kintner. But this approach would require a successful attack on the treasury regulations which infer that the requisite corporate attributes cannot be acquired merely by a contractual agreement.

Seemingly, the arbitrary position adopted by the Treasury Department discriminated against professional groups in those states which had not

4. 216 F.2d 413 (9th Cir. 1954).
5. Id. at 425.
7. Treas. Reg. §§ 301.7701-1(c), 301.7701-2(b), 301.7701-2(c)(4) (1960).
9. See note 7 supra and accompanying text.
enacted professional association acts. To end this apparent inequity and to enable all self-employed individuals to acquire employee tax status with respect to retirement income, Congress passed the Self-Employed Individuals Tax Retirement Act of 1962.10

I. NATURE OF THE ACT

A. Generally

For taxable years beginning after December 31, 1962, the self-employed person will be treated as an employee for pension plan purposes and will be permitted to contribute to a qualified retirement plan up to ten per cent of his earned income, or $2,500, whichever is less.11 Half the amount invested will be deductible in determining his adjusted gross income for the current taxable year,12 and all earnings realized under the plan will be allowed to accumulate tax free.13 Consequently, a retirement plan for the self-employed may be regarded as an income-averaging device, for it provides for the postponement of income tax with respect to a portion of earned income.

B. Who May Qualify

The basic concept of the new retirement act is to provide for pension or profit sharing plans for the self-employed individual based on his earned income. Presumably, this will include any person who is presently subject to the self-employment tax, as well as doctors, ministers, full-time salesmen other than life insurance salesmen and specified people who perform services for compensation in their own homes.14 Earned income, as distinguished from investment income, includes professional fees, commissions and compensation received for

11. Int. Rev. Code of 1954, § 404(e)(1). However, "contributions which are allocable . . . to the purchase of life, accident, health, or other insurance shall not be taken into account." Int. Rev. Code of 1954, § 404(e)(3).
13. "A part of the funds so set aside would be deductible from current income for income tax purposes, and the earnings on such funds would be entirely exempt from current taxation. Although the funds and earnings would be taxable when withdrawn, the opportunity to postpone taxation of the funds and earnings represents a very significant tax advantage, especially to those people receiving very large incomes when the funds are set aside. (1) When the funds and earnings are withdrawn, the taxpayer almost invariably will be receiving less income and, consequently, the funds and earnings will be taxable at a lower rate. (2) Furthermore, the interest received on the savings during the period of accumulation, although really a part of his income, will not be taxable although if the savings were invested in stocks, bonds, mortgages, or bank deposits, the interest would be taxable. (3) In addition, the taxpayer may, when he withdraws the funds and earnings, will be entitled to the retirement income credit and the additional exemptions allowed individuals over age 65, and these benefits would further reduce the tax ultimately paid on the funds set aside for retirement." S. Rep. No. 992, 87th Cong., 2d Sess. 56, 57 (1962).
personal services. In trades or businesses where capital and personal services are material income-producing factors, the act conclusively presumes that earned income is not more than thirty per cent of the net profits, or $2,500, whichever is greater, provided that net profits are at least $2,500. If net profits are less than $2,500, the entire amount will be considered as earned income. It should be noted, however, that an owner-employee is not required to participate under the plan, and consequently unless he consents to be included therein, no contributions can be applied to his benefit.

Finally, any self-employed person or partner is considered an owner-employee except a partner who owns ten per cent or less of the capital and profits interest. The latter is treated as an employee except to the extent that the act covers all self-employed individuals generally.

C. Employees of an Owner-Employee

If a plan covers owner-employees, the act provides that all employees with more than three years service, other than seasonal or part-time workers, must similarly be covered. However, "the contributions or benefits provided under the plan . . . [must] not discriminate in favor of . . . persons whose principal duties consist in supervising the work of other employees, or highly compensated employees." Although a plan provides for different dollar amounts, it will not be considered discriminatory if the contributions or benefits bear a uniform relationship to compensation.

In determining whether a plan under the provisions of this act is discriminatory or if all employees are covered, all the enterprises an owner-employee controls are considered as a single business. Furthermore, if an owner-employee controls a business, he may not be covered by any other plan of another business as an owner-employee, even though he controls such other business, unless he first provides as "favorable" coverage for its employees. Similarly, the two provisions relating to multiple businesses apply in the case where two or more owner-employees are owner-employees of the same businesses.

15. Ibid.
22. If an owner-employee owns "more than 50 percent of either the capital interest or the profits interest" he is considered to control the business. Int. Rev. Code of 1954, § 401(d)(9)(B)(ii).
D. Contributions

Contributions to a qualified plan are *permissible* to the extent they are not considered excessive. Generally, with one major exception, an excess contribution is defined as the aggregate amount of contributions made on behalf of an *owner-employee*, under one or more plans, which exceeds the lesser of ten per cent of his earned income or $2,500. In any event, not all permissible contributions are considered deductible for income tax purposes.

1. Ceiling

An owner-employee may contribute to a qualified retirement plan up to ten per cent of his earned income, or $2,500, whichever is less. In the case where an owner-employee is covered under more than one plan, the aggregate of all contributions made on his behalf may not exceed $2,500. On the other hand, self-employed persons, other than owner-employees, may make contributions in excess of $2,500, but with respect to the amount deductible in determining adjusted gross income, they are subject to the same dollar limitations, i.e., fifty per cent of deductible contributions but not to exceed $1,250.

If a plan covers employees in addition to owner-employees, an *owner-employee* may not make contributions, on his own behalf, at a rate that exceeds the rate he contributed on behalf of all the covered employees. However, if the plan permits employees to make voluntary contributions, the owner-employee may make such contributions at the same rate permitted to the covered employees, whether or not the employees, in fact, contribute. These voluntary contributions are not deductible for income tax purposes, but an accumulation in the retirement plan can be realized tax free. Nevertheless, the aggregate amount of all contributions made on behalf of an owner-employee under one or more plans may never exceed $2,500.

Apparently there is no proscription against a corporate employee (although covered by his employer's plan), setting up a retirement plan under this act, if he is also self-employed. Query: Are both plans viewed as a single plan in determining the aggregate amount of allowable and deductible contributions? From a literal reading of the act the answer appears to be no, since the act only coalesces those plans covering self-employed persons. However, it is doubtful that Congress intended only this.

26. Contributions which are allocable "to the purchase of life, accident, health, or other insurance shall not be taken into account." Int. Rev. Code of 1954, § 401(e)(1).
28. See note 11 supra.
32. Ibid.
33. See note 13 supra and accompanying text.
34. See note 29 supra.
2. Coordination With Social Security

Coordination with social security is permitted for plans, provided that contributions made on behalf of owner-employees do not exceed one-third of the total allowable contributions. In such a case, if the owner-employee takes into account his own self-employment tax (or the applicable amount had he been covered), he may similarly take into account the employer's portion of the Federal Insurance Contributions Act (FICA) tax paid on behalf of all covered employees. Thus, if contributions to a qualified retirement plan are based on a percentage of compensation paid, integration with the social security tax will, in many cases, reduce the overall cost of the retirement plan. More important, if the owner-employee's earned income is greater than the average compensation paid to a covered employee, such an integration will sometimes permit him to contribute to the retirement plan at a higher rate on his own behalf than for his employees. The reason for this is that the Federal In-

\[ \text{Int. Rev. Code of 1954, § 401(d)(6)(A).} \]

\[ \text{Int. Rev. Code of 1954, § 401(d)(6)(B).} \]

39. To illustrate, assume that an owner-employee has "earned income" of $20,000 per year from his business, and has ten employees with three or more years' service, each earning $6,000 annually. If he sets up a retirement plan calling for contributions of 10% of gross wages for covered employees, and 10% of "earned income" for himself, with provision for coordinating the plan with social security, the following will be the amount of his contributions:

<table>
<thead>
<tr>
<th>Earned Income or Wages</th>
<th>10% of wages or earned income</th>
<th>Credited self-employment tax or Federal Insurance Contributions Act tax paid by the employer</th>
<th>Net contributions under integrated plan</th>
</tr>
</thead>
<tbody>
<tr>
<td>Owner-Employee $20,000</td>
<td>$2,000</td>
<td>$259.20</td>
<td>$1,740.80</td>
</tr>
<tr>
<td>10 Employees $60,000</td>
<td>$6,000</td>
<td>$1,740.00</td>
<td>$4,260.60</td>
</tr>
<tr>
<td>Total</td>
<td>$8,000</td>
<td>$1,999.20</td>
<td>$6,000.60</td>
</tr>
</tbody>
</table>

Since contributions for owner-employees after coordination with social security ($1,740.80) do not exceed one-third of net contributions under the plan ($6,000.60), social security and self-employment taxes may be taken into account. If a plan were set up without being integrated with social security, he would contribute $2,000 towards his own retirement and $600 towards each employee's retirement, with total contributions of $8,600. He would thus be contributing 25% of the total expenses towards his own retirement. If, on the other hand, a plan integrated with social security were chosen, he would contribute $1,740.80 (10% of his earned income less self-employment tax) towards his own retirement, as compared to the net contribution, under the integrated plan, of $6,000.60. Thus, he would be contributing 29% of the total expense towards his own retirement.
ance Contributions Act tax is based only on the first $4,800,\textsuperscript{40} while the self-employment tax rate is 150 per cent greater than the employer's portion paid on behalf of his employees.\textsuperscript{41} Nevertheless, when the plan and social security tax are coordinated, the combined rate of contributions paid on behalf of an owner-employee may not exceed that paid for the benefit of a covered employee.\textsuperscript{42} However, it should be noted that in most instances coordination with social security will not be to the advantage of an owner-employee because: (1) the self-employment tax has to be taken into account in determining the maximum aggregate amount of allowable contributions made on behalf of an owner-employee, thereby reducing the net amount of allowable contributions to the plan; and (2) an owner-employee may not have earned income in excess of 150 per cent of the amount paid to the average covered employee, especially where capital is a material income-producing factor. The act defines earned income as thirty per cent of net profits where capital is a material income-producing factor.\textsuperscript{43}

3. Vesting

Generally, a retirement plan can provide for complete vesting, partial vesting or no vesting until retirement.\textsuperscript{44} There is, however, a special requirement if the plan covers owner-employees. In such a case, the contributions made on behalf of employees must be nonforfeitable at the time they are made.\textsuperscript{45} This requirement is made a condition governing the qualification of a plan covering such owner-employees, and unless a provision for vesting is included in the terms of the plan, a contribution for owner-employees would not be allowable nor would it be deductible.\textsuperscript{46}

**II. METHODS OF FUNDING**

In order to establish a qualified investment program under the new retirement act, contributions must be funded by certain methods.

A. **Trusted Plan**

Provision is made, under this plan, for turning over contributions to a bank as trustee.\textsuperscript{47} The trustee, in turn, may then invest the funds, in stocks, bonds,
annuities, life insurance contracts, or other investment securities. Investment decisions concerning these funds, however, may still be controlled by other persons, including the employer, even while the bank is so acting as trustee. This power to control, though, is limited to directing or disapproving investments.\textsuperscript{48}

B. Insurance and Annuity Plans

While the general rule under present law is that a trustee of retirement funds must be a bank, it is permissible, under the new act, to designate other entities, provided however, that the retirement contributions distributed to these persons are invested solely in either annuity, endowment, or life insurance contracts.\textsuperscript{49} In lieu of a trust, bank custodial accounts also may be established as legitimate funding plans.\textsuperscript{50} In order for this type of plan to qualify, however, investments are required to be solely in the stock of a regulated investment company (mutual fund) which issues only redeemable stock, or solely in life, endowment, or annuity contracts issued by an insurance company. It should be noted that the utilization of a custodial account, in lieu of a trusted plan, will usually diminish administrative costs (particularly if the mutual fund investment practice is adopted). Thus a hedge against inflation is provided for the final distributee. Finally, in addition to the establishing of either trusted or custodial plans, a plan may be qualified if its investments are funded through purchases of annuity (including variable annuity) contracts directly from insurance companies.\textsuperscript{51}

C. United States Bond Purchase Plan

An alternative qualified funding procedure permits the direct investment of contributions in a new series of United States Government securities.\textsuperscript{52} These new securities (bonds) will be issued in the name of the person on whose behalf they were purchased (nonforfeitable), will be nontransferable, and may not be cashed until the person named has attained the age of 59\frac{1}{2} or has become disabled or deceased.\textsuperscript{53} To insure that such bonds are used for retirement purposes, it is provided that the interest on them must cease within five years after the death of the bond owner.\textsuperscript{54}

III. Payment of Benefits

Since the intent of the new law is that contributed funds under a qualified plan are to be invested solely for retirement purposes, it is provided that these funds are not to be siphoned to any other private use during the period

\begin{itemize}
  \item \textsuperscript{48} Ibid.
  \item \textsuperscript{49} Ibid.
  \item \textsuperscript{50} Int. Rev. Code of 1954, § 401(f).
  \item \textsuperscript{51} Int. Rev. Code of 1954, § 401(e)(3)(A).
  \item \textsuperscript{52} Int. Rev. Code of 1954, § 405(a).
  \item \textsuperscript{53} Int. Rev. Code of 1954, § 405(b)(1).
  \item \textsuperscript{54} Int. Rev. Code of 1954, § 405(b)(1)(C).
\end{itemize}
of their accumulation. However, when the beneficiary of the plan reaches the age of 59\frac{1}{2} years, while further accumulation is still permissible, distribution of the funded sums may also begin.

When a lump-sum plan for distribution has been adopted, it will be taxed, under the new act, in a manner quite similar to that applied to qualified employer trusts created under the old law. It should be noted, however, that one major change has been inserted, i.e., while it was permitted to treat lump-sum distributions to employees, under corporate and other employer retirement plans, as long-term capital gains, such favorable treatment, under the new rules, is prohibited. This denial, however, only relates to self-employed persons (even if they are not owner-employees), and therefore, all other employees (as under the old law) are still entitled to capital gains treatment on the amounts they have received.

Congress, in order partially to compensate the self-employed individual for this capital gain limitation, has provided, in the new rules, for a special averaging device. This device taxes these lump-sum distributions as ordinary income under the following averaging computation: (1) the tax on recipient's income, exclusive of distributions, is first computed; (2) the tax on the recipient's ordinary income together with the income resulting from one-fifth of the taxable lump-sum distribution is then ascertained; and (3) the difference between these two taxes (tax attributable to one-fifth of the distribution) is then multiplied by five to obtain the amount of tax on the total distribution; (4) the product is then added to the regular tax for the year, the sum being the total tax due.

It should be noted that although retirement benefits to owner-employees may not be paid before the age of 59\frac{1}{2} (unless the death or disability of the owner-employee intervenes), distribution must begin not later than age 70\frac{1}{2} in the case of owner-employees, and not later than age 70\frac{1}{2} or the year in which he retires in the case of employees and self-employed persons other than individual employees. In addition, if a deferred rather than a lump-sum payment

56. Ibid.
58. Ibid.
60. Ibid. To illustrate this principle: Assume that a self-employed physician receives, at age sixty, a lump-sum payment of $10,000. Of this total amount, $4,000 is not taxable since it represents the recovery of contributions which were not deductible when made. In the year of distribution, the distributee also had other income totaling $5,000. In order to ascertain his annual tax, the physician should initially compute the tax due on his separate income of $5,000. He will then compute his tax on $6,200, representing the total of $5,000 (separate income) and one-fifth ($1,200) of his taxable lump-sum distribution of $6,000. The difference between these two tax computations is then multiplied by five, and when this product is added to the tax due on the physician's separate income, his total tax for the year will have been ascertained.
plan is adopted and distribution has commenced within the permissible period, in all cases, it must still be completed with a period based on the life, or life expectancy, of the employee or of the employee and his spouse.  

IV. Penalties

To insure that the general purpose of the new act, i.e., financing retirement, is not violated, Congress has provided for the imposition of penalties on premature distributions and excess contributions.

A. Premature Distributions

If a premature distribution (prior to the age $59\frac{1}{2}$) of $2,500 or more is made to an owner-employee, the law provides that

the increase in his tax for the taxable year in which such amounts are received . . . shall not be less than 110 percent of the aggregate increase in taxes, for the taxable year and the 4 immediately preceding taxable years, which would have resulted if such amounts had been included in such person’s gross income ratable over such taxable years.

If, however, the premature distribution is less than $2,500, the tax due would be 110 per cent of the increase in tax resulting from inclusion of the entire premature distribution in the owner-employee’s gross income for the present year. Also, if an owner-employee receives a premature distribution, he is disqualified from participating in a retirement plan on his own behalf for five years following the year in which the distribution is made.

B. Excess Contributions

Generally, under the new law, an excess contribution is an amount greater than the total of (1) allowable contributions, upon which the deductible amount is based, and (2) permitted voluntary contributions, which in no case are deductible. The law requires that any such excess contribution and the income earned thereon be returned to the owner-employee and that the income so returned be taxable to the self-employed person for whom the contribution was made. It is further provided that unless the excess contribution is returned within six months after notification has been received that the contribution was excessive, the plan is temporarily disqualified (until it is so returned), and the contributee is to be taxed on the annual income earned by the entire amount in this plan which is attributable to his interest.

If an excess contribution is wilfully made, no opportunity is given to return

63. Ibid.
the excess amount, and the *entire interest* of the person on whose behalf it was made, in *all* plans in which he participated as an owner-employee (including the corpus allocated to his account), must be returned to him. Furthermore, the employee is also disqualified from participating, for a five-year period, in any pension plans as an owner-employee.

C. *Exceptions to the Excess Contribution Rules*

Provision is made, under the new law, for cases where an owner-employee (but not a self-employed person who is not an owner-employee) would be permitted to purchase, directly or through his trusteed plan, annuity, endowment, or life insurance contracts without the fear of being subjected to the excess contribution penalties. This exception permits an owner-employee to contribute each year, towards the purchase price of his policy, an amount equal to the sum he would have been allowed to contribute on the basis of his *average* earned income for the three years preceding the last such policy under the plan. However, the amounts so contributed will be *deductible* only to the extent that they do not represent voluntary contributions. Moreover, this excess contribution exception is limited in that the owner-employee can, under no circumstances, obtain policies requiring annual payments of more than $2,500. If he does so, he forfeits the benefits of this exception, and the *entire* amount of the premiums becomes subject to the excess contributions rules.

Besides the aforementioned insurance policy exception, the excess contribution rules are inappropriate to funding plans which involve the purchase of special United States Government bonds.

V. *OTHER TAX CONSIDERATIONS*

The exclusions that are provided in the estate and gift tax sections of the Code in the case of an annuity under a qualified plan are not extended to the self-employed person. These provisions view contributions made on behalf of a self-employed person as if he, himself, made such payments. Accordingly, under the general rule, the exclusions do not pertain to contributions voluntarily made on one's own behalf.

A self-employed person is also not considered an employee within section 101(b) of the Code, and therefore, he can not avail himself of the $5,000 employee's death benefit exclusion. Similarly, since the amendment of section

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71. Ibid.
73. Ibid.
74. Ibid.
75. Ibid.
104(a)(3), "amounts received by an employee through accident or health insurance for personal injuries or sickness . . ." are not excluded from the gross income of a self-employed person, except to the extent such amounts are attributable to nondeductible contributions he himself voluntarily made.

Another change which is reflected in the Code as a result of this act is the addition of a new modification with respect to the net operating loss deduction. The Code now provides that any deduction allowed under a self-retirement plan to the extent made on behalf of a self-employed person "shall not be treated as attributable to the trade or business of such individual." The basic concept of the net operating loss deduction is to offset real economic losses of one taxable year against more gainful ones. Certainly, no one can reasonably contend that the above contributions are real economic losses.

With regard to the retirement income credit, distributions to a self-employed person pursuant to a qualified retirement plan in the form of "pension and annuities" or "bonds . . . received under a qualified bond purchase plan" are considered retirement income. Consequently, a self-employed person, who is sixty-five or over, may avail himself of the retirement income credit which can amount to as much as $304.80 in any single taxable year.

VI. CONCLUSION

When considering the establishment of a retirement plan for the self-employed person under the new act, if it is found that the individual, by incorporating, can also come within the scope of existing law, certain salient factors should be noted. While under present law, all allowable contributions are fully deductible, and no maximum dollar limitations exist, such liberal provisions are severely restricted in the new act. In addition, it would also seem that the present law affords more advantageous provisions with respect to estate and gift tax exclusions, lump-sum distributions by reason of death or other separation from service, employees' death benefit exclusions, and the time of vesting of contributions.

Hence, it appears that if a self-employed individual can avail himself of the provisions both of the new act and a state incorporation statute, it would probably be more advantageous to adopt the incorporation procedure when establishing a retirement program. However, if incorporation is impossible,