Self-Employed Individuals Retirement Act of 1962

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Self-Employed Individuals
Retirement Act of 1962

By Frederick W Whiteside, Jr.*

This is the side of the hill, not the top.
We have made a beginning—but we have only begun.—

John F Kennedy†

Introduction

A current symposium on tax reform should appropriately contain some mention of the Self-Employed Individuals' Retirement Act signed into law by the President on October 10, 1962, to become effective January 1, 1963.¹ This law is acclaimed as equity and reform, although as we shall see, it achieves only a partial sort of reform. Its method is to add a very restricted kind of tax shelter permitting the tax free accumulation of retirement funds for the self-employed similar to provisions already in existence for employees generally under plans set up by their employers. But it does not seek to achieve overall reform by providing equal tax benefits for all persons who save for retirement out of earnings.

The aim of the new legislation is to provide income tax relief for the self-employed comparable to that already provided for employees.² Payments irrevocably set aside by employers for the benefit of their employees under so-called qualified pension plans have long escaped income taxation until the employee receives

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The time seems ripe for this article. But a scant month has passed since the legislation was enacted, and these observations, like any one month old fruit, may seem a little green. Hopefully, a more definitive article may come with time. As suggested infra, the overall problem of tax treatment of plans for the retirement of the aged is a serious one demanding careful application of legal and sociological principles.
¹ Pub. L. No. 87-792, 87th Cong., 2nd Sess. §§1-8 (Oct. 10, 1962) [codified in scattered sections of the Internal Revenue Code, and hereinafter referred to by the appropriate Internal Revenue Code section number].
the pension benefits upon retirement. The new law's final enactment represents the culmination of some fifteen years of effort by its promoters. During this time there were lengthy hearings and debates, resulting in many amendments, compromises and adjustments, all reflecting the interplay of conflicting views and interests of different groups affected.

The new law makes possible the optional deferral of a limited portion of earned income by some estimated nine million individuals in business for themselves or in partnership with other individuals. These classes of individuals work for themselves. They are not incorporated and therefore do not have a separate entity or corporation which can serve as their employer. And not being employees of another, they therefore could not under pre-existing law come under the favorable tax treatment accorded employees under qualified pension plans set up by their employers. The groups benefited by the new law include not only various professional groups such as lawyers, physicians and accountants but also farmers, businessmen, sole proprietors and partners conducting any business or occupation individually and drawing their earnings from work or services performed. In addition to these nine million individual taxpayers thus given an opportunity to take advantage of the limited tax break provided in the statute by setting up plans for themselves, some ten million employees of the self-employed may also be helped, for the law requires a self-employed person setting up a plan for himself to include within the plan all of his full-time employees with more than three years service. This does not mean, however, that all of the nineteen million persons who may potentially be helped will receive immediate benefits from the law. This is because in order to qualify for the tax break the self-employed taxpayers must take the initiative in setting up a qualified retirement plan and many undoubtedly will delay or refrain from

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4 Sections 401-04. Occasionally the question has arisen of when partners have succeeded in establishing an association satisfying the internal revenue definition of that type of association or corporation qualifying to be treated as such for tax purposes. For example, a group of doctors in Montana succeeded; they were held to have established a corporation for pension plan and other tax purposes. United States v. Kintner, 216 F.2d 418 (10th Cir. 1954). The effect of the recent state legislation providing for professional associations or corporations is discussed infra at 338-39.

5 Section 401(d)(3).
doing so in view of the restrictions and qualifications in the statute.  

It should be kept in mind that this statute does not create a completely new type retirement plan for the self-employed, but, rather, extends the principles of the existing tax provisions governing the qualification of employees pension and profit-sharing plans. The new law uses most of the statutory and administrative framework (although with material modifications) already in existence for the benefit of employees under qualified retirement plans established by their employers.  

In effect, the self-employed are viewed for retirement plan purposes as both employers and as employees of themselves. As employers they are permitted to deduct within limits contributions made to pension and profit sharing plans for their own benefit (as well as for the benefit of any of their employees who are covered by the plan). As employees there is a deferral of their current income tax liability up to one-half the actual contribution, which is the proportion deemed to have been made by themselves in their employer capacity. The maximum contribution is limited, however, to $2,500 so that the maximum deduction in a year is $1,250 or half the contribution, whichever is the lesser amount.  

They can currently deduct and thus defer tax on this portion, until the benefits are received in annuity form when they retire.

A complicated statute is the result one would expect from building this tax relief for self-employed into the existing statutory framework governing qualified employee pension plans—and this is what one gets. The new act comprises some ten pages of new statutory provisions, requirements, qualifications and restrictions, either adding or amending forty Code provisions or subsections and resulting in a present total of more than twenty-five pages of pension plan statutory law. Further, to understand the workings of the law one must also be familiar with the content

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6 The qualifications are discussed infra at 331-36.
8 Sections 404(a)(10), 404(e).
9 These additions and amendments are listed in CCH Monograph No. 45, op. cit. supra note 7, at 4. The page counting is based upon the amended portions of the law as printed in the Monograph, id. at 21-47.
of about ten other related statutory provisions. The statute alone gives some idea of the new technicalities engrafted upon the old, and as usual one awaits with some apprehension the Treasury Regulations to be issued under the statute. In this connection this new special relief provision invites reflection upon how monstrous the entire tax structure has become, and why

Highpoints of Statute

Preliminary to understanding this latest extension of pension plan law it is helpful to recall the chief tax aspects of retirement pensions generally. Three main income tax consequences flow from the setting up of a pension plan which qualifies under the Code:

1) For the employer, irrevocable contributions are currently deductible from gross income as business expense related to compensation paid employees, despite the fact that they are not currently reported as income by the employees;

2) For the employee, the tax on the employer's contribution is deferred until actual receipt of the retirement benefits;

3) An important break, both to the employer who pays and the employee who looks forward to the build up of the accumulated funds, comes from the fact that the earnings upon all investment funds resulting from the contributions during all the years the funds are kept in the pension fund are exempted from current income taxation.

Understanding the full impact of these tax advantages is important in assessing the merits of the law governing qualified pension plans and of the most recent enlargement of that law to cover the self-employed. Non-includibility in earned income of amounts irrevocably paid for one's benefit (despite the employer's deductibility as a compensation form of expense) is of course a special rule contravening the normal principle that earnings are taxed when earned. Though not quite the only exception, this

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10 CCH Monograph No. 45, op. cit. supra note 9, at 4, lists the sections and subsections amended.
11 Section 404.
12 Sections 402(d), 403(a), and 72.
13 Section 501.
law affords the biggest gap in the "deductible by employer, includible by employee," generalization. In an income tax system with progressive rates, deferral until retirement is ordinarily highly advantageous to the employee because his peak earning years ordinarily have passed when he retires, after which time he normally has less taxable income subject to a lower rate of tax. Besides, when the retired employee has reached sixty-five he enjoys a double personal exemption and possibly one for his wife too. Furthermore, under most pension plan contracts payment of the annuity may be spread over two lives or even two generations through the joint annuity for the lives of the recipient and his spouse or other beneficiary. Perhaps the greatest benefit of all, however, lies in the fact that the income earned by the investment itself during the time the contributed savings remain in the pension fund or trust are exempted from current income tax. This last advantage is especially conducive toward building up a larger annuity if contributions for the employee are begun at an early age, say twenty-five years before retirement.

What are the economics of the probable benefits of a tax sheltered pension plan compared with an employee's own unsheltered investment? Suppose a lawyer or physician is working for an employer at an annual salary in the neighborhood of $25,000 and paying taxes on the top level of his income in the 38% bracket. Assume his employer contributes a constant amount of $1,250 each year to a qualified plan over a twenty-five year period and that the yield, through interest and dividends and capital gain on the amounts contributed and invested in securities, is 7%. Taking into account the compounding of

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15 There are a good many minor departures from this broad generalization, e.g., by a special interpretation, Rev. Rul. 59-58, 1959-1 Cum. Bul. 17, it was ruled that an employer's gift of a ham or the like worth less than $25 was not gross income to the employee. And there are other similar cases.

16 The rate is 20% on the first $2000 of taxable income, and the rate on each additional increment of income rises sharply, reaching 50% at the $16,000 level, with a maximum rate of 91% on all income over $200,000 (assuming a single taxpayer). Section 1.


18 See the example given by minority Senators Gore and Douglas in S. Rep. No. 992, at 57, in which a given individual with an income of $20,000 has a tax saving of $13,500 through non-includibility of current contributions made over a thirty year period, but saves an additional amount of almost $15,000 by virtue of the exemption of earnings of the pension trust over the same period.
earnings and the fact that the 7% is net, unreduced by taxes, the
fund accumulated and available for retirement annuity at the end
of the twenty-five year period is in the neighborhood of $85,000.20

Were the same taxpayer to make the same annual investment
on his own without the tax-sheltered plan, his $1,250 annual
contribution must be reduced to an after-tax $775 (resulting in
the same net cost to him) and, equally costly to the rate of
accumulation of the fund, the earnings on the amounts invested
are also taxed in each year, resulting in little more than half as
large a fund built up at the end of the twenty-five years.21 Of

course the tax gatherer has his take on the payout, but the tax-
sheltered taxpayer, by reason of the use of the untaxed money
meanwhile, is in the fortunate position both of having a larger
amount on which to pay taxes and being able to pay at lesser
rates on payments spread through his retirement years.

Now, contrast the case of the same professional man in
practice for himself earning approximately $25,000 over expenses.
Having no employer to contribute for him, before 1963 he was
required to make any investments looking toward old-age retire-
ment on his own—with after-tax dollars. Under the new law he
is given an option to contribute up to 10% of his earned income
(under such restrictions as are imposed to achieve qualification
of a self-employed plan) and deduct half the contribution from
current income. If he contributes $1,250 to the plan he may
deduct half the $1,250 or $625, which the new law considers to
have been made for himself as his own employer. Or he may
contribute a maximum of $2,500 and deduct $1,250. He thus
stands to accumulate more than he could have done under
pre-1963 law although not as much as under an ordinary em-
ployer's pension plan contribution upon which he would pay no
tax at all. In the latter illustration the self-employed taxpayer
may be compared with an employee under a so-called con-
tributory plan for employees, assuming matching contributions
of 50% each by employer and employees. In the case of the

20 Excellent examples of the savings, computed under given factual situa-
tions, are to be found in Prentice-Hall, op. cit. supra note 3, ¶ 503, p. 5; Hobbet &
Donaldson, 11.R. 10: Many Opportunities Exist for Minimizing Restrictions of
New Rules, 17 J. Taxation 339, 346-47 (1962) (giving tables showing economics
of 11.R. 10); Samons, supra note 7, at 338.

21 See examples supra note 20; Prentice-Hall, op. cit. supra note 3, ¶ 503, p. 6.
instant taxpayer, the employer may pay him $23,750 instead of the $25,000 salary in hand and contribute $1,250 tax free to the pension while the employee matches with another $1,250 contribution out of his in-hand salary which he has reported as income. Actually this falls short of the average benefits enjoyed by employees under corporate pension plans, since many of the latter are non-contributory under the present-day trend and since such plans call for an employer contribution, on the average, of 85%, against 15% by employees.22

The base upon which these percentages of maximum contributions and deductions is based is "earned income." Earned income simply means income from personal services, and does not include earnings from capital invested by the self-employed partner or proprietor, a departure from earlier proposals which did not pass Congress.23 An inactive partner or proprietor who performs no personal services is not allowed to participate. The statutory machinery for calculation of earned income was already available in the Self-Employment Tax provisions,24 whose definition is incorporated with qualifications deemed necessary to adapt it to self-employed plans. One major qualification, added by the Senate version of the bill finally enacted, is that in the case of "owner-employees" of businesses where capital as well as personal services is a material income-producing factor only the portion of the business profits which can be assumed to come from personal services will be allowed to be contributed and deducted. Somewhat arbitrarily the statute provides that the earned income amount may not exceed 30% of the total net profits or $2,500, whichever sum is the greater.25 This seems a practical obstacle to the setting up of retirement plans by most proprietors of business establishments. A retailer or small individual manufacturer is severely restricted by this definition of earned income. He had usually better incorporate and take advantage of the ordinary pension plan with himself and the other corporate employees as beneficiaries. Nor can the worker who earns money

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22 Holland, op. cit. supra note 18, at 1324.
23 Sections 401(c)(2), -(d)(11). For explanation, see Prentice-Hall, op. cit. supra note 3, §506 (examples given); Samons, supra note 7, at 338. A special problem is noted by Hobbet & Donaldson, supra note 20, at 341.
24 Section 1402.
25 Section 401(c)(2)(B).
both from his private practice and from a salary paid by an
industrial concern include as "earned income" the amounts
received as salary from his employer but only his earnings from
his own practice, since it is possible that his employer already
has a qualified pension plan based upon his salary. If so, the
worker can continue to participate in the latter plan and con-
currently set up his own plan, to which he may contribute up to
10% of his income earned from self-employment.

The new law classifies the self-employed beneficiaries of plans
into two groups—"owner-employees" and other self-employed
individuals. Owner-employees are defined to include those self-
employed individual proprietors and partners who own more than
10% of the business which they operate alone or in partnership
with others and are differentiated unfavorably from the other
class of self-employed who own a 10% or lesser interest in the
partnership. Although it is true that the maximum amount
deductible is the same for both groups (that is, the lesser of
$1,250 or half the actual contribution based upon earned income),
the maximum contribution allowed to be made by the "owner-
employee" is limited to $2,500 whereas the self-employed partner
with a 10% or smaller interest in the partnership is allowed to
make an unlimited contribution to the fund. The group which
most typifies the favored non- "owner-employee" class of self-
employed is the large and affluent city law firm with at least ten
members. Assuming equal division of profits, members of the
ten-man (or a larger number) partnership qualify for unlimited
contributions, whereas the firm with fewer members or the single
practitioner is limited to maximum contributions of $2,500 for
each partner or practitioner. A member of this affluent group
is thus placed in a situation more favorable than the typical
self-employed person or partner, although somewhat less favor-
able than his counterpart who works for an industrial corporation

26 See example 1 in Prentice-Hall, op. cit. supra note 3, ¶506, p. 8; and
Samons, supra note 7, at 338.
27 Ibid.
28 Section 401(c)(3)(B).
29 Ibid. See also Samons, supra note 7, example 2 at 336.
30 Sections 401(e)(1)(B), 404(a)(10).
31 See Gravck, Professional Associations and the Kintner Regulations, 17 Tax
L. Rev. 469, 486 n.87 (1962), where an example is provided which shows the
effect of the discrimination under an earlier proposed statute.
which happens to provide incentive by retirement plan contributions without any limitation upon the amount.\textsuperscript{32}

A condition to setting up by a self-employed person of a pension plan for himself is the inclusion within his plan of all of his full-time employees with more than three years' service.\textsuperscript{33} The plan must provide that the employee contributions be made on the same percentage of their earnings as the self-employed individual contributes for himself.\textsuperscript{34} Of course, as is the case with pension plans generally, the entire amount of such contributions for employees can be deducted by the self-employed, and the contributions do not constitute currently taxable income to the employees. It is possible, however, for such employees to choose to add some of their own after-tax dollars to the contributed amounts under a "contributory" system.

The rules and restrictions governing the employees are less rigid than for the self-employed's contribution for himself. Most of the rules governing employees generally in the existing statutory pattern apply as well to employees of a self-employed.\textsuperscript{35} After all, under pre-existing law it was quite possible for a self-employed individual as employer to set up a pension plan for his employees, although he could not himself participate. In one respect, however, it was necessary to give employees under plans for self-employed persons greater protection than the safeguards provided employees under the existing provisions for employees under qualified plans. Employees must receive immediate vested rights under plans set up by the self-employed.\textsuperscript{36} This gives them assurance that the contributions made for them will certainly enure to their benefit even though they should leave their employment. For pension plans generally there is no requirement of immediate vesting or non-forfeitability\textsuperscript{37} The reason for the additional protection to employees under plans set up by a self-employed person is that contributions made by the latter for

\textsuperscript{32} For a discussion of the typical industrial plan for employees, see Holland, \textit{op. cit. supra} note 18; Harbrecht, \textit{Pension Funds and Economic Power} (1959).

\textsuperscript{33} Section 401(d)(3)(4).

\textsuperscript{34} \textit{Ibid.} Under existing pension plan law, employees with up to five years service may be excluded and the contributions are not required to be vested. See also \textit{CCH, op. cit. supra} note 7, \textit{f617} at \textit{78}; S. Rep. No. \textit{992}, at \textit{13}.

\textsuperscript{35} See \textit{CCH, op. cit. supra} note 7, \textit{f9} at \textit{8}.

\textsuperscript{36} Section 401(d)(2)(A).

\textsuperscript{37} Section 401(a).
himself are necessarily non-forfeitable when made and equity was thought to require equal benefits for his employees.\textsuperscript{38} For covered employees, the self-employed (like employers generally but with some slight difference) is permitted to integrate his plan with the Social Security tax contributions he actually pays on their behalf, provided the contributions made for the benefit of the owner-employer do not exceed one-third the total contributions made for all persons covered in the plan (both the owner-employer and employees)\textsuperscript{39} When this is done the net annual contributions required for each employee and the owner-employer is reduced by the Social Security and Self-Employment tax payments made, thus reducing the overall cost of the plan.

The details for setting up the plan contemplate that the funding or investment of contributions follow a pattern similar to the ordinary pension plans.\textsuperscript{40} Thus, the contributions may be made into a trust fund administered by a bank; or there may be annuity or endowment contracts purchased from an insurance company. Or the self-employed may instead open a special custodial account with a bank permitting investments in open-end regulated investment companies with bank custodianship of the fund shares.\textsuperscript{41} Investments may also be made in a prescribed type of “face-amount certificates” registered with the Securities and Exchange Commission by regulated investment companies as well as in a new series of United States bonds which are issued for the purpose of investment by self-employed’s plans and are therefore non-transferrable and redeemable at the time the law permits benefits to be paid.\textsuperscript{42}

As would be expected, more rigid rules had to be drawn for the self-employed than for the ordinary pension plan with regard to excess contributions,\textsuperscript{43} premature distributions\textsuperscript{44} and prohibited

\textsuperscript{39} Section 401(6)(d). For the explanation of why this was done, see S. Rep. No. 992, at 15-16; CCH, op. cit. supra note 7 8622.
\textsuperscript{40} See Treas. Reg. §1.401-1 to -5 (1956).
\textsuperscript{41} Sections 401(d)(1), 401(b).
\textsuperscript{42} Section 405(a).
\textsuperscript{43} Defined in §401(3)(1).
\textsuperscript{44} Section 72(m).
transactions by the self-employed with the agency he selects to administer the fund. With stated exceptions, contributions which exceed the allowable amount must be returned with interest and there are severe penalties for failure to return within six months. A premature distribution before the age for payout of retirement benefits may require the owner-employee not only to do a little more than make up the tax deficiency but also may disqualify him from participating in a plan for a five year period. Self-dealing by owner-employees in trusts forming part of pension plans is prohibited without exception in view of the extreme difficulty otherwise of regulating or policing the larger number of small trusts which may be established under the statute.

Benefits paid out as retirement pensions are of course taxed under the annuity formula, under which that part of each payment which represents the taxpayer's own investment is excluded and contributions not taxed as made as well as earnings upon the investment are taxed. Thus, just as in the case of an employee drawing pensions, the self-employed under the formula is not taxed on that part of the payout attributable to contributions not currently deducted but subjected to a tax when made. This prevents a second tax upon employee contributions under a contributory plan and likewise upon the non-deductible half of self-employed contributions. It also taxes upon receipt all amounts upon which current tax was deferred as earned or contributed. If all the taxpayer's contributions are recoverable within three years, self-employed persons are again treated like employees under pension plans generally in that no amount is taxed under those circumstances until the full investment in the contract is recovered.

In several instances the self-employed is treated decidedly less favorably upon the payout than his counterpart drawing a pension as a retired employee of a corporation. The statute has

45 Section 503(j).
46 Section 401(e)(2).
47 Section 401(d)(5)(C).
49 Section 72.
50 Section 72(b) sets up the exclusion from each installment paid which bears the same ratio as the taxpayer's investment in the contract bears to the expected return as of the contract's starting date.
51 Section 72(d).
long favored the latter with the special benefit of capital gains treatment when pursuant to a plan he elects to receive the entire amount due in a lump sum within a year.\textsuperscript{52} Although advocates of this special favor urge that the lump sum really deserves some special treatment,\textsuperscript{53} the door is opened to possible abuse whereby the shrewd taxpayer or his lawyer skillfully converts ordinary income into capital gains.\textsuperscript{54} So, although this possible abuse survived attempts at the correction in the case of employees, Congress balked at the capital gain dispensation for the self-employed.\textsuperscript{55} Congress did, however, temper the ordinary income treatment by a five-year spread provision which prevents taxing the lump sum payment in the year of receipt at a higher rate than would have been imposed had taxpayer received the money in equal amounts over a five year period.\textsuperscript{56}

In other respects the self-employed may not enjoy all the advantages of the employee-annuitant under the same circumstances. If he dies the amounts due are not excluded from his gross estate for estate tax purposes as in the case of the employee.\textsuperscript{57} Further there is no gift tax exclusion for the self-employed's transfer of benefits by way of gift.\textsuperscript{58} And, not being an employee, his beneficiary is of course denied the $5,000 exclusion from taxable income of death benefits which the employer pays the beneficiaries of a deceased employer.\textsuperscript{59}

To guard against manipulation without irrevocable commitment to the plan, the payout of benefits is required to begin not later than age 70\(\frac{1}{2}\) and not earlier than 59\(\frac{1}{2}\). In the event of


\textsuperscript{53} Seligman, \textit{Pension and Other Employee Benefit Plans}, Tax Revision Compendium, vol. 2, 1383, 1385-89 (taking the position that the lump sum may be used to buy a house or a business and thus provide the same security as a periodic annuity does for the average elderly retired person).

\textsuperscript{54} See the arguments against this favorable treatment by Lesser, \textit{Pension and Other Employee Benefits Plans}, Tax Revision Compendium, vol. 2, 1383, 1385-89, and by Mornson, op. cit. supra note 52.


\textsuperscript{56} Section 72(n)(2) [this five-year averaging device applies to the self-employed recipient, but not to their employees who are subject to the lump sum treatment for employees generally under §403(2)].

\textsuperscript{57} Section 2039(c), last sentence.

\textsuperscript{58} Section 2517(b), last sentence.

\textsuperscript{59} Section 101(b)(2)(A).
prior death or disability neither the age floor nor ceiling is applicable to self-employed pension plans.60

Prospects for Self-Employed Plans

The current year will see a large number of self-employed persons take advantage of the tax saving opportunity. However, setting up a plan requires that the initiative be taken by the taxpayer. As with a great many tax breaks nowadays, failure to get the word will undoubtedly prevent or delay a great many entitled taxpayers from actually enjoying this tax favor. In addition, the difficulty of understanding the law as well as its limitations and restrictions will deter others from taking advantage of the opportunity.61

Despite these drawbacks immediate use by the self-employed of qualified plans under the statute is still highly advantageous to them. The upper limit on the amount of the contribution and the deduction does not destroy, but goes only to reduce, the extent of the potential benefits. And the requirement that employees be blanketed under all plans for the benefit of the self-employed persons does not reduce the benefits to the point of no return. The minimum three years employment required in order that employees must be included may reduce the average cost of employees inclusion. It is hoped that this limitation of the required inclusion of employees to those with three years' tenure will not increase the turnover of workers employed by individuals.62

Those self-employed individuals who are members of well organized professional groups should overcome any technical or

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60 Sections 401(a)(9), -(d)(4)(B).
62 Already the average rate of turnover for unskilled laborers is high, and unemployment ran over 5% in 1962. It is worthy of note that Secretary of the Treasury Douglas Dillon has recently predicted eight million unemployed in 1963 if there is no tax cut. Louisville Courier-Journal, February 8, 1963, p. 3.
mechanical hurdles to the tax break with greater ease than others. For example, the American Bar Association at the time of enactment of the statute had a committee already set to go to work upon a group plan. This committee has been studying a variety of types of plans best suited to the Association's membership. As a result it is expected that its plan will "offer economies that could not be achieved on an individual basis."63

Enactment of the federal legislation for the benefit of self-employed comes hard on the heels of recent self-help provisions by some twenty state64 legislatures. These state provisions enable various professional individuals or partnerships to form corporations or associations so that they can enjoy federal tax advantages in the form of pension plans and other benefits consequential upon being a corporation within the meaning of the federal statute and regulations.65 These statutes are widely divergent as to the types of professional groups permitted to incorporate.66 The Kentucky Professional Service Corporation Act,67 effective June 15, 1962, defines the qualifying professional groups broadly to include those engaged in any type personal service which could not ordinarily be rendered to the public by a corporation but which requires a license issued to a qualified individual. Other types of taxpayers, although engaged in personal service to the public, were allowed to incorporate under pre-existing law and thus achieve the tax benefits from pension plans set up for them by their corporation-employer. The new state law thus fills a big gap. It permits an additional class of persons who make a living by rendering personal services to incorporate and achieve the federal tax advantages.

It is said that the new federal legislation will take the pressure

65 Some of the other benefits are discussed infra at 339.
off the state legislatures to permit professional incorporation in order to achieve favorable federal tax treatment. If so, it is somewhat ironic that the federal relief making state action unnecessary came only after so many states had already pushed their legislation through and after other states had given the matter hard and serious study through bar associations and other groups. The situation is somewhat reminiscent of the pre-1948 (the marital deduction year) days, when the state legislatures were considering and even passing community property laws in order to take advantage of the split income consequences for federal tax purposes, followed by the 1948 split-income provision giving favorable tax treatment to man and wife and rendering unnecessary what the state legislatures were doing.68

It is also possible, however, that the watered-down Keogh bill that actually passed, with its restrictions, may still not provide as extensive tax relief as incorporation under state professional incorporation laws. The lawyer must therefore continue to be aware of the possibilities under the state legislation. In the past the inability of the self-employed proprietor or partner to qualify as an "employee" under federal tax law has deprived him not only of the benefits of qualified pension and profit sharing plans but also of other breaks obtainable by incorporating under state law. These tax advantages stemming from the employment relationship have been the non-taxability to the employee, within certain elaborately defined statutory limits, of (a) sick pay,69 (b) premiums on group term life insurance,70 (c) food and lodging furnished for the benefit of the employer,71 and (d) medical expenses paid by the corporate employer for the benefit of the employee or his dependents.72 Occasionally, even in the service type of corporation, incorporation has made possible the incentive to executive talent in the form of restricted stock options.73 Furthermore, after death, there is excluded up to

68 See Note, Epilogue to the Community Property Scramble: Problems of Repeal, 50 Colum. L. Rev. 332 (1950).
69 Section 105(d).
71 Section 119.
72 Section 105(b).
$5,000 paid by the employer to the employee's survivors. All these additional benefits, plus the failure of the new statute to accord the self-employed individual as much of a break through qualified retirement plans as is allowed his counterpart engaged in corporate employment, may cause statutes like the Kentucky Professional Service Corporation Act to be used in order to achieve the maximum tax benefit.

**Evaluation**

The considerations urged in support of this legislation are linked to the central premise that fairness demands similar treatment for self-employed workers and employed workers alike. The income earned by the self-employed and by employed persons is of the same nature. The earnings of both come from personal services—work performed. Both groups have similar needs, demands and expectations upon retirement. If a departure from the revenue raising purpose of taxation in favor of the social policy objective (encouraging retirement provision) is justified for one group, it is justified for the other. Taxpayers similarly situated deserve similar treatment. This equity and fairness argument has been consistently urged by proponents of the legislation.

True, some differences in the two groups have been noted. The individual professional man may sometimes by careful planning continue to share heavily in the profits of a professional firm years after his salaried twin is caught by the maximum employment age. Further, one in business for himself as compared with the employed taxpayer may enjoy preferred treatment in the deductibility of business expenses. There are also differ-

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74 Section 101(b).  
75 See the reasons for the bill given in the Committee Reports, H.R. Rep. No. 378, at 8; S. Rep. No. 992, at 8.  
78 Retirement age for the corporate executive rarely runs beyond sixty-five.
ences as to risks taken and security provided. None of these factors, however, has decisive bearing upon the policy of encouraging provision for retirement through tax legislation. The employee under a qualified pension plan, by virtue of the tax benefit, has been more fully enabled to achieve his retirement goals than either the self-employed or an employee with another company which has not set up a qualified plan for its employees.

These policy considerations which can be urged in favor of all pension plans are bolstered by the increased need to make provision for old age in our time. Twentieth century social and economic philosophy has pointed to the duty upon industry and government to apply advance measures to prevent retired workers from becoming a charge upon society Adequate provision for their care must be made. Today earlier retirement from productive work, combined with increased longevity, has resulted from expanding industrial production and rapid medical advances; consequently, heightened public awareness of the problems of the aged has become acute. Not alone the increase in number of retired persons and longer years of retirement but also the spiraling cost of living and medical care has accentuated the need. Inflation and high tax rates have made it more difficult to save and produced pressure to provide tax incentives.

But even the proponents of this type legislation are critical of the effect of the statute finally enacted. It falls far short of equating the tax privileges of the self-employed with those of the corporate executive in regard to income set aside for retirement, for in truth the benefits for self-employed are less than those for employees. This fact has been noticed above. The limitation of the deductibility of current contributions (within the monetary ceiling) to 50%; the requirement of coverage of all full-time employees with three years service; the denial of the capital gains loophole on lump sum payments and of the estate and gift tax exclusions for amounts payable to the bene-

79 Morrison, op. cit. supra note 52, at 1339.
80 Cliffe & Marshall, op. cit. supra note 76.
81 See the statement of Prof. Sterling Surrey at the Hearings Before the Subcommittee on Retirement Income of the Special Senate Committee on the Aging (at Springfield, Mass.), 87th Cong., 1st Sess., pt. 5, at 448 (1961).
I do not think that the private programs alone, or even supplemented by the current social security program will meet the total retirement program of the individual.
82 Squier, Old Age Dependency in the United States 272, 338 (1912).
beneficiaries of the self-employed—all cut down upon the potential benefits for self-employed. For these reasons the statute may be only a stop gap toward fuller relief. As Senators Douglas and Gore pointed out in presenting the minority views to the Senate Finance Committee, we may expect advocates of the self-employed to be back again in a year or two asking Congress for more. They will want to liberalize further the rules to equalize the two groups. And those professional people who can qualify will continue to take advantage of the state laws permitting them to incorporate.

The chief opposition to the law is the argument that it goes in the opposite direction from fundamental tax revision. It simply adds a loophole (or part of a loophole) to an existing loophole. The extensive work and debate on this statute might better have been spent in cleaning up some of the abuses in the entire pension plan area, rather than merely adding another class of persons to be permitted to enjoy some of the benefits of the qualified pension plan. There is also the thought that other taxpayers and the United States need the money more than those who stand to benefit. A relatively small group, whose relative need for the subsidy is less than others, is helped. Half of the total tax saving (and tax loss to the government) from the statute will come to those with incomes higher than $20,000, a group comprising only 6% of the total number of eligible self-employed persons. The bill thus provides relatively greater benefits to

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85 This is the view of Senators Douglas and Gore in their minority reports, S. Rep. No. 992, at 59-60. The Treasury position, though at first in complete opposition to the bill, was that passage of the bill should await comprehensive tax reform so that the problems in the pension and retirement area could be considered as a whole and in relation to the entire tax base and rate structure. See the statement of Hon. Stanley S. Surrey, Assistant Secretary of the Treasury in Hearings on H.R. 10 (Self-Employed Individuals Retirement Act) Before the Senate Finance Committee, 87th Cong., 1st Sess. 20-25 (1961).

86 Id. at 58.
the higher income groups, and, like so many of our taxes, is regressive in that it violates one of the announced policies to study tax reform with a view to taxation according to ability to pay.\textsuperscript{87}

Many of the objections to the bill as originally proposed were ironed out during the long drawn out debate and compromise. The original objection of the insurance interests disappeared when insured plans and annuities by insurance companies were provided as a means for funding.\textsuperscript{88} Labor's original strong opposition was satiated when employees were on a compulsory basis blanketed into any plans set up by self-employed persons for their own benefit.\textsuperscript{90} It would be impossible, however, to satisfy any objections by corporate management based upon the idea that industry deserves a special incentive in the tax laws in order to attract capable professional talent from the ranks of self-employed practitioners.\textsuperscript{91}

A most valid objection to passage of the law was that it "rather loosely bastes another patch on this crazy quilt."\textsuperscript{92} This is not the first such patchwork. Early employee pension plan tax law was amended into its present form with most of the elaborate details and loopholes in 1942.\textsuperscript{93} In 1958 the equity of providing similar qualified pension plan relief for the benefit of employees of tax exempt educational, charitable and religious organizations

\textsuperscript{87} Ibid. The way Chairman Wilbur Mills of the House Ways and Means Committee has expressed this objective is that "tax reform must seek (3) assurance that the degree of progression accords as closely as possible with widely held standards of fairness." Panel Discussions, op. cit. supra note 84, at 2.

\textsuperscript{88} See the hearings cited in note 84 supra. The original proposal in Congress was by representatives Keogh and Reed in 1951. H.R. 4371 and H.R. 4373, 82nd Cong., 1st Sess. (1961).

\textsuperscript{89} The Passing Show, Louisville Courier Journal, Nov. 4, 1962, p. 2.


Leonard Lesser also states this objection in his study for the House Ways and Means Committee. Lesser, Pension and Other Employee Benefits Plans, Tax Revision Compendium, vol. 2, 1383, 1386.

\textsuperscript{91} Industry's position is stated in the Hearings on H.R. 10 (Self-Employed Individuals Retirement Act) Before the Senate Finance Committee, 86th Cong., 1st Sess. 66, 213, 230 (1959). Throughout most of the hearings business and labor were united on the same side, though for different reasons.

\textsuperscript{92} S. Rep. No. 992 at 56 (minority report).

\textsuperscript{93} The 1942 statute was extensively liberalized in the 1954 revision, presenting some striking opportunities for tax savings. See Rice, The New Revenue Code: Pension and Profit Sharing Plans, 41 A.B.A.J. 443 (1955).
was formally acted upon by Congress in the form of a technical amendment. And in 1961 Congress extended similar, though somewhat more restricted benefits to employees of state, public and educational institutions. Each additional patch of relief has its own special details for compliance, its own limitations and restrictions. The different laws for the benefit of different industrial groups provide interesting food for speculation as to how institutionally oriented we have become.

Then, too, if one is to consider the problems of all taxpayers similarly situated as a coordinated whole, it is necessary to examine the relative position of all persons saving some of their money for future retirement. Other such groups are the so-called pensionless employed—employees whose employers have been unable or unwilling to set up a qualified plan. Into this general class fall also those employees for whom a plan has been set up but the plan for some reason fails to qualify. It has already been shown that self-employed persons under the new law are much more favored taxwise than these latter groups, although less highly favored than employees under existing plans. Thus, we have the big size group of the most highly favored under qualified plans, the medium favored group of the self-employed, and the non-favored group of pensionless employed. All three groups with similar needs deserve similar treatment.

And for a really integrated tax treatment of taxpayers in the same situation, one must view the comparable problems of all those seeking retirement income in old age, in relation to treatment of the savings or contributions both when earned and upon the actual receipt on retirement. There are purely private investments including life insurance, endowment income and disability

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95 See Myers & Quiggle, Annuity Programs of Educational Institutions, 48 A.B.A.J. 389 (1962) (discussing the effect of Public Law 87-370).
96 It is largely in the past ten or fifteen years that the large educational institutions have expanded the amount of their scientific research under grants from industry and from government.
97 Their plight is discussed by Strecker, supra note 77, at 74-78. Representative Keogh, who introduced the first proposal, included provision for the pensionless employed as well as self-employed, but this was eliminated because of the Treasury position. Hearings on H.R. 10 (Self-Employed Individuals Retirement Act) Before the Senate Finance Committee, 86th Cong., 1st Sess. (1959).
98 Strecker, supra note 77: Cliffe & Marshall, op. cit. supra note 76.
99 See text, supra at 330.
insurance. There are government administered plans: Social Security, railroad retirement and veterans' payments, as well as government employees retirement programs. The treatment of the contributions as earned and the payout of benefits is widely different in each situation. Several different suggestions to an approach for integrated treatment of the entire problem have already been made. Certainly overall tax reform demands that a halt be called to the patchwork process and that the problem be treated as a whole.

100 There are excellent sources suggesting treatment of all these forms of savings for retirement as a coordinated whole. E.g., Holland, Some Characteristics of Private Pension Plans, Tax Revision Compendium, vol. 2, 1301, 1304; Cliffe & Marshall, op. cit. supra note 76, at 1397 (proposing a graduated percentage deduction increasing with age of worker for amounts set aside); Morrison, Income Taxation of Savings for Retirement, Tax Revision Compendium, vol. 2, 1337, 1344 (noting the possibility of a spending tax); Strecker. supra note 77.

101 Proposals contemplating current deductibility of all contributions or amounts irrevocably set aside include Seligman, Pension and Other Employee Benefit Plans, Tax Revision Compendium, vol. 2, 1353-54, 1368, 1372; Morrison, op. cit. supra note 76, at 1344; Strecker, supra note 77, at 84-88.