PENSION PLANS FOR OWNER-MANAGERS OF CORPORATIONS

HEARINGS

BEFORE THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

EIGHTY-SIXTH CONGRESS

SECOND SESSION

MAY 11 AND 12, 1960

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PENSION PLANS OF OWNER-MANAGERS OF CORPORATIONS

WEDNESDAY, MAY 11, 1950

U.S. SENATE,
COMMITTEE ON FINANCE,
Washington, D.C.

The committee met, pursuant to notice, at 10:25 a.m., in room 2221, New Senate Office Building, Senator Harry F. Byrd (chairman of the committee) presiding.

Present: Senators Byrd, Kerr, Frear, Long, Smathers, Douglas, Gore, Talmadge, McCarthy, Williams, Carlson, Bennett, and Curtis.

Also present: Elizabeth B. Springer, chief clerk, and Colin F. Stam, chief of staff, Joint Committee on Internal Revenue Taxation.

The CHAIRMAN. The committee will come to order.

The Chair desires to insert in the record a copy of the press release issued by the Committee on Finance on May 4, 1960, outlining the scope of the hearings today.

(The press release follows:)

The Committee on Finance will hold 2 days of public hearings, beginning Wednesday, May 11, 1960, 10 a.m., room 2221, New Senate Office Building on that part of the Treasury alternate to H.R. 10 which proposes amending existing law by limiting benefits of pension plans covering owner-managers of corporations. The hearings will not include further testimony relating to pension plans for the self-employed. The committee feels the hearings held last year on H.R. 10 are sufficient for consideration of the House-passed bill and related amendments.

There is insufficient time for the committee to consider adequately the Treasury Department's suggested amendment to H.R. 10 to eliminate capital gains treatment accorded to lump-sum distributions from qualified pension plans at termination of the employee's service or at his death and to amend the present exemptions from estate and gift taxes of pension rights attributable to employer contributions under qualified plans. Therefore, these two suggestions will not be included in the hearings.

All witnesses will be asked to limit their prepared statement for oral presentation within 10 or 15 minutes with privilege of submitting a substantiating written statement for the record.

The committee will endeavor to schedule as many witnesses as it is possible to hear in 2 days. Those who make requests after the witness list is completed will be so notified but allowed to submit a written statement for inclusion in the printed record of the hearings.

The CHAIRMAN. The Chair recognizes Senator Bennett.

Senator BENNETT. I have been asked to put in the record a letter from the American Association of Small Business. And I ask that it be accepted.

The CHAIRMAN. Thank you Senator Bennett, it will be made a part of the record.

(The letter follows:)

AMERICAN ASSOCIATION OF SMALL BUSINESS,
New Orleans, La., May 3, 1960.

Senator WALLACE F. BENNETT,
Senate Office Building,
Washington, D.C.:

Within the next few days I understand the Senate Finance Committee will vote on H.R. 10, which makes provisions to permit self-employed persons to deduct from their taxable income not over $2,500, to be set aside each year for retirement purposes.

It has come to my attention that certain amendments to H.R. 10 are being considered, which millions of self-employed citizens believe should be removed. The general field of pension and profit-sharing plans should not be permitted to cloud the issue concerning the passage of H.R. 10 during this session of the Congress. Any pension and profit-sharing programs should be taken up separately because H.R. 10 has been approved by the House of Representatives almost unanimously on two separate occasions.

Millions of small business people throughout the Nation have been waiting approximately 17 years for fair consideration by the Congress with regard to pensions. Furthermore, the Treasury Department recognizes that the self-employed people are not being given an opportunity to establish retirement savings on the same basis as heads of and employees of corporations.

I refer you to my statement embodied in the hearings before the Finance Committee of the Senate, 86th Congress, 1st session on H.R. 10, June 17–18, July 15, and August 11, 1959, which appears on page 152, for further consideration of the position of the members of the American Association of Small Business, Inc., as well as millions of small businesses and professions in general.

I will be grateful to you if you will have this letter recorded in the record of the hearings.

Your early reply to this communication, expressing your views on the possibility of the passage of H.R. 10 without amendments during this session of the Congress, will be very much appreciated.

I send you every good wish, and would appreciate your remembering me to the members of your staff.

Yours for keeping small business in business, and

Very sincerely,

J. D. HENDERSON,
National Managing Director.

The CHAIRMAN. Mr. Lindsay.

STATEMENT OF DAVID A. LINDSAY, GENERAL COUNSEL OF THE TREASURY DEPARTMENT, ACCOMPANIED BY JAY W. GLASMANN, ASSISTANT TO THE SECRETARY, AND ARTHUR FEFFERMAN, TAX ANALYSIS STAFF

Mr. LINDSAY. Mr. Chairman, I have on my left Mr. Glasmann, Assistant to the Secretary, and on my right Mr. Fefferman, of the Tax Analysis Staff.

I would like to ask, Mr. Chairman, if the letter of April 1, 1960, from the Under Secretary to the chairman may be inserted in the record.

The CHAIRMAN. Without objection it will be inserted.

(Letter referred to, dated April 1, 1960, follows:)

UNDER SECRETARY OF THE TREASURY,
Washington, April 1, 1960.

Hon. HARRY F. BYRD,
Chairman, Committee on Finance,
U.S. Senate, Washington, D.C.

MY DEAR MR. CHAIRMAN: After the close of the hearings on H.R. 10 before the Finance Committee last year, you requested the Treasury Department, in cooperation with the Staff of the Joint Committee on Internal Revenue Taxation, to search for a better approach to the treatment of the retirement savings of self-employed people than H.R. 10. We are accordingly responding to your request with a discussion of an approach which would grant self-employed individuals treatment comparable to that received by employees covered by qualified pension plans and at the same time avoid the many serious problems inherent in H.R. 10.

PENSION PLANS UNDER PRESENT LAW

Present law accords favorable tax treatment to pension plans, established for the exclusive benefit of employees or their beneficiaries, which qualify under the Internal Revenue Code. Covered employees under qualified plans are not taxed currently on employers' contributions made on their behalf to these plans. Instead, the employees generally include the benefits from such plans in taxable income in the year they are received or made available. The deferment of tax until ultimate distribution provided for employees with respect to employer contributions under qualified plans applies whether or not the employee has vested rights in the contributions. Typically, the employee does not have vested rights to such contributions, although plans vary considerably from immediate vesting to vesting after reaching specified years of service, or a specified age, or until actual retirement age. Trusts established to administer qualified pension plans are exempt from tax. Similarly, the Life Insurance Company Income Tax Act of 1959 granted exemption, fully effective in 1961, to income earned on insured reserves established in connection with qualified pension plans. In addition, employers are permitted to take tax deductions, within specified limits, for their contributions to qualified plans, regardless of whether the employees have a forfeitable or nonforfeitable right to such contributions at the time they are made.

The law grants this favored tax treatment only to pension plans which do not discriminate as to coverage, contributions, or benefits in favor of employees who are stockholders, officers, supervisors, or highly compensated. There are alternative tests for determining whether the coverage requirements are met. Under the first alternative, the coverage requirements are satisfied if the plan covers 70 percent or more of all the employees, or 80 percent or more of all the employees who are eligible to benefit if 70 percent or more of all the employees are eligible to benefit under the plan. Before applying these percentages, there may be excluded individuals who have been employed not more than 5 years, employees whose customary employment is for not more than 20 hours in any 1 week and employees whose customary employment is for not more than 5 months in any calendar year.

Under a second alternative under the law, instead of meeting the percentage requirements, the plan can qualify if it covers employees under a classification found by the Internal Revenue Service not to be discriminatory in favor of employees who are officers, shareholders, supervisors or highly compensated. Most plans satisfy the coverage requirements for qualification under this option rather than by meeting the percentage of employees test. The law specifies that a plan shall not be considered discriminatory merely because it is limited to salaried or clerical employees.

A qualified pension plan cannot provide a higher rate of contribution or benefit for higher paid employees than for lower paid employees or for shareholder-employees than for those who are not shareholders. However, the dollar amount of benefits or contributions for the higher paid employees may be larger than for the lower paid employees provided that such amounts constitute a uniform percentage of the compensation of participants. Under appropriate circumstances, the private plan may be integrated with the social security system whereby the portion of social security benefits which is not attributable to the employee's own contributions is taken into consideration in determining whether the benefits paid by the private plan meet the nondiscrimination test. The portion of social security benefits not attributable to the employee's own contributions is considered equivalent to a benefit which can be financed by a 9⅜-percent contribution rate on wages up to $4,800 under money purchase types of plans. In terms of benefits this portion has been valued at 37½ percent of wages covered by the social security system, up to $4,800 a year. Unless the integration rules, the benefits of the higher paid employees, after being combined with the designated portion of social security benefits, must not be larger in relation to salary than the similarly combined benefits of lower paid employees.

The income tax regulations point out that a pension or similar plan which is so designed as to amount to a subterfuge for the distribution of profits to shareholders will not qualify as a plan for the exclusive benefit of employees. The plan must benefit the employees in general. This contemplates coverage of a wider range of employees than the limited participation of a group consisting predominantly of shareholders where there are other full-time employees who have met a reasonable service requirement. The "exclusive benefit of employees" requirement is not met if, by any device whatever, discrimination is effected in favor of the shareholders. Thus, approval has been denied to plans in a number of cases where the effect of the plan provisions, including those designed to integrate with social security benefits, is to exclude nonowner-employees leaving shareholder-employees as the sole beneficiaries. However, a qualified plan may be maintained only for shareholder-employees if there are not other permanent employees.

The present problem of how to treat the retirement savings of self-employed individuals arises because they are not permitted by law to participate in qualified pension plans. Under the Internal Revenue Code, only employees are permitted to participate in such plans. It has been asserted that under some circumstances the grounds for making self-employed people ineligible for coverage under qualified pension plans are somewhat artificial. Working proprietors and partners engaged in activities which can be incorporated under the laws of their respective States may form corporations and become employees for pension plan purposes. Certain unincorporated organizations also might, for a variety of reasons, be treated as an association taxable as a corporation so that for tax purposes the members may become "employees." Indeed, under subchapter S of the Internal Revenue Code, proprietors and partners may incorporate, be taxed substantially as partnerships or proprietorships without corporate tax liability, and nevertheless be treated as "employees." The Internal Revenue Service has administrative problems in dealing with partnerships which attempt to be treated as associations in order to allow the members to obtain coverage under qualified pension plans. This constantly raises difficult questions of substance over form.

DEFECTS OF H.R. 10

As we indicated on June 17, 1959, in our statement before your committee, we do not believe that H.R. 10 represents a satisfactory approach to the tax treatment of the retirement savings of self-employed people. This bill would allow self-employed individuals to establish their own voluntary pension plans with tax advantage without making any provision for the retirement needs of their employees. For the first time it would permit the establishment of voluntary retirement plans conferring tax advantages for the exclusive benefit of the employer. Even if H.R. 10 were adopted, they would still remain substantial differences between the tax treatment of self-employed individuals covered by voluntary retirement plans and employees, including owner-managers of corporations, covered by qualified pension plans. Moreover, a precedent would be created for allowing individuals to take tax deductions for retirement savings even though historically such favored tax treatment has been allowed only in the case of nondiscriminatory plans for the benefit of employees. Such a precedent could have very severe repercussions on the fundamental nature of the individual income tax and on tax revenues. We have estimated the revenue loss of allowing self-employed people tax deductions for their retirement savings under H.R. 10 at $365 million on a full year's basis. However, the extension of comparable tax deductions to other taxpayers for their retirement savings could involve a revenue loss up to $3 billion depending on how the principle would be extended.

In view of these problems, we have concluded that it would be unwise to add the unique benefits and precedent of H.R. 10 to our existing laws pertaining to retirement income.

ALTERNATIVE APPROACH

Serious difficulties raised by H.R. 10 would be avoided under an alternative approach which, with appropriate safeguards described below, would allow self-employed individuals the right to be covered by pension plans like employees. This would permit self-employed individuals (including the partners of a partnership) to establish a qualified pension plan for themselves and their employees and thereby secure treatment similar to that accorded to owner-managers of corporations covered by such a pension plan. It would also eliminate the problems now resulting from attempts by partnerships to secure classification as a corporation for tax purposes in order to be eligible for coverage in a qualified pension plan. This approach would allow self-employed individuals to secure the benefits of a qualified pension plan only by establishing a plan meeting the requirements of the Internal Revenue Code as to nondiscrimination of benefits and coverage. Moreover, since the retirement needs of the self-employed would be met within the framework of the present provisions of the Internal Revenue Code relating to pension plans, it should not create a precedent for allowing individuals to take tax deductions for a wide variety of individual savings for different purposes. As under present law, the qualified pension plans covering self-employed individuals could be funded through contributions to a trust or by purchase of an annuity contract directly from an insurance company. Self-employed individuals establishing such plans for themselves and their employees could, if they chose to do so, use associations to pool their separate funds for investment purposes.

Any legislation allowing self-employed individuals to be covered under qualified pension plans should provide adequate safeguards to prevent unwarranted advantages. To a considerable extent, the fact that such pension plans covering self-employed individuals would be required to fulfill all the present requirements in the Internal Revenue Code as to nondiscrimination in regard to coverage and benefits would substantially reduce the possibilities for abuse. However, because the present provisions of the Internal Revenue Code were designed for plans covering only employees, the extension of such provisions to plans covering the self-employed would require additional provisions to meet the new problems that would result from such extended coverage. Some of the features that such legislation would have to contain are outlined below.

1. A proprietor or partner should be covered under a qualified pension plan only if he performs personal services. Since the objective of such pension plans is to provide retirement benefits, it would be entirely inappropriate to allow inactive owners who derive their income entirely from investments to participate. A corporate shareholder can participate in a qualified pension plan only if he is an employee of the corporation. Benefits and contributions for covered self-employed individuals engaged in activities involving significant capital investment should be based only on the part of business income attributable to personal services. Unless this is done, self-employed individuals would be given an advantage over other covered employees, including owner-managers of corporations, whose benefits under present law are based solely on their earned income. This means, for example, that pension benefits or contributions for self-employed individuals should not be based on the amount of their self-employment income for social security purposes as proposed under H.R. 10 where such income includes investment income as well as personal service income.

2. Unless, as outlined below, the vested benefits provided for employees are substantial in relation to those provided for the owners of the business, limitations should be placed on the pension contributions that self-employed individuals (individual proprietors and partners who have a partnership interest exceeding a specified percent, say 10 percent) should be allowed to make for themselves. Similar limitations, with a transition period for existing plans, should be applied to contributions on behalf of stockholder-employees who own a specified percent of the voting stock or of all classes of stock. In applying these rules, the ownership interests of close relatives should be taken into consideration. The application of these limitations to contributions on behalf of such stockholder-employees is basic to the plan both in terms of equity and revenue. It is an essential part of the plan to provide comparable treatment for the retirement savings of self-employed persons and owner-managers of corporations and to avoid reintroducing the problems inherent in attempts by partners to be treated as associations in order to secure more favorable pension treatment. Moreover, while the estimates are difficult to make at this time, as noted below, applying these limitations to pension contributions on behalf of stockholder-employees would over the years provide some offset to the cost of extending similar pension coverage to self-employed people.

Appropriate limitations would include the following:

(*a*) A basic employer contribution on behalf of each self-employed individual or corporate owner-manager would be permitted, amounting up to 10 percent of earned income, or $2,500, whichever is less. Such contributions, however, could not be discriminatory in favor of the owners as compared with employees.

(b) Nevertheless, nondiscriminatory contributions on behalf of self-employed individuals and corporate owner-managers would be permitted to exceed this basic amount under certain conditions where there are substantial contributions made on behalf of other employees. Regardless of the 10 percent-$2,500 limit, pension contributions on behalf of each self-employed individual or owner-manager of a corporation could be as much as the largest annual deductible contribution vested in any covered employee who is neither an owner nor a close relative of an owner.

(c) Moreover, there would be no special limitation on nondiscriminatory contributions for self-employed persons and corporate owner-managers if the total amount of such contributions did not exceed one-half of the total annual deductible contributions vested in all employees who are neither owners nor close relatives of an owner.[1]

(d) Individuals should not be permitted to arrange to increase the allowable amounts that can be contributed on their behalf to qualified pension plans merely because they split their activities into several businesses each with a different pension plan.

Under these limitations, contributions made on behalf of a self-employed individual or an owner-manager of a corporation could exceed 10 percent of his earned income or $2,500 a year only where the pension plan provides vested rights for at least some employees. Where employees have vested rights there is an automatic safeguard that funds contributed ostensibly on their behalf will not as a result of forfeitures, eventually accrue to the individuals establishing the plan. This helps both to prevent abuses and to reduce problems of administration. Moreover, except where he is a part of a large enterprise with numerous partners, the self-employed individual, as a practical matter, has what amounts to a vested right in the amounts set aside for him under a pension plan, even though the plan nominally provides only forfeitable rights. Thus a self-employed person would have to give other covered employees comparable vested rights if he wished to increase contributions on his own behalf above the basic allowance.

3. Pension plans providing benefits for self-employed individiuals or owner-managers of corporations should be specifically precluded from taking credit for social security payments under the integration rules so as to exclude from benefits all other individuals. For example, a self-employed individual earning a substantial income whose employees all earn not more than $4,800 a year (the amount covered by social security) should not be permitted to establish a qualified pension plan which nominally covers himself and all his employees but which, in effect, provides no contributions for the latter on the grounds that their retirement needs are met by social security benefits. To allow this would be contrary to the fundamental purpose of qualified pension plans which is to provide retirement benefits for employees generally and not merely for the owners of a business. Such problems would be reduced if plans with total is to provide retirement benefits for employees generally and not merely for the contributions for self-employed individuals and corporate owner-managers exceeding one-half of the total contributions made for all other employees were required to provide nondiscriminatory pension contributions or benefits for all covered employees starting with the first dollar of earnings regardless of social security benefits.

Moreover, even where the contributions for the owners do not exceed one-half of the total contributions made for their employees, a special problem would arise when a self-employed individual who is not covered by the social security system establishes a plan under which benefits for his employees are integrated with social security benefits. The present integration rules might be interpreted to permit such a self-employed person to contribute to the plan at a higher rate with respect to the first $4,800 of his earned income than he contributes for his employees under the social security system. This discrimination in favor of such self-employed individuals could be avoided by covering such individuals under the social security system or by restricting their pension contributions on their own behalf to their earned income in excess of the level covered by social security.

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[1] This limitation is roughly similar to the so-called 30-percent rule (I.T. 3674) which was applicable in limiting the deduction of owner-managers of corporations prior to 1950. Under the latter rule no more than 30 percent of the total employer contributions under a qualified pension, profit-sharing, or stock-bonus plan could be used to finance benefits for stockholder-employees who own more than 10 percent of the voting stock. This rule was held invalid by the Tax Court in *Volkening, Inc.* (1949 13 T.C. 723) since there was no specific statutory authority for the rule.

If this alternative approach were to be enacted, your committee may wish at some later date to consider allowing all qualified plans covering corporate owner-managers and self-employed people to take credit for social security benefits in determining whether the private benefits are nondiscriminatory. This might be considered as part of a program to provide uniform integration rules for all qualified plans, including those covering working owners. There is some indication that in certain cases the present rules have resulted in reducing unduly the benefits derived from the private plan by employees whose entire wages fall within the limits covered for social security purposes. One possibility which merits study would be to allow all pension plans to take credit under the integration rules for only the amount of the employer's social security contributions on behalf of employees.

4. Under contributory plans, self-employed individuals and owner-managers would be permitted to make additional nondeductible contributions conisistent with those permited for employees. To prevent unwarranted tax advantages through the deferment of tax on the earnings of large accumulations of funds, the additional nondeductible contributions by such individuals would be limited to 10 percent of earned income up to $2,500 a year. However, self-employed individuals without employees would not be permitted to make such additional contributions. To discourage self-employed individuals and owner-managers from contributing nondeductible amounts in excess of the allowable limits, some penalty should be imposed where such excess contributions are made.

5. Where the pension plan does not provide all covered employees with vested rights, forfeitable contributions made on behalf of employees would not be permitted to accrue eventually to the self-employed person or the corporate owner-manager establishing the plan. Instead, as under present income tax regulations relating to pension plans, any forfeitures resulting under the pension plan would be used to reduce the employer's contributions and would not be used to increase benefits for the remaining participants.

6. In the absence of special provisions, some self-employed individuals might seek to increase the tax advantages resulting from coverage under a qualified pension plan by overfunding the employees' benefits under the plan. The tax deductions for the excess contributions, for example, might be taken in high-income years and the excess amounts on termination of the plan might be withdrawn and included in the self-employed individual's taxable income in a period when his income is relatively low. To reduce the amounts reverting to an employer on termination of a plan, all employees covered at the time of termination would be given vested rights to benefits, as under present administrative rules.

7. A somewhat similar problem would arise if a covered self-employed individual could terminate the plan at any time or could keep the plan in effect beyond his expected lifetime. Although the plan is established to provide retirement benefits, the self-employed individuals, if they could terminate the plan at will, could secure special averaging advantages; they could reduce their taxes in high-income years by reason of their contributions to the plan and withdraw the funds from the plan in low tax years. This unintended tax benefit could be avoided by requiring that the plan be irrevocable and by imposing penalties on any withdrawals other than for disability before some normal retirement age, say 60. Such penalties could include an increased tax on such early withdrawals and a denial of the opportunity to participate in a qualified plan for some period such as 5 years. There should also be included a requirement that the self-employed individuals start withdrawals before some maximum age, say 70.

8. The prohibited transaction rules provided by the Internal Revenue Code to prevent abuse through the misuse of pension funds should be strengthened for plans covering self-employed individuals and owner-managers of corporations. For such plans it might be desirable to apply the type of prohibited transaction rules proposed in H.R. 10 to prevent any opportunity for self-employed individuals to take a deduction for funds contributed to a pension plan and then, in effect, take back these funds for their own use while such funds are ostensibly still in the pension plan.

9. With appropriate safeguards, instead of participating in a pension plan providing for specific contributions or benefits, self-employed individuals might be permitted to participate in a form of retirement plan which would allow them to set aside funds in profitable years and yet not commit them to do so in non-profitable years. If self-employed individuals are allowed to be covered by retirement plans providing such flexibility, contributions on their behalf should

be subject to the limitations described above to prevent abuse. In addition, plans of this type should be permitted for the self-employed only if they (1) provide a definite formula for contributions, (2) grant all covered employees immediate vested rights to employer contributions, (3) do not permit contributions on behalf of self-employed individuals to be lumped in 1 year through the carryover of unused deductions in prior years, and (4) provide that benefits to covered self-employed individuals are not to be paid before the age of 60, except in the case of earlier disability. It would be basic to the approach to apply similar limitations to qualified profit-sharing plans covering owner-managers of corporations, with a transition period for existing plans.

10. The present long-term capital gains treatment accorded to lump-sum distributions by qualified plans at termination of the employee's service or at his death should be removed. Instances have come to our attention where employees have received lump sums in excess of $800,000 taxable at capital gains rates. These lump-sum distributions are not true capital gains and the present capital gains treatment seems to have been extended to them primarily to mitigate the impact of the progressive tax rates on sums which have accumulated over long periods of time. This aim would be served better by providing some form of direct averaging treatment for these lump-sum distributions, such as would be provided by H.R. 10 for lump-sum distributions received after the age of 65.

The exemption from estate and gift taxes of pension rights attributable to employer contributions under qualified plans should also be reexamined.

The revenue loss resulting from the basic approach outlined in this letter, insofar as it is attributable to the tax relief provided for the self-employed, would be less than the $365 million estimated annual revenue loss involved under H.R. 10. Utilization of the legislation would be reduced because self-employed people would be able to secure the tax relief for their retirement savings only by establishing qualified pension plans providing comparable benefits for their own employees on a nondiscriminatory basis. Under this approach, self-employed individuals making substantial pension contributions for their employees could make larger contributions on their own behalf than under H.R. 10. However, the additional cost attributable to this factor would be more than counterbalanced by the fact that the approach would base the allowable deductions of the self-employed only on their earned income and would not allow extra deductions to be taken automatically by older people without employees.

A portion of the revenue loss resulting under this approach would also be due to the coverage under new pension plans of employees of self-employed persons. While it is difficult to estimate the total revenue effect, we believe that the annual overall revenue loss attributable to the coverage of self-employed people and their employees in new pension plans as outlined above would range between $150 million and $250 million before taking into account offsets due to corresponding changes in the corporate pension and profit-sharing area. In the long run some part of this revenue loss would have resulted apart from the approach since, with the rapid growth of pension plans, a significant number of the employees covered under the new pension plans might eventually have been covered by pension plans in any event. The long-run revenue loss resulting from the approach we have described should be considerably less than that resulting from H.R. 10 in its present form, particularly since it avoids the precedent that the latter would offer.

It is difficult to estimate the increase in revenue that would result from placing the limitations described above on qualified plans covering owner-managers of corporations and from elimination of the present capital gains treatment of lump-sum distributions. However, the revenue effect of these changes should over the years provide significant offsets to the revenue loss from extending coverage under pension plans to self-employed people.

The Treasury believes that the alternative approach as outlined is more sound and equitable than the measure now under consideration. However, the committee and Congress in considering the alternative approach must also consider whether, if the tax base is to be further limited and legislation which will reduce tax collections enacted, this particular area is entitled to first priority. Any legislation should also take into account current and future budgetary requirements and the essentiality of substantial debt reduction in fiscal 1961 and subsequent years.

If your committee desires to recommend legislation along the lines of this approach, the Treasury staff will cooperate with the joint committee staff in drafting a bill. This plan represents a different approach to the problems involving the self-employed and, as an integral part of the approach, concerns

(1) corporate plans covering stockholder-employees with substantial proprietary interests; (2) the capital gains treatment now accorded to certain lump-sum distributions by pension and profit-sharing plans; and (3) possibly, the gift and estate tax exemptions now provided for pension rights attributable to employer contributions under qualified plans. While the Treasury is not advised as to whether in the discretion of the committee it is intended that hearings be held concerning all aspects of the approach as outlined, we should point out that the changes suggested are both substantive and important.

Sincerely yours,

FRED C. SCRIBNER, Jr.,
Under Secretary of the Treasury.

Mr. LINDSAY. It is a privilege to appear before this committee. We had the opportunity to state our views on H.R. 10 in its present form before this committee last June and, therefore, will not repeat our objections to the bill at this time.

We are mindful of the committee's announcement that these hearings are on that part of the Treasury alternate to H.R. 10 which proposes amending existing law by limiting benefits of pension plans covering owner-managers of corporations.

Senator GORE. Did you use the word "foreclose"?

Mr. LINDSAY. Well, I believe that the hearings are intended to be limited to that part of the Treasury alternate that pertains to applying certain limitations to corporate plans rather than to concentrate on the self-employed.

Before discussing the proposed limitations, it is necessary briefly to describe in general terms the alternate to H.R. 10.

The alternative approach is described in Under Secretary Fred C. Scribner, Jr.'s, letter of April 1, 1960, to the chairman of this committee.

In brief, it would allow, subject to limitations, self-employed individuals, including partners, the right to be included in qualified pension plans. This would permit self-employed individuals to secure the benefits of such a pension plan only by establishing a plan meeting the requirements of the Internal Revenue Code as to nondiscrimination of benefits and coverage. In other words, a self-employed person would have to give his employees, if any, access to pension benefits on a comparable basis in order to obtain these benefits himself. His plan, however, would not necessarily have to cover all employees, but could exclude seasonal and part-time workers as well as full-time employees with not more than 5 years of service.

While an owner without employees could establish a qualified pension plan for himself, the terms of the plan would have to provide for granting comparable benefits to any future employees.

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

In order to simplify administration from the standpoint of not only the individuals concerned, but also the Internal Revenue Service, consideration should be given to permitting self-employed individuals to invest their pension funds directly in special nonnegotiable Federal Government retirement bonds without the use of a trust. This would make possible the investment of pension funds with a minimum of complexity and expense. It would also be likely to reduce abuses in the misuse of pension funds and attendant complexity in the application of so-called prohibited transaction rules.

I shall now turn to the need for limitations.

Historically, pension and profit-sharing plans have been accorded special tax treatment on the premise that they are for the exclusive benefit of employees. As we have already noted, the statute confines this special treatment to qualified pension plans which meet certain tests as to nondiscrimination in favor of shareholders, executives, or highly paid employees.

Moreover, from the outset, the regulations have provided that a pension plan which is so designed as to amount to a subterfuge for the distribution of profits to shareholders will not qualify as a plan for the exclusive benefit of employees.

Though a self-employed person cannot now be covered by a qualified pension plan, an owner-manager of a corporation may be covered by such a plan. This is because technically the latter is an employee of the corporation even though he owns it. This means that an owner-manager of a corporation may now arrange to secure all the tax advantages associated with coverage in a qualified plan despite the fact that, as the owner, he can establish the plan and arrange the conditions including the size of the contributions and benefits for covered individuals.

As a practical matter, where there are a substantial number of employees besides the owner, there are limits to the amounts that an owner-manager can afford to have contributed for himself under a qualified plan. Since qualified pension plans must not discriminate in regard to coverage and benefits, an owner-manager of a corporation with many employees generally can receive substantial pension benefits only by going to the considerable expense of providing other employees pension benefits on a comparable basis.

However, owner-managers of corporations who have no employees, or a relatively small number of employees earning modest salaries, can now provide themselves with substantial pensions under qualified plans without incurring considerable extra costs to pay for comparable pension benefits for others. Under such conditions, therefore, the contributions under the plan in effect may benefit only or mainly the owner of an enterprise. The tax avoidance possibilities in this type of situation can be substantial.

In an effort to deal with this problem, the Service, in 1944, ruled as follows:

> A pension or profit-sharing plan shall not generally be considered to be for the benefit of shareholders if contributions which are required to provide benefits for employees, each of whom owns, directly or indirectly, more than 10 percent of the voting stock of the corporation, do not exceed, in the aggregate, 30 percent of the contributions for all participants under the plan. For the purpose of determining stockownership, an individual shall be considered as owning the stock owned by the spouse and minor lineal descendants of such individual (I.T. 3674, C.B. 1944, 315).

However, this 30 percent rule, which was designed to prevent owner-managers of closely held corporations from using pension plans as a device to provide benefits principally for themselves, was held invalid by the Tax Court in *Volkening Inc.* (1949–13 T.C. 723), since there was no specific statutory authority for the rule.

The House version of H.R. 8300, the bill which was adopted into law as the Internal Revenue Code of 1954, would have restored, in modified form, the 30 percent limitation on contributions made for stockholders as part of a thorough-going revision of the pension provisions.

However, in view of the very fundamental changes involved in the House bill, at the recommendation of the Treasury Department, your committee decided to postpone them pending further study.

Accordingly, quite apart from the extension of coverage under qualified pension plans to self-employed individuals, legislative provisions are required to prevent owner-managers of corporations from securing unwarranted advantages by establishing pension plans providing benefits mainly for themselves.

For similar reasons it would be essential to impose similar limitations on the pension contributions or benefits that self-employed individuals would be permitted to provide for themselves if they are permitted to be covered by qualified pension plans.

Moreover, in order to provide equal tax treatment it is necessary to apply the same limitations to pension contributions on behalf of owner-mangers of corporations and self-employed people. Unless there is such equal treatment of both groups, there will be a continuation of the very troublesome problems that now result from attempts on the part of partners to be treated as corporations in order to secure pension advantages. The result would be to grant owners different tax treatment with regard to retirement savings depending upon the form of doing business.

We now come to proposed limitations.

Under Secretary Scribner's letter of April 1, 1960, indicates the kinds of limitation that should be placed on pension contributions on behalf of self-employed individuals and owner-managers of corporations in order to prevent unwarranted tax advantages from accruing to such individuals under qualified plans.

The Treasury Department believes that these limitations should be put into effect immediately for pension plans covering self-employed individuals and corporate owner-managers which are established after the effective date of the legislation. To allow a transition period, existing plans covering owner-managers which were established before the effective date of the legislation should be allowed a 2-year grace period before being required to comply on a prospective basis with the new rules. Such action would permit, if found necessary, further extension of the grace period and in the meantime focus adequate continuous attention to the problem to insure that the soundest possible solution is developed.

We do not believe that legislation that does nothing more than grant benefits to the self-employed is justified at this time in terms of either competing priorities for tax relief or sound budgetary requirements. Legislation may be justified, notwithstanding loss in revenue, if it accomplishes needed reforms and points the way to equalization in the pension area on a sound and consistent basis.

Under the Treasury's approach, deductible contributions to a qualified pension plan for self-employed individuals or owner-managers with an ownership interest of 10 percent or more would be permitted up to 10 percent of earned income but not more than $2,500 a year. This basic allowance is the same as under H.R. 10, except that:

(*a*) Consistent with the treatment of employees under pension plans, the allowance under the Treasury approach is based on earned income rather than on self-employment income which may include earnings from investment;

(*b*) H.R. 10 limits the total lifetime deductions for any self-employed person to $50,000—the Treasury alternative does not impose any lifetime ceiling on deductions; and

(*c*) H.R. 10 allows all self-employed individuals over 50 on the effective date of the legislation to invest and deduct extra amounts.

The 10-percent-$2,500 limits are intended to provide a basic allowance for contributions to a pension plan on behalf of owners who do not provide substantial contributions for employees. However, it would be consistent with the purpose of pension plans to allow deductible contributions for owners to exceed these basic limits where the plan provides substantial contributions for other employees.

Accordingly, we have suggested that a self-employed person or an owner-manager of a corporation should not be bound by the 10-percent-$2,500 limits otherwise applying to deductible contributions on his own behalf if the deductible contributions vested in employees are at least twice the amount he contributes for himself.

Senator GORE. Percentagewise or amountwise?

Mr. LINDSAY. Amountwise.

Senator BENNETT. You mean all employees, not for any single employees?

Mr. LINDSAY. All eligible employees under the plan.

Senator GORE. You mean by that, that if an employer contributed a total of $5,000 for all of his employees, he could contribute how much tax deductible to his own?

Mr. LINDSAY. $2,500; $2,500 is the ceiling, and the basic limitation, and $2,500 is half of what he contributes to all his employees, if you were talking about the employees other than himself.

Senator GORE. Do I correctly understand, then, that in the case I cited he could receive tax deduction to the extent of $5,000 per year?

Senator BENNETT. Not for himself.

Mr. LINDSAY. No; $2,500 for himself. It would be $2,500 for himself if all the other employees received $5,000 invested contributions. He is limited to $2,500 on either of two theories: one, the basic limitation of 10 percent up to $2,500, and, secondly, he cannot exceed more than half, that is, more than half of the $5,000 contributed on behalf of the other employees.

Senator GORE. Suppose he contributes 10?

Mr. LINDSAY. If he contributes 10, then, assuming that the plan was nondiscriminatory, he could go up to $5,000 for himself.

Now bear in mind that we are limiting deductions to 10 percent for the working employer who does not make substantial pension contributions for his employees. Under the pension plan provisions there is a basic limitation of 5 percent, but you can exceed that under a variety of exceptions. One of the most important of these is that as long as the benefits are nondiscriminatory, if you look at the rate of benefit, X percent of salary, even 50 percent of salary, then whatever is actuarially necessary to fund that benefit would be permitted.

When you move into the profit-sharing area, which we are not talking about now but which we may talk about later, contributions may be 15 percent of salary. But under any theory in the example you just posed, the owner would be limited to $5,000 for himself.

Senator GORE. Then to this extent you would make H.R. 10 a little sweeter?

Mr. LINDSAY. Sweeter, but offset by the fact that to obtain that sweetness you have to fund the benefits of your employees.

Under H.R. 10, you can take the $2,500 all for yourself and ignore your employees.

Senator GORE. Then your answer is a conditional "Yes"?

Mr. LINDSAY. A conditional "Yes" or a conditional "No."

Senator BENNETT. Also, this must vest, must it not?

Mr. LINDSAY. We are not talking about immediate vesting. You can have graduated vesting, but you would look at the amounts vested to determine the limitation for the owner.

Suppose the plan did not start to vest until——

Senator BENNETT. I am talking about page 30, which says if the vested amounts attributed to the employers is at least twice as much as that.

Mr. LINDSAY. That is covered in my next sentence.

Senator LONG. About that same point, suppose an employee does not care to come in under the plan—is it voluntary?

Mr. LINDSAY. Yes.

Senator LONG. Suppose the employees would rather have the money to put food on the table, could the employer go ahead and set the whole thing up for him?

Mr. LINDSAY. Maybe I misunderstood your question. This is voluntary, the employer does not have to establish a pension plan.

Senator LONG. Does the employee come in whether he wants to or not?

Mr. LINDSAY. No, it is up to the employer. But the employer may choose to set up a plan for his employees and not participate.

Senator LONG. Suppose he sets it up for his employees and himself, the prime purpose being to get himself under, and the employees do not care to participate. Is that possible?

Mr. LINDSAY. I would say as a general rule, no.

Senator LONG. But there are cases like that—it is all right if they want to come in, but suppose they do not care to come in?

Mr. LINDSAY. I can't imagine an employee refusing to participate unless it was a contributory plan and he might not want to make a contribution. Of course you have very large plans of organizations that bargain with different unions; one union group may come in and say, "We don't want a pension plan any more; we want more salary."

Senator LONG. A doctor has a single employee in his office and he sets up a contributory plan and the employee says he would rather have the money to look after the children. Is the doctor then privileged to set the plan up for himself?

Mr. LINDSAY. Not unless if it is a contributory plan, and the contribution is reasonable, isn't so high that obviously the employee could not participate, but if it is a reasonable contributory plan, he has to make sure that at least 70 percent of his employees are eligible, and that 80 percent of those eligible come in. He may have a large enough organization with a sufficient variety to justify covering a classification of employees. One group of employees might want to come in, and another group might want to stay out.

Senator KERR. Or he could set up a plan for himself and his employees on a basis that was noncontributory by the employees.

Mr. LINDSAY. That is right.

Senator SMATHERS. Is that not what you actually have the most reference to, the type of plan that is noncontributory?

Mr. LINDSAY. Yes. However, we have made provisions for contributory plans, as mentioned in the letter of April 1, 1960. The trend is in the direction of noncontributory plans just as the trend is in the direction of greater vesting.

The CHAIRMAN. In the noncontributory plan the employer pays the total cost?

Mr. LINDSAY. Correct.

The CHAIRMAN. And the employee pays nothing?

Mr. LINDSAY. Pays nothing.

The CHAIRMAN. And the employer is limited in his ability to pay on the percentage basis of his salary as compared to the salaries of the employees?

Mr. LINDSAY. Yes, the employer will gear the contributions to percentage of salaries.

The CHAIRMAN. In other words, if it is 10 percent and the employee earns $5,000, then the employer would pay $500 for the employee?

Mr. LINDSAY. That is correct.

The CHAIRMAN. From the earnings of the business?

Mr. LINDSAY. That is correct.

The CHAIRMAN. And there would be no cost to the employee?

Mr. LINDSAY. Of course, one problem here, when we talk about 10 percent or $2,500, which is the thrust of the Smathers-Keogh bill, is the use of limitations which seem relatively simple only in terms of money purchase plans, which are useful if you want to invest in Government bonds, or if you want to use a trust.

There are many plans, however, which don't look to the contribution, but look to the benefit, and then actuarially work back to determine what the contribution must be. Some of the criticism we have had from insurance companies is based on that difference in concept in working out an across-the-board solution.

Senator GORE. May I ask a question, Mr. Chairman?

It appears to me that the U.S. Treasury has just taken a very peculiar position. You are proposing to allow a man up to $5,000 deduction of his own income, tax deductions, not because he needs it, not because he has made an eleemosynary contribution, not because he has contributed to a social purpose, but merely because he has added to the salaries and the benefits of a few of his employees.

Heretofore the U.S. Treasury, it seems to me, has stood steadfastly by the purpose that tax deduction, the deductibility of income, was limited to certain specified purposes, not for the personal benefit of the man who is the beneficiary of the deduction.

Here now you are giving him a tax deduction because he makes an investment peculiarly for his own benefit. That is a remarkably peculiar position for the Treasury to take.

Mr. LINDSAY. You raise a very searching question.

Senator GORE. You must have done some soul searching before coming to that.

Mr. LINDSAY. We start out by looking at pension plans at the corporate level, and bear in mind you don't always have a corporate tax, particularly in the service area, because you can possibly sustain high salary deductions if all of the income is derived from services. Add on a profit-sharing plan and that further reduces the corporate income for tax purposes. Even if it doesn't eliminate the corporate tax altogether, it might bring the 30-percent rather than the 52-percent rate, which could be an advantage of itself.

Some corporations can elect not to pay the corporate tax and still have pension plans.

Now, the question we are trying to look at as an alternate to H.R. 10 is this: If you set up a pension plan, may not the person who sets it up participate, or is he foreclosed from participating?

If you are disturbed about the fact that the nondiscrimination rules look to percentage of salary, you are raising a very fundamental question as to whether or not it is appropriate to set aside 5 percent or 10 percent across the board.

Senator GORE. I think it is highly inequitable and inappropriate, because in this instance, if it is going to be on a percentage basis, we should have an inverse graduation.

Mr. LINDSAY. Well, you don't have an inverse graduation——

Senator GORE. I know we do not.

Mr. LINDSAY. In the progression of the tax rate.

Senator GORE. No, you have a progression.

Mr. LINDSAY. I think a deduction——

Senator GORE. And if the Government is to allow benefits of tax deduction on a percentage basis, then it should be graduated inversely.

Mr. LINDSAY. I see what you are getting at.

Senator GORE. I agree with you that the provisions of present law with respect to corporate pension plans are grossly inequitable——

Senator KERR. Pardon me.

Was that his position?

Senator GORE. I understood him to say that he was—he began his consideration on the basis that under corporate pension plans now a number of things were possible. I do not believe that he described them as being grossly unjust and unfair.

It seems to be obvious that the very statement of them is such a recognition.

You do not have to agree to that, of course.

Senator KERR. I just wondered if the similarity was expressed or implied by my friend. I had not understood the witness to take that position.

Senator GORE. I will ask Mr. Lindsay if he does not in fact consider——

Senator LONG. A point of order, Mr. Chairman, I believe any questioner asking a question should have the floor for that purpose.

Senator GORE. I have no objection to the interruption.

Senator KERR. I ask him on the basis of the Senator being willing to yield.

Senator GORE. Yes, I yield indeed.

Senator KERR. And I assume that he is not only friendly in granting the floor, but he is capable to take care of himself.

Senator GORE. I am willing to yield to my friend.

I will ask the distinguished witness if he does not consider the provisions of law inequitable and inadvisable, and that he recommends change with respect to corporate pension plans, and profit-sharing plans?

Mr. LINDSAY. I cannot state at this time, Senator Gore, that all pension plans and profit-sharing——

Senator GORE. I did not ask you about all, I asked you about provisions of law.

Mr. LINDSAY. But I do say in the area where the owners have few or no employees, the tax avoidance possibilities can be substantial and should be corrected.

And further, that we think that these corrections——

Senator GORE. Just a moment.

If tax avoidance plans and schemes possible under existing law are not inequitable, how would you describe them?

Is tax avoidance as such in substantial amounts in itself inequitable?

Mr. LINDSAY. I think tax avoidance is. And I speak of avoidance in terms of what is permissible under existing law.

I am not suggesting that anybody is doing what they should not do under existing law.

Senator GORE. Well, I was not directing my questions with respect to any particular taxpayer. You have just said that it was inequitable. Just prior to that you said that substantial tax avoidance was possible under existing law.

Would not it therefore follow logically that the present provisions of law are inequitable?

Mr. LINDSAY. To a certain extent, that is correct.

We are now here trying to get corrections to avoid that situation, Senator Gore.

Senator GORE. Then you start with an inequity, and because of its existence you now propose the establishment of another bylaw.

Mr. LINDSAY. Quite to the contrary.

We start off saying, why is it that the self-employed claim that they are being discriminated against. And we view the original H.R. 10 in that context and find it is quite different from the pension plan area in general.

The next step logically is to ask, why not apply the pension plan area to the self-employed. Whether or not you are an employee can be a very artificial concept. A man may run and own his own business as self-employed, but if it is the kind of a business that he can incorporate, lo and behold, he becomes an employee and subject to the pension plan provisions.

Therefore, if the real answer is not to let this so-called technical definition of employee stand in the way of the participation by self-employed people in a properly set up plan, we ought to examine carefully the pension plan area, and see whether it fits. In examining it we find troubles. And therefore we say we have to clean up the house—that is too strong language—we have to make certain corrections——

Senator GORE. No. I accept it.

Mr. LINDSAY. We have to make certain corrections in the area in order to achieve equality.

Senator GORE. I am not surprised that you found troubles in arriving at this conclusion or in your process of arriving at it.

Do you know of another instance in the law, which you now propose to be written into the law, in which a taxpayer is allowed a tax deduction for an investment of which he himself is the beneficiary?

Mr. LINDSAY. Offhand, I don't, except in the expenses which may be incurred in connection with the production of taxable income.

Senator GORE. You are speaking now of depletion allowances and depreciation——

Mr. LINDSAY. No, I haven't gotten to these.

I would say, to answer your question more accurately, I would cite the pension and profit-sharing provisions as they have existed substantially in the same form since 1942.

Senator GORE. Have they through the corporate structure amounted to what you now propose directly for the self-employed?

Mr. LINDSAY. We propose now to permit the self-employed to be treated as employees for the purposes of the pension plan provisions.

Senator GORE. Which is preferential. The U.S. Treasury now publicly recommends that a taxpayer be given tax deduction, not of $600 for a dependent, but up to $5,000 per year for an investment for his own benefit. This is perfectly amazing.

Mr. LINDSAY. For his own benefit, in the context of a pension plan which now permits deductions.

Senator GORE. If you allow a deduction for an investment in a pension plan or investment in a retirement insurance policy, why not allow it for an investment in a life insurance policy? Why discriminate against life insurance, of which a man's widow and children could be beneficiaries?

Mr. LINDSAY. I think you could carry this to a logical conclusion by saying that any proper form of investment for savings, for any proper purpose, whether the education, life insurance——

Senator GORE. What about payments on the mortgage on his home?

Mr. LINDSAY. Or buying his home, would be one concept of how the tax law should be enacted. It is in effect in the direction of an exemption for savings within limits and a tax on spending. I am not altogether sure that that is the direction in which the tax law should go at this time. We would not be here on pension plans if we were not dealing with competing enterprises, some unincorporated and some incorporated. It is difficult to attract people to the unincorporated enterprises because they cannot participate in the pension plan provisions which have been given congressional blessing.

Now, if you say let's eliminate pension plans because other forms of savings do not justify a deduction, that would be a completely different matter. I would think that there would be some difficulties—I think if you disallow the deduction, that would not affect tax-exempt institutions like colleges, universities, scientific organizations, unions. As long as the amounts were forfeitable they could not, I do not think, easily or even properly be taxed to the employee until he receives it. So you may always start off with some benchmark of a pension plan.

The only salient attack I could see in that area would be to disallow the exemption, even in connection with exempt organizations, of the earnings of a pension trust. But this is rolling back the clock very far.

Senator GORE. Let's see what you have said.

You have said first that it would be logical to extend this benefit, this tax deduction, to other forms of saving, life insurance the same—you did not say this, but I had put the question to you with respect to life insurance, and you stated for educational purposes. I stated meeting mortgage payments on the home——

Mr. LINDSAY. May I interrupt to say that I was not recommending these things.

Senator GORE. Well, I am not sure that I am, but one is as justified as the other, and you have said that it could logically be extended. So what you are recommending here is tax deduction for saving.

Mr. LINDSAY. For retirement.

Senator GORE. Well, then, why confine it to saving for retirement?

Suppose you have an individual who simply does not have enough income to meet his life insurance payments, and then to invest $2,500 or $5,000, as the case may be, in a retirement insurance plan, why not give the poor guy an option, let him choose whether he takes tax deduction for payments on a life insurance policy for the protection of his wife and children, or whether he makes an investment in an insurance policy for his own retirement benefit.

Would you object to a taxpayer having an option between life insurance and retirement insurance?

Mr. LINDSAY. Let me try and answer you this way, without directly, if I may——

Senator GORE. You may answer it as you please, but I hope you will give a direct answer.

Mr. LINDSAY. I think what you say would make more sense, if we were talking about an option for anybody to set aside savings for retirement. We are dealing in the context of employer plans for employees, which now provide benefits apart from retirement savings; for example, an employer may set up a group health insurance policy and take a deduction on that for his employees. There is a variety of things that an employer can do, if he so chooses, for his employees and have a proper deduction so long as it is reasonable in amount.

Now, perhaps in your mind this argument about employer plans for employees begins to break down, when you look at the self-employed who has no employees. But it has broken down with the 30 percent rule rejected by the Tax Court, when you look at the one-man corporation.

The one thing you can say in that regard is that if you set up your own pension plan and you hope to be successful and grow, you are committing yourself to including future employees in that plan. So it isn't quite the easy option that you would see under H.R. 10.

A young man decides that he wants to set up a plan, and he doesn't wait 5 years after he hangs up his shingle. He includes himself right away. Then when he takes an employee in he cannot amend his plan and say, from now on he will exclude employees until they have been in the business for 5 years. He sets up a pattern to which he is committed. There is that difference.

Now, you could say, let's go back to the original 30-percent rule. This is much more stringent than the Treasury approach, because the Treasury approach merely imposes limits. It doesn't cut owners out altogether, which in a sense is to say that if you go into business for yourself, there is no way of setting aside retirement benefits even though you are willing to include the employees, whereas, if you join a large organization, your security is assured.

It is a very difficult question, but I think your questions are most pertinent. We have had to struggle with the same points that you are cross-examining me on now. For that reason we are not anxious to press for the legislation this year. We think it takes thorough study, and we think all the questions that come up, including the technical questions that came up in conenction with H.R. 10 last year, should be given very careful review, so that proper legislation can be fully considered.

But if legislation is to be enacted for the self-employed, we think that this at least means: whatever we have in the corporate area, we will extend to the self-employed on a participating basis, except that where it goes too far, it has to be limited, and should be limited across the board.

Senator GORE. Mr. Lindsay, I appreciate your generous references to my question. I will not overtax the patience of the committee to proceed further.

I did want to suggest that this was a precedent. And I suggest further that if the Congress once writes into the law the principle of deduction for savings or investment for the peculiar benefit of the taxpayer, both the Congress and the Treasury may well rue the day.

Now I know of no social institution that has greater appeal than homeownership. I do not know how we can justify giving tax deduction to an investment in a retirement insurance policy and deny the poor guy, who is struggling to meet the mortgage payments on his home to put a roof over his kids' heads, deduction for this purpose. To him this is laying up for a rainy day the same as the employer, the self-employed, who may have already paid his mortgage on his home, and may already have met the payments that established his life insurance plan for the protection of his family. But then you give him a deduction for an investment for his own personal, peculiar benefit.

I suggest to you in all seriousness and to the committee that this is not only unprecedented, but it is basically unwise.

Thank you, Mr. Chairman.

Senator BURNETT. Mr. Chairman, I would like to ask my colleague just one question.

Would you propose the elimination of all the retirement benefits now available to employees of corporations?

Senator GORE. I had not prepared a proposal along that order. When this bill reaches the floor of the Senate, I assure you that I will have a number of amendments affecting corporate pension plans.

Senator BENNETT. Including those affecting the rights of the individual employee as distinguished from owner-manager?

Senator GORE. I just said that I had not prepared such an amendment. I will, however, at the proper time submit amendments for the edification and consideration of my friend.

The CHAIRMAN. Proceed, Mr. Lindsay.

Mr. LINDSAY. I might repeat the last sentence.

Senator SMATHERS. May I ask a question there?

You talk about "at least twice the amount he contributes for himself. This does not mean all contributions must be immediately vested. The test could be met under a graduated vesting plan."

What I am not quite clear on, are you recommending that the vesting rights of the employees be geared to the amounts of the contribution which the employer makes for himself?

In other words, you do not in this recommendation give to employees vested rights, you give vested rights in these funds only upon condition as to the amount of money that is put up by the employer; is that right?

Mr. LINDSAY. Let me put it this way, Senator Smathers.

The easiest comparison to make in applying this rule is to compare the contributions in that year vested in employees as against all contributions going to the owners.

Now, where contributions are forfeitable you don't quite know where they are going. They may reduce future deductions, but may not benefit the employees. If all the employees disappear after a while, although the annual deductions of the employer have been reduced, the employer will wind up at the end with all the amounts originally and ostensibly set aside for his employees.

Now, the simplest thing to do is to require immediate vesting. That can be comparatively costly, particularly if you have a number of employees, and rapid turnover. Since vesting is costly, it means that the benefits have to be reduced for the employees. But you might have a graduated vesting plan—I will give you an example of one—under which employees coming into the organization are immediately covered under the pension plan the first year, but vesting does not start until after 2 years, and then only on a gradual basis. By the time those employees stay for 10 years they have a completely vested right to all contributions set aside on their behalf by the employer.

Now, if you were applying this test in that context, you would look at the vested contributions rather than the portion of the contributions that are not vested.

Senator MCCARTHY. May I ask a question at that point.

The study here cited by Daniel Holland said that at the present time half of the employees under the pension plan have no vested rights until retirement, under existing pension plans; is that about right?

Mr. LINDSAY. That is about right.

I want to go to vesting in more detail later, because it is a very difficult and important question.

As stated, this test does not mean all contributions must be immediately vested. The test could be met under a graduated vesting plan. Under such conditions the owners would be permitted to make contributions exceeding the basic amounts without any special limitation provided all contributions and benefits are nondiscriminatory.

Two additional limitations recommended in our letter of April 1, 1960, are intended to give more concrete statutory backing for administrative positions in the pension plan area which thus far have not been seriously challenged but which, if upset in future litigation, would create serious additional problems.

First, where the pension plan does not provide all covered employees with vested rights, forfeitable contributions made on behalf of employees should not be permitted to accrue eventually to the self-employed person establishing the plan. Instead, as under present income tax regulations relating to pension plans, any forfeitures resulting under the pension plan should be used to reduce the employer's contributions and should not be used to increase benefits for the remaining participants.

Second, to reduce the amounts reverting to an employer on termination of a pension plan, all employees covered at the time of termination should be given vested rights to benefits, as under present administrative rules.

Under the statute, employers may establish pension plans geared to social security benefits and in so doing take credit for social security benefits relating to the first $4,800 of salaries. However, we take the position that if only the owner of the business is covered by the private contributions and all or almost all employees are in reality deprived of benefits under the plan because they earn $4,800 or less or small amounts in excess of $4,800, the plan is inherently discriminatory.

While this is generally the present administrative position, it is not as firmly defined as the rules on forfeiture and termination that I described in the preceding two paragraphs.

Accordingly, we recommend that the pension plan should not take credit for social security benefits if the total amount of the contributions for self-employed persons and corporate owner-managers exceeds one-half of the total annual deductible contributions vested in all employees who are neither owners nor close relatives of the owner.

Further recommendations pertaining to the integration of pension plans with social security are suggested in our letter of April 1, 1960, for future consideration.

In our letter of April 1, 1960, we did not suggest that covered employees be granted vested rights where the contributions under the plan for owners do not exceed the basic 10 percent-$2,500 limitation. If vesting were required for all plans subject to this limitation, it is possible that some hardships might arise.

It may be possible that where there are several owners of a business, contributions made on their behalf could be made truly forfeitable. By and large, however, where there is a single owner of a business, whether or not the business is incorporated, amounts set aside on behalf of the owner are as a practical matter vested.

It would seem, therefore, that contributions on behalf of such an employer's employees should be similarly vested if we are to keep faith with the requirement that the plan is not to be discriminatory and that the employees must receive benefits comparable to those accorded the owner.

From the point of view of administration, the simplest rule is one which would require immediate vesting, at least in the area where the owner of the business, by reason of his controlling position, has in substance vested rights under the plan.

As stated in our letter of April 1, 1960, we recommend, but with appropriate safeguards, that self-employed individuals might be permitted to participate in a form of retirement plan which would allow them to set aside funds in profitable years but would not require them to do so in nonprofitable years. This suggestion, described in more detail in our letter of April 1, would, in effect, tighten the rules of existing law applicable to profit-sharing plans for the owners of a corporate enterprise, at least to the extent that the bulk of the benefits go to such owners.

While profit-sharing plans are often lumped together with pension plans, there are a number of problems in the profit-sharing area that call for special attention. Particularly in the case of an owner of a business or a self-employed individual without substantial employees, profit-sharing plans may in operation be highly discriminatory in favor of the owner because of the timing of contributions and the fact that forfeitures increase benefits to remaining employees.

Profit-sharing may be an appropriate device for permitting employees to share more in the profits of an enterprise than would be the case if the total compensation were based on commitments regardless of profits. In the case of an owner of a business or a self-employed individual without substantial employees, profit-sharing is more in the nature of a tax-saving device since such persons in any event are entitled to all of the profits of the enterprise.

Even with respect to the larger plans where the bulk of the benefits go to the employees, future consideration should be given to restoring the rule that a qualified profit-sharing plan must set forth a definite formula for determining the profits of the employer to be shared and for distributing such profits among his employees or their beneficiaries.

The foregoing highlights the major proposed limitations recommended by the Treasury with the exception of those items which, due to insufficient time, have been postponed for future consideration.

In addition, the April 1, 1960, letter contains recommendations pertaining to contributory plans, premature withdrawals, and prohibited transactions. While important, these recommendations should not require further elaboration in the context of these hearings.

In our letter of April 1, 1960, it was suggested that pension contributions on behalf of each self-employed individual or owner-manager of a corporation could be as much as the largest annual deductible contribution vested in any employee who is neither an owner nor a close relative of an owner. On further examination, this recommendation appears troublesome and we recommend against its adoption.

We appreciate the committee affording us an opportunity to discuss the alternative approach and more particularly that part of the approach which on a transition basis would make it possible to cope with the pressing problems in the corporate area.

The CHAIRMAN. Thank you very much, Mr. Lindsay.

Will you state for the record the cost of the Keogh plan as compared to the alternate?

Mr. LINDSAY. H.R. 10 has a figure of $365 million, and as stated in the hearings, that is based on 1953 statistics of income.

Senator KERR. What was the answer?

Mr. LINDSAY. $365 million.

Senator KERR. Annual loss in revenue?

Mr. LINDSAY. Annual loss in revenue, based on the 1953 statistics of income.

The CHAIRMAN. That is House bill 10?

Mr. LINDSAY. That is right, H.R. 10.

The CHAIRMAN. $350 million.

Now, what is the alternative plan?

Mr. LINDSAY. The alternative is much more difficult to estimate than H.R. 10, because there may be some inhibition on the part of some self-employed to participate, at least in the first year, where they have to establish plans to cover their employees. Our estimates range from $150 to $250 million.

I should mention that part of the reduction, and a considerable part, is due to the disallowance of permitting persons over 50 years of age to take additional deductions. That contributed to almost one-third of the revenue loss of H.R. 10.

There is another substantial reduction in applying the deductions to earned income rather than self-employment income. From there on we worked out a series of tables, assuming maximum participation and minimum participation, and came out with the figures that I have given.

I might add that Commerce estimates for 1958 state that the number of self-employed is 9.7 million. That does not mean self-employed in the taxable brackets. The number of employees of self-employed is 10.9 millions. So that while the mix is different, there seems to be almost a 1 for 1 ratio.

The CHAIRMAN. Now, the basic differences between the two plans is, H.R. 10 provides that a self-employed person could establish a pension plan for himself without making provisions for the coverage of his employees, and under your proposal his employees are covered in the same ratio as the employer, with payments made by the employer.

Mr. LINDSAY. That is correct.

The CHAIRMAN. The second basic change is that the allowance provided in H.R. 10 is based on all self-employment income, including income-including investments——

Mr. LINDSAY. Social security.

The CHAIRMAN. And the allowance under the Treasury alternative is based on earned income?

Mr. LINDSAY. Yes.

The CHAIRMAN. Would you call these the two basic differences?

Mr. LINDSAY. Yes.

The CHAIRMAN. What else would you consider important differences between the two plans?

Senator KERR. There would be the elimination of the provision in H.R. 10 to permit additional deductions after the taxpayer is 50 years of age?

Mr. LINDSAY. I would say that is an important distinction.

Another one is that we have a slightly more stringent provision to take care of premature withdrawals. We indicate that once he withdraws prematurely, in addition to the proposed penalties in H.R. 10, the individual could not participate in such a plan for another 5 years.

But the most important is that we are trying to work out an overall merging of the pension plans for self-employed and for the incorporated enterprise, at least in the closely held area, where you do not have a substantial number of employees. Where you do have a substantial number of employees, this might not touch the corporate area.

The CHAIRMAN. How do you define the owner-manager of a corporation for the purpose of applying the proposed limitations?

Mr. LINDSAY. He must own 10 percent or more of the stock of the company, and he must—here you get into the question of voting stocks, and must follow the rules in section 302 of the Code—and he must also be an employee, otherwise he would not be in the plan.

The CHAIRMAN. And would an association of physicians be barred from participating in the pension plan under either alternative?

Mr. LINDSAY. Excuse me, Senator.

The CHAIRMAN. Would an association of physicians be barred from participating in the pension plan under your alternative plan?

Mr. LINDSAY. If it is an association?

In the first place, if it is an association of physicians which is now treated as a partnership, it would be permitted, subject to the limitations, to participate. If it is an association which has in court won a determination that it is an association taxable as a corporation, then it may find additional limitations, but wouldn't be barred. Whether new limitations would apply depends on the entire plan as it exists.

I would have to see the plan to answer the question.

The CHAIRMAN. If your rule of allowing the employer as much as his highest paid employee goes into effect, will not firms be encouraged to hire high paid employees in order to raise the owners' or partners' pension contributions?

Mr. LINDSAY. It might, we have abandoned that recommendation for a variety of reasons.

Suppose you have a very fine up and coming young man in a partnership, they might find it to their mutual advantage to keep him as an employee rather than a partner, and there are possibilities of abuse. I don't think that it is a fair rule from the point of view of the people who would have to live with it.

The CHAIRMAN. Was that not included in your first plan?

Mr. LINDSAY. It was.

As I stated in my testimony, we have withdrawn that recommendation.

The CHAIRMAN. If you allow pension plans to take credit for social security benefits only in the limited circumstances, will this not cut back many existing pension plans seriously?

Mr. LINDSAY. We have tried to conduct a survey through the district director's office, and by and large, with very few exceptions, no plan has been approved, where the integration of the social security had the effect of cutting out the employees.

Now, you get into questions of degree. Suppose you have an owner-manager and a secretary, that is all. The secretary is paid $4,800. If such a pension plan were permitted to integrate under social security, she would receive no benefits under the private plan. But he has social security, too (unless he is a doctor). Though the secretary has social security, that is all she would have and it would not be fair to call such a plan an employee plan.

Under those circumstances, 99 times out of a hundred, according to our statistics, we do not permit social security integration.

Suppose the secretary has $5,000 of salary, then, assuming social security integration, she would only be included in the private plan to the extent of $200; it is almost the same type of thing.

So we have moved to the rule-of-thumb that a plan should be allowed to take credit for social security benefits only if vested contributions for other employees are at least twice as large as contributions for the owners.

Social security integration is rather peculiar, because it compares apples with bananas.

What the corporate actually contributes to social security for each employee is in the order of 3 percent. But what he takes credit for in contribution under the pension plan is 9⅜ percent of salary, or if you look at the benefit level it is something like 37½ percent of his salary. You can work that out and see what deduction it would support.

That may be fine for one particular employee, but social security benefits aren't equal, these figures were developed from looking at the mass. If you are single and have no children, all you can expect if you die before retirement age is $250 burial expenses.

Pension plans provide benefits without regard to the particular need and family situation of the employee. Social security is entirely different.

The CHAIRMAN. Now, if 10 percent stockownership makes an owner-manager, but 9 percent does not, are not your proposed restrictions on existing pension plans rather arbitrary?

Mr. LINDSAY. I think that the 10 percent, $2,500 rule is arbitrary. Somewhere along the line you have to have an arbitrary rule. The question is what is the best rule and the least offensive.

If you have no rule, then you are dealing with just the rule of reasonable compensation, which may permit abuse.

The CHAIRMAN. Senator Kerr.

Senator KERR. Under existing law, what is that percentage figure that prevents a so-called owner-manager from being covered under the pension plan of a corporation?

Mr. LINDSAY. Under existing law?

Senator KERR. Yes.

Mr. LINDSAY. Under existing law there is no limitation on his being covered. If he owns all the stock of a corporation, and he is the sole employee of that corporation, he can participate in his own pension plan and in his own profit-sharing plan.

Senator KERR. And there are numerous plans in operation which have been approved by the Department in which the so-called owner-manager has either himself or together with his family a greater than 10 percent interest in holding it?

Mr. LINDSAY. I would say that is true, Senator Kerr.

Senator KERR. What is your recommendation as to those existing plans as they would be affected by the amendments which you have recommended in the event of their adoption?

Mr. LINDSAY. They may or may not be affected. If they fund large benefits for employees who are not relatives or 10-percent owners or more, there may be no effect whatsoever. But if they don't have any employees or have so few employees that the bulk of the benefits is really going to themselves, I would say, if our recommendation were adopted, starting January 1, 1963, it would limit future contributions to 10 percent or $2,500. It wouldn't affect anything in the past. They would have 2 years to adjust, 2 years to complain, and the committee and the Treasury would have 2 years to make sure we have hit upon the right rule.

Now, there was dissatisfaction with the pension plan area in 1954. And the decision then was, we will repair it in the future and just carry forward existing law. Other priorities come up as a matter of course, including things like the life insurance bill last year.

Unless there is a target date, I doubt that we would find a solution or be forced to find the proper solution. We have come to the conclusion that this area of the law deserves very careful attention. It may be that by the end of the 2-year period you will be satisfied with existing law and will eliminate the prospective application of limitations in 1963.

Now, an example is what happened in 1942. Prior to 1942 there were pension plans. The early Revenue Acts provided for pension plans. There were many pension plans, some of which didn't have vesting, but had broad nondiscriminatory coverage.

In 1942 it was determined, because of some bizarre cases, to require nondiscriminatory coverage and benefits. That would have knocked out a considerable number of existing plans. So it was made inapplicable to existing plans until 1943.

Nineteen hundred and forty-three came along and they pushed it off until 1944, and again to 1945. By that time people adjusted and it stuck. Certainly to apply new limitations to existing approved plans immediately is something we would not ask this committtee to do.

The CHAIRMAN. Senator Williams.

Senator WILLIAMS. In the event a self-employed individual does not have any employees, would he be able to establish a plan under your proposal?

Mr. LINDSAY. He would.

Senator WILLIAMS. If, in the establishment of his plan, he included social security as a part of that plan, would he be able to deduct his contributions to the social security fund?

Mr. LINDSAY. If he is self-employed?

Senator WILLIAMS. Yes.

Mr. LINDSAY. No.

Senator WILLIAMS. If it was interwoven as a part of the plan he was establishing, would he be allowed to include it as a part of the cost?

Mr. LINDSAY. I don't think he could under those circumstances integrate it with social security. Maybe he could, that is a question I am not sure of.

Senator WILLIAMS. That is the question I was asking, I was wondering, could he or could he not?

Mr. LINDSAY. He can't deduct the social security tax, if that is your question. He can integrate the plan with social security, I would suppose, by saying, "I am not going to cover myself except for my salary in excess of $4,800." I don't see why we wouldn't approve that kind of plan in that instance, but I don't think it could be a pattern of excluding the first secretary he hired because she only received $4,800.

Senator WILLIAMS. But in any way the contributions would not be included as a part of the plan?

Mr. LINDSAY. That is right.

Senator WILLIAMS. That rule would also apply in the event that he had employees, would it not?

Mr. LINDSAY. If he had employees, and integration with social security were proper under those circumstances, all he would be deducting would be his share of the taxes, paying for the employees under social security, and the contributions for the pension plan in excess of $4,800, but he would not be deducting his own social security tax.

Senator WILLIAMS. With employees he would be able to deduct that amount of the social security tax which he is paying for the employees?

Mr. LINDSAY. Yes, It is a business expense.

Senator WILLIAMS. But he would not be allowed to count any of his tax as far as he himself is concerned; is that correct?

Mr. LINDSAY. That is correct.

The CHAIRMAN. Senator Frear.

Senator FREAR. Mr. Lindsay, you make a very pertinent statement:

> Legislation may be justified notwithstanding loss of revenue if it accomplishes needed reforms.

I assume the word "legislation" means all types and classes of legislation.

Mr. LINDSAY. I am talking in the context of H.R. 10 and the alternate.

Senator FREAR. Would it not apply to any other legislation?

Mr. LINDSAY. I would think at this time yes, Senator Frear.

Senator FREAR. Fair enough.

The CHAIRMAN. Senator Bennett.

Senator BENNETT. You were discussing the comparative cost of the two approaches. If I remember correctly, you indicated that if the H.R. — I will ask the question slightly differently.

Suppose that these additional proposals were not accepted by the committee, but the committee—but the committee did accept with respect to the coverage of the self-employed your two proposals: First, that this 10-percent limitation would apply only on earned income and not to total income; and second, that the people above 50 would not have the privilege of paying in extra sums. Can you give me an estimate of how much that would reduce the loss of revenue to the Treasury?

Mr. LINDSAY. Let me ask a question first.

Would that also assume that the self-employed must include their employees or is this question just in the context of H.R. 10 in its original form?

Senator BENNETT. At the moment it is in the context of H.R. 10 in its original form, with no inclusion of the employees.

Mr. LINDSAY. That would bring the revenue down to $160 million.

Senator KERR. The loss?

Mr. LINDSAY. The revenue loss.

Senator BENNETT. If the self-employed, without any consideration of their other employees, were not allowed to include their total income but only their earned income, and were not allowed past the age of 50 to step up contributions, that would bring the revenue loss down to $160 million?

Mr. LINDSAY. Yes. But all of these are subject to the fact that these estimates originally were based on the statistics of 1953, but the same proportion is there.

Senator BENNETT. The relationship is what I want to get, the relationship of $360 and $160 million in the context of 1953 statistics.

Now, if you were to require them to include their employees and make the same limitation apply, what would be the difference?

Mr. LINDSAY. Well, we figure it might be up to $250 million. The theoretical maximum we have is $376 million, but we think that is unrealistic, that assumes everybody.

Senator BENNETT. The first question was the one that was really on my mind. Those are the figures that I wanted.

Thank you, Mr. Chairman.

The CHAIRMAN. Senator Long.

Senator LONG. Would you give me some idea as to how far these corporate owner claims go? I don't have any direct knowledge of them. Under those existing plans, what percentage of corporate incomes does a corporate owner set aside in a retirement plan for themselves. How high do some of them go?

Mr. LINDSAY. It depends on the basis. But he may decide that he should have a pension, and all his employees have like pensions, of 50 percent of salary, or even more, and then he can contribute whatever is necessary actuarially to produce that—it may be based on the salary of the last 5 years in which he was active before retirement. If he didn't want to use actuarial computations, he could use a basic 5 percent of compensation, with additions for past service.

There is an overall limit, I believe, when you combine a profit-sharing plan and a pension plan, which is 25 percent. A profit-sharing plan is 15 percent of compensation.

Senator LONG. For a profit-sharing plan, can that be used to get him additional deductions?

Mr. LINDSAY. Sure. You can have a combination of both a profit-sharing and pension plan if you are in a corporation.

Senator LONG. What I am trying to understand is—this looks to me like it offers some tax avoidance possibilities, and I was trying to see how far it can go under your present situation.

Suppose a man had a corporation where he is the only employee and he owns an oil well where he only has to have someone go out to check the gages from time to time, so his labor cost is extremely small.

Now, how far can he go with that? If he has a hundred thousand dollars income, how much of it can he set aside for himself under a profit-sharing plus a pension plan?

Mr. LINDSAY. There is only one break on that situation, and that is the test as to whether or not the amount he sets aside for his retirement, when added to his compensation or salary, is unreasonable in amount, whatever that means. And it is a very difficult rule to administer, as you can imagine.

Now, when you have comparable situations, comparisons can be made. That fellow might be in more trouble than somebody else with more employees. In the first place, he owns all the stock, and presumably, if he goes too far, he won't be paying any dividends. We would probably attack him by saying his contributions are really disguised dividends, and disqualify the plan and disallow the deduction.

Senator LONG. What I am trying to find out—and you ought to know—if you have not examined some of these specifically to know, why you ought to so you can give us this information. I want to know how far some of these corporate owner plans go. What percentage of the net income of the corporation area would you set aside for retirement and under profit sharing—you keep profit sharing as being a way that they can achieve even more of the same rule—how far do some of them go?

Mr. LINDSAY. Well, as I say, the only limit is on the reasonableness of the amounts. I was looking at a case yesterday—we didn't bring it with us—where the excess profits tax came along and somebody had boosted his salary from something like $8,000 or $9,000, in that area, up to $80,000, and then a similar amount for his pension plan, but he was denied his deductions.

Mr. GLASMANN. Senator Long, take your oil well example. Let's suppose that man performed no services himself, he just had the money invested in the oil well——

Senator LONG. I am trying to take a case where he has got some basis.

Mr. GLASSMANN. If he is managing an oil well, the question is: What can you reasonably pay him for the services performed? That takes into account both his current salary plus the amount you pay him under the pension plan as a form of deferred salary. Whether you have a profit-sharing plan or pension plan, reasonableness of the salary plus the contribution to the pension plan for him, depend on the services actually rendered by that person. You check that with what comparable companies would pay for similar services.

Senator LONG. How much could he set aside? Suppose he could justify a salary of $25,000, how much could he set aside?

Mr. GLASSMANN. Let's assume he was the only employee, and he wanted to say, "I will take no salary at all currently." He might be able to set the whole thing aside as a deferred compensation on this reasonable salary concept.

Senator LONG. He might set the whole thing aside for compensation, you say?

Senator BENNETT. In that case he would have no salary.

Mr. GLASSMANN. He would take no current salary, he would defer his entire income by fitting it into a profit-sharing or pension plan to be paid out at some future date.

Senator LONG. And that would be deferred?

Mr. GLASSMANN. If it were a qualified plan, since he is the only employee, he wouldn't be discriminating against the others.

Senator LONG. In other words, he could not only match his salary, he could, under some circumstances, put the entire salary into the pension plan?

Mr. LINDSAY. If I may interrupt, I would not agree for the record that that would be proper or that we would allow it.

Senator LONG. All I am trying to get is a simple answer.

How far can these plans go? That is what I want to know.

Mr. LINDSAY. We have some statistics here——

Senator LONG. You ought to have some illustration of the possibility for tax avoidance in these plans—let's not say avoidance; a possibility for the reduction of tax liability—let's put it that way.

Mr. LINDSAY. We have percentages of net income set aside for deductions for contributions to qualified plans. We have some corporations with assets of under $50,000—82 corporations selected in that group, with a net income of $602,000, and with the amount set aside of $348,000, or 57.8 percent of net income.

Now, as the assets go up, these percentages set aside tend to go down. And whether that is because of the number of employees or not I do not know.

But to give you illustrations of tax avoidance: In the profit-sharing area, since under the *Lincoln Electric* case you do not have to have a fixed and definite formula, you can have a one-shot arrangement under which just in 1 year 15 percent of compensation is set aside as profit sharing for all the participants that may be paid out in some later years, perhaps before retirement.

Now, there may be quite a few employees in the year of contribution—a kind of a peak year—and those employees leave, and their amounts are forfeitable, so that what is left for the remaining participants—not the new employees, but the remaining original participants—increases. That is what we meant by timing and forfeiture when we talked about profit sharing.

Now, with respect to pension plans, you can theoretically set aside more of compensation for a pension plan than you can for a profit-sharing plan, because in any event the amount you set aside in a profit-sharing plan is limited to 15 percent of compensation. In a pension plan you can look at the benefit end, percentage of salary as pension, and whatever is actuarially necessary to support that on a nondiscriminatory basis may exceed 25 percent, assuming you are not combining profit sharing with the pension plan.

Now, supposing that is done in an excessive amount. We would say when we are dealing with this owner that it is a disguised dividend; but it is a difficult argument and there has been very little litigation in this area.

And also, we have not been unusually successful in the past in those areas in which we have litigated issues under the pension plan area.

We have run into the danger, although I don't think it is proper and likely, but it is still a danger, of finding that the excess amounts set aside, if clearly unreasonable, would result only in the denial of deductions to the corporation. Don't forget that those amounts are transferred from the man's corporation into an exempt trust, and unless you can get the trust disqualified, you have exempt earnings for him building up over the years.

Now, I do not have an individual——

Senator LONG. Why is the trust tax exempt?

Mr. LINDSAY. Because the deduction rules are a little bit different from the qualification rules. You have particular rules under section 404, and then the earlier section of the code, section 162, as to whether compensation is reasonable or not. The particular rules in section 404 measure how much you can deduct in any one year. The basic rules for the pension plan qualification are whether or not they plan is discriminatory and whether or not you have adequate coverage.

Now, with a one-man plan, you have 100 percent coverage. We would have said that it is discriminatory because it benefits only the owner, but the 30-percent rule was rejected and we have no rule in the statute to support that at this time. The only rule we have is our assertion in the regulations that we may treat some contributions as a disguised dividend. We may or may not with that case.

I would like to assume we do, but after all, it would involve litigation. In the meantime, you may not be able to police all these types of arrangements.

Senator LONG. You might lose that one like you lost the 30-percent regulation.

Mr. LINDSAY. Right.

Now, even aside from limiting deductions, you have quite an opportunity here to transfer funds from a taxable corporation, your own corporation, into an exempt trust, and let it build up, the exempt earnings accrue, without any tax whatsoever. And this is compounded by the fact that he might draw it all down in a lump sum at capital gains rates.

Senator LONG. You are referring here to 82 small companies closely held, I assume, where 57.8—roughly 58 percent of the income—is then put into pension-sharing and pension plans and profit sharing. Then you say that that can in turn be transferred to a tax-exempt trust?

Mr. LINDSAY. No. When it is deducted, it is put into a tax-exempt trust unless—we are talking here about these statistics and the breakdown doesn't show it—they may have group annuity policies or even individual annuity policies with insurance companies. That I don't know.

Senator LONG. Assuming that those securities or that money is then invested, it could easily over a period of 20 years double the amount originally set aside, could it not?

Mr. LINDSAY. Oh, yes.

Senator LONG. And then when taken down it would be at capital gains rates?

Mr. LINDSAY. If taken down as a lump sum.

Senator LONG. If taken down as a lump sum.

Mr. LINDSAY. On termination of employment.

Senator LONG. So the amount of money that would eventually come out after taxes could exceed what the necessary income of the corporation was to begin with, could it not?

Mr. LINDSAY. Yes, it could.

Senator LONG. Now, would it not seem to you that before we go to expanding some of the tax-avoidance possibilities that are presently in the law, that we ought to close up some of the obvious loopholes that already exist in those fields?

Mr. LINDSAY. Well, our approach is along those lines.

We were saying, if we could do these things and put these limitations on, then we think that we could provide for equalization in the pension plan area. We think the two go together.

Senator LONG. It seems to me—and this argument has been made to me repeatedly by self-employed people—that here are advantages that are given to a person in the corporate form and it is not fair to deny them to me because I am self-employed. However, if this exists, not by reason of study or consideration, but just by reason of accident or by reason of the fact that somebody uncovered a tax loophole, would it not make better sense to close the loophole rather than to give somebody else the benefit of the same loophole?

Mr. LINDSAY. In connection with that, whether or not the committee acts in this area and puts in this advance date for the corporate cutback, we have started the groundwork for a very extensive and more detailed study of these plans and how they work.

Senator LONG. But why a cutback?

Nobody ever had any intention—I know I did not—where 50 percent of the corporate net worth is set aside in a trust and then taken out at capital gains rates after it has gathered interest. Why should we lose it there?

Have you people not recommended closing loopholes in the past—I mean closing the existing ones today?

Mr. LINDSAY. We are not recommending extensive revisions today. But I would say that you cannot necessarily set aside that amount and have an exempt trust. I think we have to know exactly, more precisely, how these particular plans work, and how they come out. They may result in a very modest pension, I don't know.

I think this whole area deserves intensive study, and such a study deserves priority.

Senator LONG. It does not look as though some of it deserves study.

Do you think this thing of these people getting 57.8 percent of net income—I take that is after salary—do you think it needs any study to close that one?

Mr. LINDSAY. Let's say this as a possibility: Suppose that all of those are corporations in which the principal or sole or few shareholders are in personal service. When you are in personal service, you can justify in the marketplace a reasonably high salary, and we would assume—in the first place, you can justify some earnings for the corporation for what you do—that if you are in personal services your services create a large percentage of the corporate income.

Now, when we talk about 57 percent of the net income, we are talking about income after salary. It may be that the income after salary is small, so that the amounts may not be huge; in other words, you cannot prove too much with this table.

Senator LONG. Let's look at it this way. These doctors are in here asking for $2,500 that they can set aside for retirement for themselves. Does it seem likely that the executives in these companies are performing any greater service than these doctors are performing?

I ask that for the predicate of this question. Why should the executives of these 82 companies receive any better tax basis than the doctors?

Mr. LINDSAY. Let's assume that you have an association of doctors. It may be that after what they considered to be their fair salaries, which are deducted from the income, if it is a taxable-type association as a corporation, that $2,500 for each would amount to 57 or 58 percent of the taxable or net income, so that we might jump to a very fast conclusion by looking at a table like this. And there again we can say, I think this deserves continuous and intensified study.

Now, if there is no action on this legislation this year at all, because of the fact that so many people have worked on it and have been interested in it and the committees now have had an opportunity to look into it, that study, I am sure, would be made and be given priority.

The only other way it can be given the priority, that I see, and make sure that it sticks, is this: If you do have to act in the self-employed area now, include this limitation on corporations, which may turn out to be too arbitrary, but do not make it effective for 2 years from now, so that we can make sure that at the end of the road we have a sound rule and a fair one.

Senator LONG. It appears to me that if you are satisfied that you have a big loophole here, that it is best to close the loophole, rather than just to leave it open indefinitely.

You have at least gone to the extent of bringing in an amendment that in your best judgment is the way to go about closing that loophole.

Mr. LINDSAY. At this time. Now, there are other things that we would recommend, and there are things in the House version of the 1954 code, some of which have merit, that we might like to recommend again.

We would like, for example, to recommend that any profit-sharing plan must have a fixed and determinable formula. But that is going beyond this particular problem of self-dealing in the one-man type corporation, and therefore obviously beyond the scope of what the committee can be asked to consider at this time this year.

Senator LONG. Let me ask a question along a different line.

Is there any logical reason, just from the social and the governmental point of view, why we should accord any better tax treatment to the person who is in a position to supplement his social security than we accord to those who have only the basic social security coverage?

Mr. LINDSAY. We have some question on the integration rules there.

Senator LONG. Here is what I have in mind. Under social security, the employer puts up 3 percent, and that is deductible. The employee puts up 3 percent of income on which he has paid taxes. That works out, then, to 6 percent going into social security.

Now, when he draws it back—which ordinarily would be what he put up, what his employer put up, plus the interest—that is not taxable to him?

Mr. LINDSAY. It is not taxable; it is tax exempt.

Senator CURTIS. Would you yield right there?

It is tax exempt by executive ruling and not by statute; is that correct?

Mr. LINDSAY. That is correct.

And I believe the theory of it at the time was based on some rather strict court interpretations of what is "income" that "income" is from capital or labor or both combined. It was based on the fact that the benefits of social security did not depend on how long you worked, or what you contributed, but according to your need—if you had a wife you got more; if you had dependents you got more; if you died without wife or dependents, you only got $250—you didn't have something that went into your estate. So at that time it was felt that this was not in the nature of income.

Since then the courts have come out with very broad definitions of what is income.

In view of the *Glenshaw Glass* case, I imagine if the question came up anew it would probably, or might be regarded as taxable income although I don't know. However, with that rule having been made administratively so long ago, I don't think it could now be administratively changed.

Senator LONG. I believe you will find it fixed on a different basis, Mr. Lindsay; I believe you will find that there was fear of a constitutional attack on the social security law as such on the theory that the Government had no right to tax for this purpose. On that basis the Government levied a social security tax as a tax for Government revenue purposes and then proceeded to provide a retirement program just as though it, too, were independent, although they were both considered as being together for practical purposes.

That is what Colin Stam thinks. He is our expert on the staff. And you are the expert for the Treasury. If you two can get together, I will be satisfied.

In any event, I know it is deductible as far as the employer is concerned; it is not deductible as far as the employees are concerned. And that is all I care to get to—whether it is deductible as a policy or a matter of law. As a matter of law it is deductible, but as a matter of policy you are not proposing to change it, or anybody else, so that half of it is tax-paid income, and half is deductible income, and it goes into a fund and accumulates interest, and it is paid back out on a nontaxable basis when it comes back out.

Now, if you compute that you would find that the amount that would be taken down would be substantially less in any case than if you gave a person a complete deduction for the whole 6 percent, and then at the time you took it down, let him have it back at 25 percent capital gains rates.

Now, I ask this question: Why should we not treat it on the same basis that we treat social security?

We would certainly get more revenue if we do it that way. And why should a person who is in a position to supplement his social security get a better tax break than the fellow who cannot supplement his social security?

Mr. LINDSAY. Well, I am not sure that I have all the details of your proposal.

As I understand it, you are looking at the fact that the employer deducts the 3 percent he pays for the employee; the employee cannot deduct the 3 percent he puts in for himself. And to equate that type——

Senator LONG. If a man is both the employer and the employee, he is at both ends of it, why should he not pay taxes on half and then draw it out in the way of social security?

Mr. LINDSAY. There is some modification there for the self-employed. The self-employed doesn't pay the same amount, he is acting as half the employer, and he pays half the employer's share, but he cannot deduct it.

Now, if your question just goes to whether the self-employed can deduct that half of what he puts in, that is one thing. If your question is whether or not pension plans ought to follow the route of social security, that is another.

Pension plans and social security are only alike in this——

Senator LONG. Here is the question I am asking. My question is: Would it not make sense that in no event should the pension plan approach exceed and receive better tax treatment than the social security approach.

Mr. LINDSAY. I am not altogether too sure that it can be mixed.

Senator LONG. With capital gains you paid tax on half of it. The kind of thing I am suggesting is, if a person puts this into a pension plan for himself, why should he not pay tax on half, and then when he draws it back——

Mr. LINDSAY. Your suggestion then——

Senator LONG (continuing). He can draw it without taxes the same as he does in social security.

Mr. LINDSAY. You are suggesting, then, instead of putting in taxable income without a deduction, into your share of social security or a pension, or getting a deduction for that amount, that you take the amount that you put in and say that amount of your income is then taxed at the capital gains rate.

Senator LONG. No, taxed on half of it.

Mr. LINDSAY. Taxed on half of it, if he puts in $2,500, tax him on $1,250. That would be to carry him through the social security type tax treatment.

Senator LONG. You would certainly get more revenue from the Government point of view and you would certainly give this person a definite tax advantage.

Mr. LINDSAY. That is similar to Senator Cotton's suggestion, that the self-employed, if they set aside $2,000 for themselves, that they get a deduction of $1,000 but not $2,000.

Senator LONG. Would that not make better sense than it would to give this person a better tax treatment than a person that is required to have social security gets for his program?

Mr. LINDSAY. One has to consider the situation where the self-employed has employees, and whether or not he has a contributory plan. If he has a contributory plan, the amount representing his own contribution would not be deductible, and if that amount equals the employer's contirbution, you would come out with a rule that he is deducting half. It would reduce the revenue cost, if that is your suggestion, for the individual without employees to participate, since he can only deduct half what he puts in instead of 100 percent of what he puts in.

Now, the people who worked up the 10 percent, $2,500 limitations were endeavoring—I am not saying whether they did this accurately or not, I don't know; maybe they didn't, but I don't know—were endeavoring to try to match what they thought was generally half the contribution, looking at contributory plans.

Senator LONG. What they were doing was directing—asking to put themselves in the position of these corporate people to the extent of $2,500. But it seems to me they would be on a much better basis if they had asked to put themselves by analogy in the same position as a person who is under social security, providing he gets half at the tax rate and the other half he pays on his own.

Mr. LINDSAY. What would you do at the other end?

Senator LONG. No taxes.

Mr. LINDSAY. Tax exempt on the other end?

Senator LONG. There is no tax at the other end on social security, he just gets it, and that is it.

Mr. LINDSAY. Yes. But it might be wiser to reverse the rule on social security.

Senator LONG. Well, let me say this, that as far as any person—as far as the person is concerned, he is paying more taxes the way I suggest, he is certainly paying more than with social security—figure it out—as to how the Government gets it or what the person winds up with, any way you want to take it. And the Government winds up a lot better if he is paying it on social security because if a man is in an 8 percent bracket on this $2,500, let's say, you are giving him $2,000 back, and then he is collecting interest on that money for a period of 20 years and taking out as capital gains after a period of 20 to 30 years.

And in the meantime the Government is collecting $2,000 less, the Government is borrowing money at 4 percent to offset the $2,000 that it failed to collect in taxes.

Now, the Government would be better off, and it would still be a tremendous benefit to the person if he treated it the same as it is under social security.

Would you care to comment on that?

The CHAIRMAN. Senator Curtis.

Senator CURTIS. I will pass at this time, Mr. Chairman.

The CHAIRMAN. Senator Smathers.

Senator SMATHERS. Mr. Chairman, I have just one or two questions in the same area as Senator Bennett from Utah, as to the cost of these specific amendments which you recommend.

Before we get into that, how many approved owner-managers do we have?

Would you say just 82?

Mr. LINDSAY. No. I was thinking, looking at a table—it is not a complete table, and its shows a plan of only 82 corporations as of 1952.

Senator SMATHERS. Do you follow the table in bringing about a remedy in so-called owner-manager pension plans?

Mr. LINDSAY. We do not have the figures on that, because our statistics don't break pension plans down by the number of employees. It is one of the things that we hope to obtain in the near future as we continue working on this problem.

Senator SMATHERS. Do you have any idea, then, how many people are involved?

Mr. LINDSAY. Well, there are theoretically 18 million or 19 million people covered by private pension plans. Now, when you say covered by private pension plans, how many of those are really carved out by social security integrated plans, I don't know. There are 7,000 new pension plans a year. Most of the large corporations have pension or profit-sharing plans, so the chances are that most new plans are small.

Senator SMATHERS. I am not talking about the large ones, because I don't think they fall into the owner-manager pension area.

Mr. LINDSAY. No, they do not.

Senator SMATHERS. What I am talking about is the owner-manager pension area.

Do you know how many people are generally involved in that area?

Mr. LINDSAY. I haven't got a figure.

Let me ask my associates.

No. An indication that there are a number is the fact that under subchapter S which is limited to corporations with 10 shareholders or less, quite a few people who have elected under that section are trying to set up pension or profit-sharing pension plans.

Senator SMATHERS. Do you have any idea or estimate as to how much money would be saved by the Government if recommendations which you make with respect to the owner-manager pension programs were adopted?

Mr. LINDSAY. Because we don't actually know how many plans of that character there are, it is almost impossible to make an estimate.

We did, however, through our experts who tried to come out with estimates when there was very little to go on, make comparative assumptions as to how many employees there are according to assets, and so forth. Roughly the estimate is in the area of $30 to $50 million. But that is very rough, and it is based on a whole series of assumptions.

Senator BENNETT. $50 million what?

Mr. LINDSAY. Of additional revenue involved in these cutbacks.

Senator KERR. Is that taxable revenue, or tax loss?

Mr. LINDSAY. Tax revenue.

Senator SMATHERS. So if we adopted your recommendation, your very rough estimate is that there would be that much gain to the Treasury, $30 million, is that what you are saying?

Mr. LINDSAY. Yes. But there wouldn't be a gain immediately, because we wouldn't affect any existing plan for 2 years. In the long run it would put some kind of a brake on this thing and put some limitations in the area, so we would not have to cope with the open-ended rules we have now.

Senator SMATHERS. Now, if this committee should only adopt the two amendments, one having to do with earned income and the other having to do with disallowing the 50-year-old self-employed to move under these provisions of H.R. 10, you say that that would result in a loss of $160 million to the Treasury under 1953 statistics?

Mr. LINDSAY. Yes. That of course depends very largely on how you define the earned income.

Senator SMATHERS. Suppose we would define earned income as you have outlined?

Mr. LINDSAY. Yes.

Senator SMATHERS. And it would then cost $160 million?

Mr. LINDSAY. Yes.

Senator SMATHERS. That is all the questions I have, Mr. Chairman.

The CHAIRMAN. At that point, does that exclude, then, the employees of the self-employed?

Mr. LINDSAY. That was the question.

The CHAIRMAN. Your question excluded——

Senator SMATHERS. The employees of the self-employed. Because I understood his answer to Senator Bennett was that if you excluded the employees of the self-employed, then it would cost in the neighborhood of $250 million.

Is that your understanding?

Senator BENNETT. Yes.

Senator SMATHERS. Is that what you said?

Mr. LINDSAY. That is what I said.

Senator SMATHERS. As compared to $350 million?

Mr. LINDSAY. $365 million.

The CHAIRMAN. Senator Douglas.

Senator DOUGLAS. Mr. Lindsay, as I understand it, the chief argument for H.R. 10 is that we already permit corporations which have voluntary supplemental pension plans to deduct for tax purposes contributions which they make to the pension of their employees, but we do not accord a similar privilege to the employees of the self-employed; is that right?

Mr. LINDSAY. That is correct.

Senator DOUGLAS. Suppose we pass H.R. 10, will there not be a demand that we accord similar privileges to employees and executives in companies which do not have pension plans but who individually would like to purchase an annuity?

Mr. LINDSAY. I think you will have the demand.

Senator DOUGLAS. Would it not be very hard to resist?

Mr. LINDSAY. I would think so.

Senator DOUGLAS. Have you made any estimates as to what the probable cost of extending it in this way will be?

Mr. LINDSAY. It would be in addition to the cost of H.R. 10, $1.2 million.

Senator DOUGLAS. Pardon?

Mr. LINDSAY. I mean $1.2 billion.

Senator DOUGLAS. $1.2 billion?

Mr. LINDSAY. Yes. But I am assuming now that you are——

Senator DOUGLAS. $1.2 billion a year?

Mr. LINDSAY. Yes. But I am assuming, Senator Douglas, that you are only talking about people who have no coverage in any plan.

Senator DOUGLAS. That is right.

Mr. LINDSAY. If they then tried to move into the area of inadequate coverage to supplement the difference, it would be still higher.

Senator DOUGLAS. So that this figure of $1.2 billion loss a year is a bedrock minimum figure?

Mr. LINDSAY. Yes.

Senator LONG. You are not limiting that to corporate executives, are you?

Mr. LINDSAY. If you applied it to any employee who was not covered by a pension plan, I imagine you would include the corporate executive as well as any other employee.

Senator DOUGLAS. Now, suppose we extended it to that group, and the demand comes that we exempt contributions under civil service plans, Federal, State and local, how much would your annual loss be there?

Mr. LINDSAY. On contributions for——

Senator DOUGLAS. Toward pension plans.

Mr. LINDSAY. Toward pension plans, including Federal, State, and local?

Senator DOUGLAS. Yes.

Mr. LINDSAY. Would you include social security in there?

Senator DOUGLAS. No; let's take these each one in turn.

Mr. LINDSAY. For social security——

Senator DOUGLAS. No; let's take it——

Mr. LINDSAY. I will give you them all.

Senator DOUGLAS. All right.

Mr. LINDSAY. Social security would be $880 million.

Senator DOUGLAS. Social security $880 million.

Mr. LINDSAY. Railroad retirement, $52 million.

Senator DOUGLAS. $52 million.

Mr. LINDSAY. Federal, State, and local retirement plans, $312 million; private pension plans, $130 million.

Senator DOUGLAS. These are the contributions of individuals?

Mr. LINDSAY. Contributions by the individuals. And that all adds up to $1.372 billion.

Senator DOUGLAS. Plus the $1.2 billion that you mentioned making 2.——

Mr. LINDSAY. If you did both, I suppose you would have to add them, yes.

Senator DOUGLAS. Making $2.6 billion, plus the amount under this bill, so you get a possible revenue loss close to $3 billion a year.

Mr. Lindsay, those are staggering figures.

Mr. LINDSAY. I agree with you.

The CHAIRMAN. Senator Gore.

Senator GORE. Mr. Lindsay, let me ask you a question about a hypothetical case.

Suppose that a well-known and successful doctor owns a clinic. He serves as principal medical head, superintendent of the professional facilities. He has one son who is a doctor, and he specializes in gynecological determinations, and so forth. And he has another son who is a lawyer, and he devotes his attention to legal advice, tax records, et cetera. And he has a daughter who supervises a contract for the performance of technical facilities, and another daughter who acts as hostess, public relations officer, supervisor of realty lease. These are the sole employees. The building is leased under conditions such that the charges for room service, room rental, go to the contractor, the laundry is under contract, the nursing service is under lease. These are the four employees. The doctor himself has an income, after salaries of his four employees, derived from his professional services well in excess of $50,000, and he pays a salary to each of his children of $25,000 each.

I ask you if, under your amendment, under your proposal he could not obtain tax deductions from taxable income of $5,000 per year for himself if he invests that much in a retirement insurance policy, and $2,500 each for his four children who are the sole employees of this clinic?

Mr. LINDSAY. On those facts I would state that the doctor is limited to $2,500.

Senator GORE. Why?

Mr. LINDSAY. Because under those circumstances we would limit him to 10 percent up to $2,500 a year.

Senator GORE. Or one-half of the amount that he contributes to the pensions of his employees?

Mr. LINDSAY. "Unrelated."

Senator GORE. "Unrelated."

I did not see that. I stand disrobed.

Mr. LINDSAY. If they are all in-laws, it would probably be all right. Generally speaking, related for tax purposes is limited, with exception, to the taxpayer, or his lineal descendants and ancestors, but not his collateral relatives except in the definition of personal holding companies.

Senator GORE. Then, I ask you another hypothetical question, the same question, except that the two young men are sons-in-law, and the two young ladies are daughters-in-law. Would not this man, then, receive a tax deduction of $5,000 a year for investment for his own personal and peculiar benefit in an insurance retirement plan and $2,500 each or a total of $10,000 tax deductions for two sons-in-law and two daughters-in-law?

Mr. LINDSAY. Yes, provided those salaries were reasonable under all the circumstances.

Now, that is quite a large total income, I suppose, to take in for that family group in a small family clinic. I don't know how much in terms of the total earnings they could justify as salaries which would in effect give them all those deductions.

Senator GORE. But if that was justified, you say under the plan——

Mr. LINDSAY. If it is reasonable under the plan, he would.

Senator GORE. And the Treasury of the United States seriously recommends the adoption of such a law, such a provision of law on May 11, 1960?

Mr. LINDSAY. When you state a case like that, it would be very easy to say, we should cut out all relatives. I am concerned about the fact that there are many and different related-person definitions throughout the code. We have to move toward uniformity, and for most purposes, collaterals should be ignored except in personal holding companies, and maybe even there. Generally speaking—you have given the toughest case, with son- and daughters-in-law—generally in the case of brothers and sisters, no matter how close they are, they all have their individual family responsibilities.

Senator GORE. The same principle would apply, Mr. Lindsay, even if these are unrelated.

Mr. LINDSAY. The same principle if they are unrelated.

Senator GORE. Because you are recommending deduction of taxable income for investment in one's own personal and peculiar benefit.

Mr. LINDSAY. That clinic may be an association classifiable as a corporation deducting a lot more than that.

Senator GORE. There again you undertake to justify what you recommend by the existence of an inequitable—that is my description of it—unfair and unjust provision of the law.

It seems to me the function of the Treasury, if I may respectfully submit—and I do respectfully submit to you—I know of no one in the executive branch of Government for whom I have a higher regard than you.

Mr. LINDSAY. I thank you, sir.

Senator GORE. You do have a keen sense of the public welfare, you have a brilliant mind, and you are forthright and honest. I would support your confirmation as the Secretary of the Treasury any day. So I do not submit this to you in any ill temper; I just say you seek to justify one questionable provision by the existence of another.

It seems to me that the proper performance of the Treasurer of the United States would be to come to the Congress recommending the removal of unjust provisions of law, not the creation of another.

Thank you.

Mr. LINDSAY. May I say, Senator Gore, if I were recommended for such confirmation there would be two people in trouble, Uncle Sam and I.

The CHAIRMAN. Senator McCarthy.

Senator McCARTHY. Mr. Lindsay, we accept the objective is to remove inequity. We can do it two ways, by taking away the advantages that some of the people have now, or by extending the advantages that some of the people have now to everybody else?

Mr. LINDSAY. May I say that those are the two obvious ways. There is a third way.

The third way is to see that the advantages people have now shouldn't be eliminated, but curtailed.

Senator McCARTHY. That is what I mean.

Mr. LINDSAY. Yes.

Senator McCARTHY. You can back it up?

Mr. LINDSAY. You could, I suppose, remove all pension and profit sharing.

Senator McCARTHY. I said, all inequities. And it is not necessarily true that all of these are inequities, because there are complicated factors involved.

Before the Ways and Means Committee a few years ago we had under consideration the same proposition. There was a question relating to railroad retirement in which the proposal was offered to predispose the tax on the rate of what was paid on social security, and above that rate anything paid up to $200 on H.R. 551 would be deducted or taxpayment would be postponed. Would it be possible to apply a rule of that kind in this instance, accepting social security as a special kind of program?

This is a social program, it is not an investment program, it is not an independent pension program, as you have stated in your discussion. This takes into account the fact that the benefits are not limited to the amounts put into it, they are related to need, and so on; they can establish that this is a tax, a kind of social tax imposed on everyone.

Perhaps we should impose social security to everyone, and then we should begin to consider other pension plans and advantages which are in addition to that personal advantage, the amount of the income the individual receives, and the amount taken into account, and try to establish more or less universal standards, to extend to this railroad retirement, let's give them the right to postpone the payment of income tax up to $400 or $300 or whatever it might be. And do the same thing to civil service retirement, extend to the people who are inadequately covered now under private pension plans the right to improve their program up to $2,500.

Would this not be moving toward a way of eliminating inequity rather than stopping short of the program itself in H.R. 10?

Mr. LINDSAY. Well, one must consider, in looking at the railroad retirement, social security, civil service, that there are amounts set aside by the employer which are not now included, and the self-employed will point to that and say, "That is unavailable to us." So you are moving in the direction of that plus the contributions by the individual himself, notwithstanding the fact that in two of these programs there is no tax on benefits.

Senator McCARTHY. I understand that. That is another inequity.

As I understand it, the total amount of revenue lost if you take all of these things into account would approach $3 billion a year.

Mr. LINDSAY. Depending on how it was done.

For example, you could approach $3 billion by taking care of those inadequately covered and those not covered, assuming you could figure out who was inadequately covered, because some people may have substantial benefits which are forfeitable, so you dont know how it is going to come out in the wash. Add that to the contributions by the individual and you approach $3 billion.

If, on the other hand, you just said, leave everything the way it is, but let everybody in the country set aside——

Senator McCarthy. From the point of view of Government finances, there are really two advantages from the point of view of the individual, two financial advantages: one that he has the use, at least he would get the benefits of the use from the investment of money which in part would otherwise have gone to the Government in taxes, and the second is that he may pay taxes eventually at a lower rate than he would have paid at the time.

Mr. Lindsay. A considerably lower rate.

If you are married and both wife and husband are over 65, and you have a retirement type income, dividends and pensions as opposed to earned income, you can earn in the neighborhood of $5,300 without paying tax.

Senator McCarthy. In the last question I raised the question about the possibility of Government bonds in which this money might be invested. If that were possible and feasible, at least the Government would have some advantage in the use of this money, would it not?

Mr. Lindsay. It would. The question would remain, though, as to how much it would replace current payroll savings plans rather than be an additional investment.

Senator McCarthy. The second question is, in 1959 I had the staff people work out legislation which would accomplish this purpose. The question was this, whether we could work it out so that it would be a tax credit, the amount of money that went into a pension program of this kind, up to 20 percent, but the individual would pay at the time he put the money into the pension fund the difference between 40 percent, which is the basic rate of income tax, and whatever the surtax is on his income tax; in other words, if he is in the 55 percent bracket, you take it off the top that he would pay, 25 percent or 35 percent on what went in, and he would receive a 20-percent credit.

Do you have any comments on that?

This would serve to offset the advantage of paying taxes at the lower rate rather than at the rate that would be imposed at the time the money was put into the pension.

Mr. Lindsay. Well, I may be wrong, but I have always had a belief that where we have a progressive rate system, the kind of tax allowance to which you refer would make it more progressive. It is this steep progression in rates that causes all of these pressures or exceptions, and you make it even more topheavy by saying deductions only go to the bottom bracket.

And also, I am a little leery of tax credits as opposed to deductions, for a variety of reasons. There are many pressures on tax credits. You see it in tuition for education, and you see it in other areas; and the States point to tax credit for foreign taxes and say, "Why isn't there a credit for State income tax purposes?"

If this were done, that would in effect give the States a blank check on the Federal Treasury and separate spending power and tax responsibility. People answer that by saying, "Well, put a limit on it."

If you put a limit on it, you may get to the point of double taxation, because a low credit may not serve the same purpose as a deduction, which lets the chips fall where they may.

Senator McCARTHY. My proposal was that he would be taxed at, say, the difference between 52 percent and 20 percent.

Did you get that?

Mr. LINDSAY. I understand your point.

Senator McCARTHY. That is all I have, Mr. Chairman.

Senator CARLSON. Mr. Lindsay, just one or two questions here.

Do I understand from your statement this morning that it would be necessary for every self-employed person to set up a written plan or trust?

Mr. LINDSAY. Well, I would say so. But it could be done simply. And if the Government bond route was used, it could be very simple.

The simplest type of plan to set up, if you have employees, is the vested plan, and use bonds and turn the bonds over to the employees and forget about them. If you are all by yourself, you have no employees, you would either deal with an insurance company or you might prefer to deal through a trustee, or you could just participate in the bond program. I don't think it has to be too complicated, but I don't want to minimize the administrative, possibly serious administrative difficulties that we may face.

I have a memorandum on that in this folder, discussing the kinds of problems that might arise. It is true that complexity tends to be of the taxpayer's own making, the more they try to get away with and go close to the line in eliminating certain employees, the more necessary it is to get the protection of an advance ruling.

But I would imagine you could have a straightforward, simple plan.

Now, one complexity comes in this. We are talking, when we speak in terms of 10 percent or $2,500 of the money purchase type plan. We are not focusing on what many plans really look to, which is a plan which is based on the benefits. Some say, it isn't so important whether you put aside 10 percent this year, the important thing is if you can look to a salary of $10,000, $20,000, $30,000, or whatever it is, a certain percentage of that should be a pension at the other end. And there you have to deal with the actuaries and insurance companies that are best able to handle that kind of a pension plan.

Now, whether that kind of a pension plan fits easily within the money purchase type limitations is a difficult question.

Senator CARLSON. Mr. Lindsay, as I understood the objective of H.R. 10, it was to help the self-employed, even those with modest incomes. And my question was asked for the reason that if it is going to be necessary for those with very modest incomes to hire counsel and accountants to set up trusts and plans, it will be so expensive that there will be no advantage to it.

Mr. LINDSAY. Let's take the situation of a person with modest income, no employees, practicing law by himself or medicine by himself. He can avoid all that by just computing 10 percent up to $2,500, which is not more difficult than any other computations he has to make on his return anyway, and that entitles him to purchase a bond, or an annuity contract from a life insurance company.

Senator BENNETT. Or there is another alternative, is there not, if there is an association of similar people he would already have a plan set up and you can just become a part of it to the extent of his contribution.

Mr. LINDSAY. That is right.

And there his problem is to make sure that he does not exceed the amount in these percentages and dollar limitations. It grows more complicated when he has employees, there is no question about it.

Senator CARLSON. I assume most of them do have employees.

Mr. LINDSAY. Not necessarily.

I think if you say there is a roughly 1-to-1 ratio of employees to self-employed—the chances are that large numbers are self-employed without employees. Many of them pool services—or they might have tele-service, they might just lease a secretary from a commercial organization that provides them for their peak loads. And they might share a secretary with 10 other lawyers on the same floor.

I don't know the actual statistics.

Senator CARLSON. That is all, Mr. Chairman.

The CHAIRMAN. Senator Williams.

Senator WILLIAMS. Mr. Lindsay, in your estimate of $3 billion as being the prospective cost of extending this across the board, did you take into consideration that in the case of social security there is also the equivalent of a 3 percent tax deferment now, in that the employer's contribution is not taxable to the recipient until it is received?

Mr. LINDSAY. That is apart and aside from that estimate.

Senator WILLIAMS. That is aside from it?

Mr. LINDSAY. Yes. But that is there now, and after all, that is part of doing business, you have to pay compensation plus certain tax——

Senator WILLIAMS. I appreciate that, I am not questioning the procedure, I merely want—that is in effect a 3 percent deferred tax exemption?

Mr. LINDSAY. Well, it is an expense of doing business, I would say.

Senator WILLIAMS. But as far as the recipient is concerned, it is a deferred credit?

Mr. LINDSAY. Well, it is more than that, because it is not going to be taxed at the other end, so that it is not a deferred tax.

Senator WILLIAMS. I agree with you, it is tax exempt.

Now, in the case of the civil service employees, the Government contributes 6½ percent into the retirement fund of each employee's salary as a matching operation, the 6½ percent which the employees themselves pay is not a tax credit.

Mr. LINDSAY. That is correct.

Senator WILLIAMS. But the 6½ percent—neither tax credit nor deferrable—but the 6½ percent which the Federal Government pays into the fund, is that not the equivalent of a 6½ percent deferred tax?

Mr. LINDSAY. It is.

And I might say that, as I looked at the actual benefits paid out today under civil service, there is a question as to whether or not the 6½ percent contribution really funds that benefit; it may be in effect a higher contribution.

Senator WILLIAMS. I have understood that it is rated officially at about 12 percent. But that in effect is a tax deferment now under existing law.

Mr. LINDSAY. That is in effect a tax deferment under existing law with respect to the Government's contribution, correct.

The CHAIRMAN. Mr. Lindsay, you have made a very able——

Senator GORE. Mr. Chairman, I have one additional question.

The CHAIRMAN. Senator Gore.

Senator GORE. Mr. Lindsay, at this hour I will not go into this question or series of questions, but would ask your general comment. I have the feeling that if we are to deal with this general subject, including the corporation pension plans, profit sharing, deductibility for self-employed, that we must also deal with restrictive stock operations.

As I say, I will not ask a detailed question, but if you could give me the benefit of your general view in that regard, I would appreciate it.

Mr. LINDSAY. I think in one sense restricted stock operations is different from the pension plan area, in that it has not the same philosophy behind it.

Senator GORE. You mean—you say in one sense, but in another sense——

Mr. LINDSAY. In another sense I think one reason that the self-employed are rather agitated about this whole situation and are pressing for legislation for themselves is because of the sum total of benefits available to corporate executives which include restricted stock operations.

Senator GORE. So that that extent, and in that sense, it is related to this problem?

Mr. LINDSAY. I think it is in the atmosphere, so to speak.

Senator GORE. I am sure it will be, more so.

Now, in our earlier discussion with respect to discriminating against all other types of the insurance policies, and restricting this benefit to a retirement policy, would you not think a sick and accident insurance policy would be just as socially and philosophically justified for tax deduction?

Mr. LINDSAY. Employers may deduct the expense of group sickness and accident health policies for their employees.

Senator GORE. I am speaking now of the self-employed, if you give a man a deduction, a tax deduction, or a deduction from taxable income—you understand how I use the term "tax deduction"——

Mr. LINDSAY. Yes.

Senator GORE. You give a man a tax deduction for his investment, and an insurance annuity plan, which takes effect, say, when he is 60, would it not be just and justifiable to give him a deduction for investment in a sick and accident policy which would pay to him an annuity when he became permanently and totally disabled at whatever age?

Mr. LINDSAY. First, under the pension plan provisions we are discussing, benefits would be permitted to be withdrawn in the case of total permanent disability following the same rules as social security.

Secondly, with respect to hospitalization, premiums for health insurance are deductible with limitations.

First, you have to be able to itemize them to get them.

Secondly, only that part of your medical expenses, including premiums that exceeds the first 3 percent of adjusted gross income is deductible, unless you are over 65, and if you are over 65 the 3 percent limitation does not apply.

Senator GORE. I understand those conditions.

My question still remains, Would it not be just as justified from a philosophical standpoint, from the standpoint of loss of security of the individual, of investment, to give the taxpayer an option as to whether he buys an annuity plan, the benefits to begin at age 60, or whether he buys a plan which would give him an annuity at such time as he may suffer sickness and accident to the point of disability?

The question I am asking is, Why is it sound for the Treasury Department to discriminate in favor of one particular type of investment or saving when others are equally desirable and justified?

Mr. LINDSAY. One must look at the situation relating to these other things.

First, there is a medical deduction today for everybody though it has a limitation of 3 percent for everyone over 65.

Secondly, on top of that, any employee who is hospitalized may receive his wage continuation and exclude $100 a week. He can even do that for the first 7 days of illness—he can even do that if he is not hospitalized, but not for the first 7 days unless for one of those days he was in the hospital or bodily injured.

Senator GORE. That is for the self-employed person?

Mr. LINDSAY. I am talking about employees generally. I think that the minute you discuss treating self-employed as employees for any one purpose, you are necessarily opening the door to treating self-employed as employees for other purposes.

Senator GORE. I shall not press you to adopt any conclusion that a sick and accident policy which would provide an annuity at such time, irrespective of age, as the person may become disabled is equally justifiable with the other; I will satisfy myself with your statement that once you establish it in one particular instance, then you open yourself to the logical extension, which seems to me to illustrate the point that I tried to make with you in the very beginning, that this recommendation of yours is precedential, as is H.R. 10, in that it proposes tax deduction for savings or for an investment for the peculiar and personal benefit of the taxpayer.

Thank you, Mr. Chairman.

The CHAIRMAN. Mr. Lindsay, we certainly thank you. You have made a very fine statement.

The next witness is the very distinguished Senator, the Honorable Carl T. Curtis.

STATEMENT OF HON. CARL T. CURTIS, A U.S. SENATOR FROM THE STATE OF NEBRASKA

Senator CURTIS. Mr. Chairman, I assume that I may testify from here.

The CHAIRMAN. You may.

Senator CURTIS. I thank the distinguished chairman, and I shall be very brief.

I have no objection to answering questions, but I would say, in the matter of saving time, that I will be available when we have our executive sessions.

Mr. Chairman, I favor this legislation. I have a proposal that is in addition to it. It is based upon the premise that every citizen should have a tax incentive to save for his own old age. It is based on the premise that this should not be confined to the people who are arbitrarily defined as employees, employers, or self-employed, and that it is an individual responsibility; not an employer responsibility. I will cover this plan in a very few minutes.

(1) It will create a new series of U.S. savings bonds, possibly called X-bonds, X for exempt. These bonds could have varying maturities, and would be sold at discounts based on the time of maturity.

For example, a $100 maturity in 10 years could be sold for $75, similar to the present E-bonds. Under this plan I do not believe the interest rate would have to be higher than the present E-bonds. A $100 bond with a longer maturity would, of course, be sold for less because of the longer maturity.

(2) Add an amendment to H.R. 10 that provides, anyone, self-employed or employed, could deduct from his earned income purchases of new X-bonds up to a certain amount per year. The purchase price of these bonds would be free from tax, but when the bonds are cashed the entire proceeds would be taxable income and not just the interest accrued.

(3) This program could be made available for any year to any person with earned income who in that year was not covered by an employer plan of either a corporation or an individual employer. It would be very easy to administer.

For example, when a person buys an X-bond, he would also receive a duplicate to be filed with his tax return to support his deduction for tax purposes.

I might also add that there would be a perforated attachment to the bond so that when he cashed it, the cashing agent could tear it off and mail it under frank to the nearest internal revenue office.

(4) There would be no complication in relating the age of the individual to his bond purchase program. For instance, the lower the age the greater discount the individual would get on a $100 bond. An individual 55 years of age might be able to buy a $100 bond for $75. If he is 40 a lesser amount; and if he is 25, still less. There would be provided a discount table based on the nearest birthday showing what a bond would cost.

(5) The bonds would be nonnegotiable; therefore, the individual would have to play for keeps. That was my original intention. However, we might provide for a cashing in and withdrawal on the same basis as we permit on the other plans, if that seems desirable.

In case of death of the purchaser, his heirs or beneficiaries could elect to hold the bonds or take their present value. The entire proceeds would be taxable.

(6) The advantages of this plan are many. Among them:

(*a*) Equalize the system for the many fine citizens who will never come under a plan established by an employer.

Mr. Chairman, this category includes most of the people in the United States.

(*b*) Retard inflation.

(*c*) Promote thrift.

(*d*) Place bonds in the hands of individuals.

(*e*) Give long-range maturity to Government bonds.

(*f*) Cause millions of our citizens to be interested in the fiscal stability of the Government.

(*g*) Materially lessen the pressure for increased retirement benefits in social security and other public plans.

(*h*) Lessen the demand for a tax deduction for contributions to public plans.

I believe so strongly in this that I would be willing to settle for a top annual limit of $300 earned income, or even $100. This $100 top limit could be reached in 2 years, allowing a $50 deduction in calendar 1961 and then raised to $100 for 1962. To get the benefits of this part, the purchaser would have to certify that in no part of that year was he covered by any corporate plan or any other plan under H.R. 10.

Mr. Chairman, the credit for this basic idea belongs to a distinguished constituent of mine, Mr. J. Edmunds Miller, a well-known and capable certified public accountant of Lincoln, Nebr. He has a statement, prepared before he saw my memorandum, which is brief. He has some observations which I am delighted to have in reference to my memorandum, and a short closing statement.

Mr. Miller has given this matter thought for several years. He first presented it to some friends some 5 or 6 years ago.

As I say, Mr. Chairman, I shall not resist questions. The hour is late, and I will be here when we consider this matter further if anyone wishes to ask me about this. Otherwise, I would like to call Mr. Miller.

The CHAIRMAN. Thank you very much.

Senator BENNETT. There is one question which I think ought to be cleared up, if I may.

The Senator relates the price of the bond to age, but in his statement he does not relate the age at which the bond would be cashed in.

Senator CURTIS. I am glad the Senator raised this point. It was an oversight on my part.

I think we should have the bond mature at age 65, so it could be cashed in, but follow the principle that is now followed in reference to someone who does not exchange a matured E-bond, and provide automatically for it to draw interest until he does cash it in.

Senator BENNETT. My other question has to do with this requirement that the person has to make an affidavit or a statement that during any year he was not covered by any—or that he is not covered by any corporate retirement plan.

Suppose I am an individual, I get covered by a corparate retirement plan, and it is vested, but after 1 year of employment I lose that job, I am no longer able to get any further benefits under that corporate plan. And yet I would have to say that I am covered by a corporate plan.

Senator CURTIS. By the terms that "in no part of that year was he covered," I meant to say that during no part of that year was anything being set aside for him in a corporate plan.

Senator BENNETT. I wanted to get those two things cleared up.

Senator CURTIS. I thank the Senator very much.

Senator GORE. Mr. Chairman, I would like to ask a question, please, sir.

As I understand it, Senator, you are taking the position that if we are to extend the benefits proposed in H.R. 10 to the self-employed, that we must extend the benefits of the same nature through the availability of discounted bonds to all of our citizens alike.

Senator CURTIS. If they are not otherwise covered; yes. I think that is absolutely essential. Most of our people in rural areas, and even in the larger cities, will never be covered by an employer plan. Many businesses are of short duration. Pension plans are based upon the expectation of a continuity of the business, and there are a variety of reasons why they cannot.

Furthermore, since we have in the social security system, a compulsory tax that should provide old age income at a level to prevent the individual from becoming a public charge, beyond that point we should recognize individual responsibility. And this plan is built upon that recognition.

Senator GORE. Then if I correctly understand your proposal, if a self-employed person with unfortunately small remuneration, income, desired to invest in bonds such as you have proposed, X bonds, instead of buying an annuity policy, that option would be available to him?

Senator CURTIS. Oh, very definitely.

I think that we should not force all plans into Government bonds, it would be artificially supporting the bond market. But I think that we should make this available to the individual who cannot tie himself to an insurance contract because some years he might not be able to pay, and who cannot go into the necessary steps of setting up a trusteed plan.

Senator GORE. I endorse your idea that the intended beneficiary or real beneficiary of such a bill should have an option or options. I just wonder why you would be satisfied to limit it to $100, why not make this $2,500 a year.

Senator CURTIS. I do not want to be a party to any legislation which creates deficit. And I think at this time, when we are considering H.R. 10, we are faced with a principle, are we going to give equitable tax treatment to all of our citizens, or are we going to give it on arbitrary definitions as to the type of business organization?

Senator GORE. Understand, you and I are in agreement that we should not limit this to one particular type of investment. I did not like——

Senator CURTIS. Or participant.

Senator GORE. I do not quite understand why we should limit this to retirement insurance policy when up to $2,500 of what you are proposing here would amount to a similar benefit, a similar tax deduction, if the amounts permitted were comparable.

Senator CURTIS. Well, we are talking about an academic proposition. Many of the young people that I represent who are employed never will come under an employer's plan. Many are not self-employed on a high-paying level. They are not going to be able to save but a few hundred dollars each year anyway.

Now, eventually, I would like to see the amounts I have mentioned raised. But I realize the broad base that this would include has potential for a considerable loss of revenue, and therefore it is my position to adopt the principle and withhold its application until the budget can stand it.

Senator GORE. I am not attempting to disagree with the Senator's idea. Like him, I represent a large number of people who will never be—who will likely never be covered by a corporate pension plan, who are not so successful in their self-employment that they can invest $2,500 a year in a retirement annuity. These people should have equitable consideration. And the Senator has made a laudable suggestion. But I must suggest that his last paragraph certainly limits it severely.

Thank you.

Senator CURTIS. On a temporary basis, because of budgetary requirements.

Senator GORE. Budgetary requirements fit H.R. 10 the same as it does your amendment.

Senator CURTIS. I did not write H.R. 10.

Senator BENNETT. Mr. Chairman, I have to have one more question. When you talk about employer plans and set up that provision, do you also include the Federal Government, the State government civil service plans, railroad retirement, and these other existing retirement plans to which employers who may not be corporations make contributions?

Senator CURTIS. I have no fixed opinions on that, because I have not had a chance to collect the figures. If the committee should look with favor upon this, I would say the area should be explored.

The CHAIRMAN. Mr. Miller, will you come forward, sir, and take a seat.

Senator CURTIS. Mr. Miller, I gave you quite an introduction, but I had to answer some questions since then. Again let me say that we are most happy to have you here.

The CHAIRMAN. Proceed, Mr. Miller.

STATEMENT OF J. EDMUNDS MILLER, CERTIFIED PUBLIC ACCOUNTANT, LINCOLN, NEBR.

Mr. MILLER. Mr. Chairman and members of the committee, my name is J. Edmunds Miller. I am a partner of the firm of Miller and Moore, certified public accountants, of Lincoln, Nebr. I am a member of the American Institute of Certified Public Accountants and a member and past president of the Nebraska Society of Certified Public Accountants.

I am authorized to practice before the U.S. Treasury Department and the U.S. Tax Court.

I appreciate the privilege of appearing today before your committee to present a proposal for the authorization of a new U.S. savings bond as an additional method by which the purposes of H.R. 10 could be accomplished.

I might add, I think this would also fit in with the Treasury Department's proposal.

This proposal has been formulated after considerable study of the tax and fiscal complexity involved in achieving the laudable objectives of this legislation. Although I have discussed this proposal with a number of people, including members of my profession and officers of insurance companies, and have encountered no opposition from them, I advance the proposal purely as an interested individual and not in behalf of any group or organization.

I am indebted to Senator Curtis for his courtesy in bringing the proposal to the attention of the committee. The purpose of H.R. 10

is to achieve greater equality of tax treatment between self-employed individuals and employees.

Under present law an employee can postpone income tax on retirement income savings if his employer pays into a qualified pension, profit-sharing or stock-bonus plan, what he might have paid directly to the employee. The amount so contributed can be placed in a tax-exempt pension trust or can be paid as premiums on an annuity policy with a life insurance company. In either case the employer claims the amount paid as a tax deduction but the employee is not taxed until he draws the benefits. The Government eventually gets its tax although probably a lesser amount because the employee will have less income after retirement and thus will be in a lower tax bracket.

Under H.R. 10, self-employed persons would be permitted similar tax deferment by claiming as deductions limited amounts invested in certain types of retirement annuities or retirement trusts. Many types of people would be affected, farmers, small business people, doctors, lawyers, engineers, ministers, artists, et cetera. All of such persons are now denied the advantages enjoyed by employees who are under qualified plans.

The Treasury accepts the principle that the self-employed should be entitled to defer taxes on limited amounts of income set aside for retirement purposes, but only if a pension plan is also set up for employees, if any, of the self-employed person.

Loss of tax revenue appears to be a major objection to H.R. 10. The same objection applies to pension plans for employees which are already in effect, yet the principle of encouraging people to provide for their own retirement is well-established public policy. It is in keeping with the American traditions of thrift and individual initiative and independence. From the standpoint of government it is a sound way of minimizing the number of older people who require public assistance.

The tax deferment results in a current decrease in revenue, but it should be borne in mind that in a few years the tax on the benefits will begin to come in, and then the loss on the deductions should be largely offset each year by the tax on the benefits.

Serious objections to present pension plans and the proposed plans are:

(1) They are complicated and difficult for the average person to understand; and

(2) It is and will be increasingly difficult for the Treasury to police such plans to make sure that the Government receives all the tax to which it is entitled.

A more simple way of accomplishing the same purposes is badly needed. This proposal presents a more simple method. If adopted, the plan would also have beneficial effects with respect to certain other serious problems now facing the Government, which I will subsequently discuss.

For years the Treasury has tried to convert a larger portion of the Federal debt to long-term obligations which would not require the frequent refinancing that is necessary at present. These efforts have not met with much success. In fact the short-term obligations are becoming an increasing portion of the total debt. This is borne out by published statistics.

The Treasury is constantly forced to go into the money markets for refinancing of the Government's obligations. The short-term nature of so much of the debt aggravates this problem. The Government must compete with other borrowers in the money market. Interest rates are governed by the supply of and demand for money. When, as in the last few years, demand for money has been intense, interest rates go up.

The Government has had to meet the competition for funds by paying higher rates of interest than heretofore on its obligations. Obviously this further intensifies the Treasury's problem.

As a method of alleviating these problems, it is proposed that a new series of savings bonds should be issued. These could be known as X bonds. They would be the same type of bonds as the series E bonds, except they would be used only for this special purpose. Anyone purchasing an X bond could claim the purchase price as a deduction from taxable income.

When the bonds are cashed, at maturity or before, the full amount of the proceeds, both principal and interest, would be subject to income tax.

The new bonds could be used either by themselves or as a supplement to the benefits outlined in H.R. 10. Even employees now under qualified plans could buy them to supplement such plans.

Limits as to maximum annual deductions, such as those included in H.R. 10, could also be set up for these bonds.

Provision for retirement should be encouraged. Present pension plans, as well as H.R. 10 and the Treasury's proposals, have this as one of their principal purposes. The tax deferment is important, but it is secondary.

A regular program of monthly savings bond purchases would be a form of retirement annuity. The bonds could be issued with maturities of 5, 10, 15, 20, 25 years to satisfy the needs of purchasers of varying ages. The bonds could be issued for terms representing the differences between the current ages of purchasers and age 65. The purchase price would, of course, vary according to the time from purchase date to maturity.

I will go into this situation a little further in detail in my statement.

High tax rates place a premium on tax deductions. There would be a strong incentive to purchase such bonds. Also, there would be a strong deterrent against cashing such bonds because of the tax involved. This would tend to lengthen the average term of the Federal debt and also to reduce the amount of bonds being cashed before maturity.

The tax deferment should provide sufficient incentive for the purchase of such bonds so that they would not need to bear high interest rates. The reduction in cash received by the Government as a result of these tax deductions would be more than offset by the principal sums received from the sale of the bonds.

From a revenue standpoint only, the tax on bonds being cashed should, in later years, largely offset the tax loss in such years from deductions for bonds being purchased. Everyone knows about savings bonds. Facilities for their sale and redemption are already set up.

When an X bond is purchased, an extra form could be given to the purchaser. He would attach that form to his income tax return to support the deduction claimed. If his purchases exceeded the allowable limit in any year, the excess deduction could be carried forward to future years in the same manner as operating losses or capital losses are now carried forward, preferably without limitation.

When an X bond is cashed, the cashing agency could send notice to Internal Revenue Service in the same manner as ontice is now given on form 1099 of dividends, interest, et cetera. The Internal Revenue Service would thus automatically have the facilities for policing the reporting of this type of taxable income.

This was my original statement. It is, in general broad terms, intentions. There has been a considerable amount of discussion of these very same points this morning. I drew up some comments with regard to the suggested amendment by Senator Curtis, and he has asked that I present these comments also.

I have written this out in the form of comments on the suggested amendment paragraph by paragraph.

The first paragraph was:

Create series of U.S. savings bonds, possibly called X-bonds. These bonds could have varying maturities and would be sold at discounts based on the time until that maturity. For example, a $100 maturity in 10 years could be sold for $75, similar to the present E-bonds.

Under this plan I do not believe the interest rate would have to be higher than the present E-bonds. A $100 bond with a longer maturity would, of course, be sold for less because of the longer maturity.

My comment there is "OK." The maturities could range from 1 to 50 years. By this I mean that a person 35 years old who assumed that he wanted to retire at age 65 would start annual purchases of 30-year maturity bonds; each year he would buy a bond of 30-year maturity.

Maybe I should leave this go until a little bit later.

The second paragraph is:

Add an amendment to H.R. 10 that provided that anyone, self-employed or employed, could deduct from his earned income purchases of new X-bonds up to a certain amount per year. The purchase price of these bonds would be free from tax, but when the bonds are cashed the entire proceeds would be taxable income and not just the interest.

My comment there is "OK" again, with the additional statement that if the basis for calculating the exemption is to be earned income, that term should be very clearly defined in order to avoid confusion. I think that has been discussed in some detail here this morning.

My point is simply the avoidance of confusion.

Paragraph 3:

This program could be made——

Senator Curtis. Mr. Miller, since my statement is in the record, you may make your comment without repeating it if you wish.

Mr. Miller. Fine.

My comment with regard to paragraph 3 is: The remainder of the maximum annual deduction after deduction—I beg your pardon, I started to read the wrong spot.

My comment is: Why restrict the purchases to persons not covered by an employer plan?

The sale of savings bonds is to be encouraged, so why not let anyone with earned income buy them, subject to the overall annual and lifetime limits such as are proposed in H.R. 10.

The duplicate to be filed with the tax return could be designed to include a form for the calculation of the allowable deduction containing the following information:

(1) The amount of deferred compensation during the year, and also the accumulated total under an employer plan;

(2) The amount of deferred earned income during the year and the accumulated total under a self-employed plan;

(3) The remainder of the maximum annual deduction, $2,500 or 10 percent, after deducting items 1 and 2, would be the maximum deduction for bond purchases subject, of course, to the overall lifetime limitations.

Credit for excess bond purchases in any year—since you never would have the exact amount purchased—could be carried forward to subsequent years, again subject to the annual and lifetime limits. Thus, every taxpayer would have freedom of choice as to the type of retirement plan. The lifetime limit would not necessarily restrict present employer plans. It could simply mean the individual could not avail himself of the bond purchase plan after the deferment credit under all plans combined had reached a total equal to the lifetime limit.

My comments on paragraph 4 are: This paragraph seems to anticipate that all bonds will mature in the year of retirement. This could cause hardship unless alleviated by some provisions similar to those in H.R. 10 for lump-sum benefits received in the year of retirement.

It might be well to provide that a person wishing to make annual purchases for a number of years could buy bonds maturing whenever he wished. The purchases could thus be planned so that a given amount would mature each year and no special relief provisions would be necessary.

The simple fact that a tax would become due when the bonds are cashed should make it unnecessary to have any special penalty for cashing before maturity.

Senator CURTIS. May I ask you Mr. Miller, at this point, Could that be handled in the manner I suggested a few moments ago, even though the bonds were mature, by letting them automatically draw interest until cashed?

Mr. MILLER. I would think so.

My comment on paragraph 5 is again OK, whoever cashes the bond would pay the income tax. Estate tax would be payable on the redemption value at the date of death, which is no departure from the present situation.

My comment on paragraph 6 is somewhat of a disagreement with Senator Curtis here. I feel very strongly about this plan myself. I believe that the full benefits with regard to lengthening the term of the Federal debt and holding down interest expense would not be realized until the allowable deductions for bond purchases were at least as high as the limits proposed in H.R. 10.

Also persons employed or self-employed who do not have an opportunity to be under a plan would need the larger limits in order to have similar benefits to those who are under a plan.

I wrote these last comments this morning, and Senator Curtis' office typed it for me. I would like to read this.

The Treasury in its proposed alternative to H.R. 10 points out that chief among existing rules governing qualified plans is the rule that they must be nondiscriminatory. Nondiscriminatory contribution and benefits are proportional to wages and salaries paid to each employee.

I am not here to quarrel with that. I only want to point out that there are and will continue to be a great number of persons, both employees and self-employed, who are not covered by qualified plans. They are and will be discriminated against unless some provision is made for them.

I believe the proposed bond plan used in conjunction with qualified employer and self-employed plans can be the equalizer, and I believe this equality can be achieved at little cost to the Government. The initial loss of tax receipts through bond purchase deductions would be more than offset by cash receipts from the sale of bonds. I am speaking of receipts as distinguished from revenues in that case.

The loss in tax revenues as distinguished from tax receipts could well be offset by the savings through lower interest rates and in the expense now incurred to promote the sale of savings bonds. I cannot accurately estimate the amount of bonds that would be sold, but I believe it would be a very substantial sum, with the tendency toward longer maturities, and that is what the Government has been trying to achieve.

Thank you.

The CHAIRMAN. Thank you, Mr. Miller. I appreciate your appearance.

Senator CURTIS. May I ask just a couple of questions?

Mr. Miller, you come from a rather important insurance center in the United States, do you not?

Mr. MILLER. We have the most home offices, they say.

Senator CURTIS. More home offices than any other place.

Do you have some insurance companies among your clients?

Mr. MILLER. I do.

Senator CURTIS. In your discussion with them about using the bond approach, what reaction have you found? Is there approval or disapproval?

Mr. MILLER. Well, the first reaction is, usually, "Will this hurt us?"

Frankly, after they have thought about it a little bit, they feel that it should not hurt them, and it might even benefit them; in fact, the president of one insurance company has been a very strong proponent, as you know, for this particular statement that we have made here this morning.

Senator CURTIS. And of course neither you nor I are recommending it as an exclusive plan, but merely an alternative?

Mr. MILLER. That is right.

Senator CURTIS. This would add to a general program in which they would all be participating?

Mr. MILLER. That is right.

Senator CURTIS. I again want to thank my distinguished constituent for his contribution.

The CHAIRMAN. Thank you very much, Mr. Miller.

Our next witness will be Mortimer M. Caplin, professor of law, University of Virginia, and counsel to Perkins, Battle & Minor, Charlottesville, Va.

Please proceed, Mr. Caplin.

Mr. CAPLIN. At the outset, I wish to state that I am in accord with the Treasury's approach to the retirement problem of the self-employed. It recognizes that the self-employed are presently at a sharp tax disadvantage, and corrects this inequity by meshing the new proposal into the existing pension pattern of the Internal Revenue Code.

The Treasury alternative is not as favorable to the self-employed as H.R. 10. Nevertheless, the approach is sound and answers the most important questions raised at the 1959 hearings of the Committee on Finance.

I. While suggesting a positive program for the self-employed, the Treasury is also taking this occasion to attain certain subsidiary aims. This would be accomplished by extending to corporations all of the safeguards and limitations imposed on self-employed pension plans.

While the Treasury may have salutary objectives, effecting important changes in existing tax law, I am moved to inquire whether this is the appropriate occasion to consider these corporate amendments?

1. The House Ways and Means Committee has considered many of these corporate problems in its tax revision compendium and at its lengthy hearings on general revenue revision. Hence, before the Finance Committee passes upon such additional and fundamental changes, it would seem fitting that this phase should first await action by the Ways and Means Committee.

2. The House of Representatives has already approved H.R. 10, applying to the self-employed alone. However, the Treasury's corporate provisions move far beyond H.R. 10, involving problems clearly separate from those of the self-employed.

3. The Treasury's corporate features, which are controversial, may be viewed separately and apart from those applying to the self-employed. The self-employed provisions are clearly severable, and may be adopted by themselves without undercutting the Treasury's basic approach.

II. As chairman of the Committee on Taxation of the Virginia State Bar Association, I have discussed the Treasury alternative with a number of individuals and leaders of self-employed associations. Although many would prefer the greater freedom provided by H.R. 10, most of them expressed general satisfaction with the Treasury's views so far as they pertained to the self-employed. At the same time, there was almost unanimous objection to introducing corporate proposals now in a bill originally devoted to the self-employed only.

A very large number of self-employed individuals, all over the country representing a wide variety of trades and professions, are anxiously awaiting this committee's decision. It is hoped that a recognized inequity will be corrected this session by favorable action on the self-employed aspects of the Treasury alternative.

It is further hoped that delay on this legislation, which has roots reaching back to 1951, will be avoided by separating the Treasury's corporate proposals and removing them from consideration at this time.

With the permission of the Chair I submit for insertion in the record my full prepared statement.

The CHAIRMAN. Thank you, Mr. Caplin, it will be made a part of the record. We appreciate your testimony.

(The prepared statement of Mr. Caplin follows:)

STATEMENT OF MORTIMER M. CAPLIN, PROFESSOR OF LAW, UNIVERSITY OF VIRGINIA, COUNSEL TO PERKINS, BATTLE & MINOR, CHARLOTTESVILLE, VA.

In February 1960, the chairman of the finance committee kindly arranged for a small group to meet with the General Counsel of the Treasury Department to discuss a possible alternative to H.R. 10. A series of meetings was held to discuss means for permitting the self-employed to establish retirement plans, and this was followed by the April 1 communication from the Under Secretary of the Treasury setting forth the Treasury's alternative proposal. I was privileged to attend these meetings, and wish to take this opportunity to express our appreciation to the General Counsel, Mr. David A. Lindsay, for his splendid spirit of cooperation and complete frankness in considering this important income tax problem.

I. At the outset, I wish to make it clear that I am in accord with the Treasury's approach to the retirement problem of the self-employed. While it is recognized that they are presently at a sharp tax disadvantage, correction of this inequity should be sought by meshing any new proposal into the existing pension pattern of the Internal Revenue Code. Thus, in striving for equality of treatment, the Treasury alternative properly requires the self-employed to establish qualified pension plans covering reasonable groupings of employees and not discriminating among employees as to contributions or benefits.

The Treasury alternative will usually involve heavy cost to an employer where there are other employees. And, in this and other aspects, it is not as favorable to the self-employed as H.R. 10. Nevertheless, the approach is sound and answers the most important questions raised at the 1959 hearings of the Committee on Finance.

II. However, in addition to the program for the self-employed, the Treasury alternative embodies subsidiary aims:

(1) To "eliminate the present very troublesome problems that now result from attempts on the part of partners to be treated as corporations to secure pension advantages."

(2) To remove "the present long-term capital-gains treatment accorded to lump-sum distributions from qualified plans at termination of the employee's service or at his death."

(3) To reexamine "the present exemption from estate and gift taxes of pension rights attributable to employer contributions under qualified plans."

The Treasury would accomplish these aims by extending to corporations all of the safeguards and limitations which are to be imposed on self-employed pension plans. After a transition period, existing qualified plans of corporations would have to meet all the new rules pertaining to the self-employed.

While these may be salutary objectives effecting important changes in existing tax law, I am moved to inquire whether this is the appropriate occasion to consider these amendments?

The House Ways and Means Committee has considered many of these problems in its tax revision compendium and at its lengthy hearings on general revenue revision. At the invitation of the chairman of the Ways and Means Committee, I appeared before that committee and participated in discussions involving some of the points contained in the Treasury's subsidiary aims.

Before passing upon these additional and fundamental changes in our tax laws, it would seem that the Committee on Finance would await action of the Ways and Means Committee. Since the House of Representatives has already approved H.R. 10, which applies to the self-employed alone, it would seem more appropriate at this time that only the self-employed aspects of the Treasury alternative be considered. These provisions may be viewed separate and apart from the corporate provisions, and are entirely severable from the Treasury's proposal pertaining to corporations.

III. The Treasury alternative is quite controversial in its application to corporations, particularly as to existing qualified plans of closely held corporations. As the 1959 hearings of the Committee on Finance did not cover the corporate aspects, the committee might feel impelled to call further hearings which would involve costly delay at this late stage of the current session of Congress.

Without going into details, it might be helpful to list some of the differences between the Treasury alternative and existing plans of closely held corporations (involving individuals owning more than 10 percent of the outstanding shares):

(1) Corporate pension plans are not subject to the 10 percent–$2,500 ceiling of the Treasury. Nor are they subject to the other conditions for higher contributions for owner-employees:

(*a*) Permitting each owner to deduct an amount equal to the largest annual contribution vested in any other employee who is neither a close relative nor part owner.

(*b*) Permitting all owners to deduct an amount which is not over 50 percent of the total annual contributions vested in all nonowner employees. (This, in effect, substitutes a 33⅓-percent rule for the old 30-percent rule which was repudiated in *Volkening, Inc.*, 13 T.C. 723 (1949), acq.)

(2) Many corporate pension plans do not have vesting until retirement. Under the Treasury alternative, there are a number of instances where immediate vesting is required.

(3) Many corporate plans involving shares of corporate profits do not use a definite formula defining the corporation's contributions. The Treasury would require this.

(4) Many corporate plans provide for lump-sum distributions on termination of employment, anticipating capital gains treatment. The Treasury would deny this.

(5) Corporate plans take full advantage of the estate and gift tax exemptions for pension rights attributable to employer contributions. The Treasury would reexamine this, presumably with an eye toward repeal.

Again let it be emphasized that, despite the merits of the Treasury alternative, the corporate phase will be controversial. It moves far beyond H.R. 10, into a broader field, and involves problems which are clearly separate from those of the self-employed.

IV. In conclusion, I would want this committee to know that, as chairman of the Committee on Taxation of the Virginia State Bar Association, I have conferred with a number of people about the Treasury alternative. Although there are some that would prefer the greater freedom provided by H.R. 10, most of them expressed satisfaction with the Treasury's views so far as they pertained to the self-employed. I have also had the occasion to discuss the Treasury alternative with a number of leaders of self-employed associations and they, too, have indicated general satisfaction with the Treasury's approach to the self-employed. At the same time, there was almost unanimous objection to introducing corporate proposals in a bill originally devoted to the self-employed only.

A very large number of self-employed individuals, all over the country, representing a wide variety of trades and professions, are anxiously awaiting the action of this committee. It is hoped that the recognized inequity to them will be corrected this session by favorable action on the self-employed aspects of the Treasury alternative.

It is further hoped that delay on this legislation, which has roots reaching back to 1951, will be avoided by separating the Treasury's corporate proposals and removing them from consideration at this time.

The CHAIRMAN. The hearings are recessed until 10 o'clock tomorrow morning.

(By direction of the chairman the following is made a part of the record:)

Hon. HARRY F. BYRD,
Chairman, U.S. Senate Finance Committee, Washington, D.C.

DEAR SENATOR: My name is Charles D. Spencer. I am president of Charles D. Spencer & Associates, Inc., 180 W. Adams St., Chicago, a corporation established in 1946. We have nine employees and we have a tax-exempt pension trust.

I wish to submit the following statement in connection with your May 11–12, 1960, hearings regarding the proposed corporate owner-managers' rule included in the U.S. Treasury Department's recommendations dated April 1, 1960, in regard to suggested changes in code section 401(a).

IMBUED WITH MISCONCEPTION

Ever since 1942 the Internal Revenue Service has been imbued with the misconception that smaller corporation owner-managers have been getting away with murder because a high percentage of the total contribution by the corporation to a pension plan goes to provide benefits for the owner-managers, simply because they may be older and usually earn more and have more years of service.

On a rule of thumb basis, the owner-manager situation arises among firms with 15 or less employees, or among small, small businesses.

Code section 401(a) sets forth a discrimination rule and the Treasury Department is ever alert to the possibilities of discrimination in favor of stockholder employees.

Thus, it is impossible under the present law to apply a different set of benefits under section 401(a) plans for owner-managers as contrasted to other employees of a corporation.

There are two sets of circumstances involved:

1. A pension plan may simply provide for a benefit based on the participant's entire pay.
2. The code permits a plan to integrate its benefits with social security benefits.

10 PERCENT OF PAY PER YEAR OF SERVICE

A pension plan which provides benefits solely under method 1 is not a luscious one for owner-manager by any means. Furthermore, even when a modest 1 percent of pay per year of service formula is used, owner-managers of small corporations run smack into the proposed 10 percent and 50 percent rules.

The average corporation with 15 or less employees generally stays fairly close to a 1 percent of pay for each year of service pension formula without a benefit integrated with social security. So let's apply the proposed limitations to a typical case.

HAS GUTS AND GUMPTION

For example, assume that Mr. A. had the guts and gumption to give up a job and start his own business. During the first few years it is touch and go. At the end of 3 years he hired Mr. B, who subsequently acquired stock representing over 10 percent of that outstanding. The first 5 years of a new corporation are usually the hardest. There are still troubles after that time, but by the end of 10 years the corporation may be finally in the clear and is accumulating a small surplus.

During the first 10 years a pension plan would have been a luxury which a small corporation can ill afford as its paramount concern is in meeting its regular payroll.

Sometime after 10 years assume Mr. A and Mr. B realize that they are not getting any younger. However, they are still wary about the commitment under a pension plan, so it is not until the 15th year that they adopt one.

THREE-YEAR ELIGIBILITY RULE

Past experience indicates that employees who stay 3 years generally are considered permanent employees. So Mr. A and Mr. B decide to require 3 years of service in order to become eligible to participate in the plan. However, in determining benefits of 1 percent of pay credit is given for service since employment.

As is fairly common under this type of plan, the percentage of anticipated service from date of employment until 65 (the normal retirement age) is applied to current pay, in order to purchase annuities on a level premium basis. However, the pay is subject to adjustment until age 55. Thus, younger employees eventually will be entitled to higher benefits as their pay increases.

CENSUS SHOWS RESULTS

A census similar to this is prepared in determining the employer's contribution to a noncontributory annuity plan with benefits purchased on a level premium basis:

Employee	Sex	Annual pay	Monthly pay	Age on effective date	Service to date	1 percent per year of service to 65	Monthly pension	Estimated 1st year annual contribution
Mr. A [1]	Male	$15,000	$1,250	50	15	30	$375	$3,937
Mr. B [1]	do	12,000	1,000	45	12	32	320	2,463
E.B.V.	do	7,200	600	35	10	40	240	960
A.K.P.	Female	4,800	400	35	7	37	148	662
H.A.K.	do	4,200	350	30	5	40	140	404

[1] Owners over 10 percent of the employing corporation's stock.

Keep in mind that under the above plan all employees, including Mr. A and Mr. B, receive the same percentage of pay benefit: 1 percent of pay for each year of service from date of employment, with pay adjusted until age 55.

HOW RULES APPLY

How does this stand up under the proposed tests?

Under the 10 percent of pay test, the contribution for Mr. A's pension would be subject to a limit of $1,500 a year, about 50 percent of the amount needed to pay him a pension in proportion to other employees. The contribution required to pay Mr. B's pension would be reduced to $1,200 or about 50 percent of the required contribution.

How about the proposed 50 percent rule?

The contributions required to pay mensions for the other three employees total $2,026, of which 50 percent is $1,013. Mr. A's pension and Mr. B's pension require a contribution of $6,400 a year. Under the 50 percent rule the permissible contribution for Mr. A and B would be $1,012.

WHAT SHOULD THEY DO?

What should A and B do about it? They have put a lot of sweat and blood into the business. Maybe they should give up their independence and merge with a larger corporation.

There is no discrimination against larger corporations under the proposed rule, since there are a sufficient number of non-manager-owners to nullify the effect of the 50 percent rule.

Mr. Mr. A and Mr. B decided to start their pension plan they knew the present pension tax laws had been on the books since 1942, so they felt that they could count on continued fair treatment under them. Although they were told there was once a 30 percent rule, the Treasury Department had withdrawn the rule in 1950 and since no action was asked of Congress to restore it they had concluded that after 10 years it was a dead issue.

INTEGRATION SITUATION

In setting forth the rules governing integration of corporate pension plan benefits with social security, there is so much hocus-pocus that it is difficult for laymen to understand the fairly simple principles involved:

Under the present social security benefit schedules an employee with a wage average of $250 a month will receive a primary benefit of 38 percent of that pay. As a percentage of the wage base, the benefit declines to 35 percent of $300 and to 33 percent of $350 a month. The benefit on pay between $351 and $400 a month is not fixed. Assume that it will be $120 a month at the time the employee retires based on $400 a month wage average, or 30 percent.

The social security benefit as a percentage of total pay declines as income exceeds $400 a month. For example:

Total monthly pay:	*$120 monthly social security benefit as a percentage of total pay*
$600	20
750	16
1,000	12
2,000	6

A 25 percent of pay pension plus social security of at least 30 percent of pay provides a fairly adequate total[1] pension (55 percent) for those with a wage average $400 or less.

In contrast, the total pension for a $1,000 a month employee on the same basis would be 37 percent of total pay while the $2,000 a month man will receive 31 percent of total pay.

INTEGRATION RULE

Under the present social security integration rules the Internal Revenue Service permits a corporation pension plan to provide benefits on pay in excess of $400 a month equal to 30 to 37½ percent of the excess pay (depending upon the auxiliary benefits).

In effect, the extra benefits on the excess pay project the equivalent of the 30 percent social security benefit payable upon pay up to $400.

Although the owner-manager of a small corporation may fare considerably better than an average employee under an integrated plan, the total pension (including social security) for both will be about the same percentage of total pay as for those receiving benefits on pay in excess of $400.

TWO BASIC APPROACHES

Two approaches are permissible under code section 401(a) plans for providing retirement income for employees:

1. The employer contributes an established amount and by the time the employee retires, his retirement income is based on the amount accumulated. It may or may not be adequate, depending upon the length of service under the plan.
2. The other approach is to determine how much has to be accumulated prior to retirement age to pay the employee a specified pension.

BASICALLY A SAVINGS PLAN

If a pension plan is considered simply as a savings plan you can get a fairly good idea of the problem without getting confused by more complicated actuarial computations.

Readily available standard compound interest tables show that if you contribute $1 at the start of each year and earn 3 percent compound interest, you'll have $1.03 the end of the first year, $2.091 the end of the second year, etc. Using that same table and adding ages, here is what you get:

Age when savings start:	*Amount accumulated at age 65*
60	$5.468
55	11.808
50	19.157
45	27.676
40	37.553
35	49.003
30	62.276

It can be readly seen why more is needed in the way of contributions to provide modest pensions for older owner-managers. A person age 60 when the plan

[1] Including social security.

is started will receive about one-twelfth the amount of pension that could be provided a 30-year-old by the same percentage of pay contribution. Thus such a procedure is not generally satisfactory.

Although mortality and turnover factors are introduced by actuaries in determining the actual contribution, the relative comparison does not vary much from the above.

The owner-managers of corporations with less than 15 employees, who are primarily affected by the proposed limitations, generally receive a substantial percentage of the corporation's total contributions for pensions solely because they have more years of service, receive more pay than the average employee, and are older than the average employee under an identical pension formula which applies to all employees.

The Treasury's recommendations should be rejected, in my opinion, because of the harsh results treatment which would result upon business owners with less than 15 employees simply because they have a few employees.

CHARLES D. SPENCER.

STATEMENT BY WILLIAM L. SPENCER, YOUNGSTOWN, OHIO, REPRESENTATIVE OF EQUITABLE LIFE ASSURANCE SOCIETY OF THE UNITED STATES

Re Treasury alternate to H.R. 10, proposing to limit benefits of pension plans covering owner-managers of corporations.

The Equitable Life Assurance Society of the United States has authorized me to represent them as a life insurance salesman. Qualified salaried employee pension trust plans constitute a large volume of that business. By last count my office handled 50 individual policy pension trust plans on salaried employees. Cases with over 25 lives were 16; cases with under 25 lives were 34; cases with premium volume per year of over $20,000 were 17; cases with less than $20,000 annual premium volume were 33. Total premium volume was approximately $1,500,000 per year.

The Treasury proposals are disturbing for these reasons. There are two basic assumptions in the Treasury proposals:

1. A desire to penalize the small employee-owner.
2. A wish to discourage the establishment of small employee-owner pension plans.

This constitutes a complete reversal of the established and declared policy of Congress as set forth in the Internal Revenue Code.

The regulations established by the Treasury Department to carry out the intent of section 165 of the original code presupposed that all employers were dishonest. Arbitrary, restrictive regulations were imposed. One example was the 30 percent ruling, which provided that not more than 30 percent of the contributions to the plan could be used for the benefit of employee-stockholders. This rule was thrown out by the Tax Court in *Volckening* (13 T.C. 723). In practice the Treasury has continually liberalized the benefits for employers because it has been found that most employers establish their plans in good faith and for the benefit not only of themselves, but their employees.

The proposed rules of the Treasury are again arbitrary and unrealistic and two small cases are cited below to show how they would destroy the incentive of a small employee-owner to establish a plan for his employees.

Example No. 1.

Funeral home. Present participants, two; pension benefits, 25 percent of basic salary: employee-owner, male age 49, annual salary, $12,000; employee participant, age 52; amount of pension for employee-owner, $250 a month life income 10 years certain, death benefit $25,000, annual cost $2791.75; employee pension is $110 a month, death benefit $11,000, annual cost $1536.04; corporation is in 30 percent tax bracket. Under the Treasury proposals the employee-owner would be limited to a pension of $56.69 with a premium of $1,200. It is submitted that a pension of $250 a month is not unreasonable, in fact it may be entirely inadequate. Under the Treasury proposals the employee-owner would be foolish to add a qualified pension for his employees.

Example No. 2

A small Federal savings and loan. Two participants; employee-owner, age 59, to retire at age 69, annual salary, $7,500, monthly pension $200 a month;

no insurance, annual premium $3,368; employee female, age 44, to retire at age 65, $85 monthly pension, annual premium $524.63. If the Treasury proposals were adopted on this case 10 percent of salary would provide $44.27; $2,500 premium would provide only $148.25 monthly pension.

The important point the Treasury is overlooking is that the employee-owner we are trying to encourage to establish a plan is often in his fifties or sixties while the employees are considerably younger. For example, $300 a month pension for a male age 55, life income 10 years certain, with a death benefit of $1,000 for each $10 of retirement benefit would cost $5,259. The same amount of pension for a 25-year-old employee would cost $987.60.

The Treasury's proposals are ideally designed to penalize the small businessman and to deprive the employees of a small businessman of qualified pension benefits.

STANNARD POWER EQUIPMENT CO.,
Chicago, Ill., May 2, 1960.

Subject: Self-employed individuals' retirement bill (H.R. 10).

Hon. HARRY F. BYRD,
Chairman, Senate Finance Committee,
Washington, D.C.

DEAR SENATOR BYRD: The undersigned are trustees of a qualified profit-sharing fund. In effect, this fund is a retirement fund as those participating in the benefits of the fund cannot receive their respective shares unless they leave the employee of the company, retire, or die, one exception being that, in emergency, an individual participant may receive, at the discretion of the trustees, a portion of his vested interest.

We have been advised that the above-mentioned bill is coming up for committee consideration in the very near future hence we hasten to give you our views especially as they apply to Treasury Department proposals as reported to us.

We cannot understand why these Treasury Department proposals should receive any consideration in reference to a bill covering self-employed individuals' retirement funds. It would seem that the Treasury is going far afield from its duties and it would also seem that if these proposals are unsolicited by your committee, it is another instance of the executive department's usurpation of the duties and prerogatives of Congress.

1. The suggestion of elimination of long-term capital gains will work a particular hardship on the individuals who will ultimately benefit from our own profit-sharing plan. The elimination of capital gains treatment will usually not apply until retirement or after death when the participant in the fund is least able financially to be taxed at high income rates. Furthermore, a lump sum settlement would bunch a very heavy tax payment in 1 year.

2. The suggestion to reexamine the exemption from estate and gift taxes now provided, we believe, is also objectionable and unfair to the participants in our profit-sharing plan.

3. The proposed restriction that a stockholder in a corporation be restricted in participation in and benefits from such a qualified plan is most unfair as it applies to many of the small corporations. This corporation is one of many, many thousands of small corporations.

An arbitrary restriction based on percentage of ownership of the outstanding capital stock, we believe, should not apply below the ownership of practically the entire corporation by one individual. We suggest some such amount as 85 or 90 percent of the corporation. For example, in this small corporation, we have a total of 15 employees. The management and sales team including 2 junior members of the sales force totals 7 of the 15 employees. This company would have established a profit-sharing plan several years earlier than we did if the earlier laws and regulations on profit-sharing plans had not contained just such a restriction. We seriously considered the matter but found that it would be most unfair to those employees who were also management and, at the same time, owned the major portion of the company's outstanding capital stock.

4. Rather than try to take a position on integration of qualified pension and proft-sharing benefits with social security, we believe it would be much better for both Congress and the executive department to make a real effort to put

social security on an actuarial basis and then cut it loose from all pension and profit-sharing funds.

Respectfully submitted.

STANNARD POWER EQUIPMENT CO.,
PROFIT SHARING TRUST.
HARRY P. BARTON.
MARIE G. MARSHALL.
ARTHUR O. MAY.
CHARLES BOUNDY.

(Whereupon, at 1:35 p.m., the committee adjourned to reconvene at 10:15 a.m., Thursday, May 12, 1960.)

PENSION PLANS OF OWNER-MANAGERS OF CORPORATIONS

THURSDAY, MAY 12, 1960

U.S. SENATE,
COMMITTEE ON FINANCE,
Washington, D.C.

The committee met, pursuant to recess, at 10:15 a.m., in room 2221, New Senate Office Building, Senator Harry F. Byrd (chairman of the committee) presiding.

Present: Senators Byrd (presiding), Kerr, Frear, Long, Smathers, Gore, Williams, Carlson, Bennett, and Curtis.

Also present: Elizabeth B. Springer, chief clerk, and Colin F. Stam, chief of staff, Joint Committee on Internal Revenue Taxation.

The CHAIRMAN. The hearing will come to order.

The first witness is Mr. William C. McCamant of the American Retail Federation.

STATEMENT OF WILLIAM C. McCAMANT, DIRECTOR OF TRADE AND PUBLIC RELATIONS, AMERICAN RETAIL FEDERATION

The CHAIRMAN. You may proceed.

Mr. McCAMANT. Mr. Chairman, may I begin by expressing our appreciation for the opportunity of appearing before the committee this morning.

My name is William C. McCamant, director of trade and public relations, American Retail Federation, 1145 19th Street NW., Washington, D.C. The federation is composed of 30 National and 38 State retail associations comprising over 800,000 retail outlets. A list of these is attached, and we would like to have it as a part of the record.

(List referred to follows:)

NATIONAL ASSOCIATIONS

American Retail Coal Association
Associated Retail Bakers of America
Association of Family Apparel Stores, Inc.
Institute of Distribution, Inc.
Mail Order Association of America
National Appliance & Radio-TV Dealers Association
National Association of Chain Drug Stores
National Association of House to House Installment Cos., Inc.
National Association of Music Merchants, Inc.
National Association of Retail Clothiers & Furnishers
National Association of Retail Grocers
National Association of Shoe Chain Stores

National Council on Business Mail, Inc.
National Foundation for Consumer Credit, Inc.
National Industrial Stores Association
National Luggage Dealers Association
National Retail Farm Equipment Association
National Retail Furniture Association
National Retail Hardware Association
National Retail Merchants Association
National Retail Tea & Coffee Merchants Association
National Shoe Retailers Association
National Sporting Goods Association
National Tire Dealers & Retreaders Association, Inc.
Retail Jewelers of America, Inc.
Retail Paint & Wallpaper Distributors of America, Inc.
Super Market Institute, Inc.
Variety Stores Association, Inc.
Women's Apparel Chains Association, Inc.

STATE ASSOCIATIONS

Alabama Council of Retail Merchants, Inc.
Arizona Federation of Retail Associations
Arkansas Council of Retail Merchants, Inc.
California Retailers Association
Colorado Retailers Association
Delaware Retailers' Council
Florida State Retailers Association
Georgia Mercantile Association
Idaho Retailers Association, Inc.
Illinois Retail Merchants Association
Associated Retailers of Indiana, Inc.
Iowa Retail Federation, Inc.
Kentucky Merchants Association, Inc.
Louisiana Retailers Association
Maine Merchants Association, Inc.
Maryland Council of Retail Merchants, Inc.
Massachusetts Council of Retail Merchants
Michigan Retailers Association
Minnesota Retail Federation, Inc.
Mississippi Retail Merchants Association
Missouri Retailers Association
Nebraska Federation of Retail Associations, Inc.
Nevada Retail Merchants Association
Retail Merchants' Association of New Jersey
New York State Council of Retail Merchants, Inc.
North Carolina Merchants Association, Inc.
Ohio State Council of Retail Merchants
Oklahoma Retail Merchants Association
Oregon State Retailers' Council
Pennsylvania Retailers' Association, Inc.
Rhode Island Retail Association
Retail Merchants Association of South Dakota
Tennessee Retail Merchants Council
Council of Texas Retailer's Associations
Utah Council of Retailers
Virginia Retail Merchants Association, Inc.
Associated Retailers of Washington
West Virginia Retailers Association, Inc.

Mr. McCAMANT. Within the industry, business is conducted in all the forms of business organizations; that is, proprietorships, partnerships, and corporations. It is in the interests of the small and medium-sized retail firms operating as corporations that we appear here today.

A large percentage of these firms are closely held or family-owned corporations. They are the ones which would be most directly affected by the Treasury-proposed amendments pertaining to pension plans of owner-manager corporations. Approximately 100,000 of these retail corporations have sales less than $100,000 per year, and about 75,000 have an annual volume between $100,000 and $300,000.

Employment in these stores range from a minimum of no nonowner employees to a maximum of about 30. Much of this employment is seasonal or part time. Also, one can expect a goodly percentage of the employees to have worked a short period: less than 3 years.

However, there are many thousands of firms which have workers who have extensive records of employment and for whom pension plans have been established. These plans provide for the owner-managers, as well as the nonowner employees, and some of the plans in being are now integrated with the Social Security System.

This committee, in its consideration of H.R. 10, indicated it desired testimony on the Treasury proposal to alter existing legislation pertaining to these firms, and how these proposals would affect the pension plans now in being.

We have given careful attention to these proposals, but time has not been available for constructive study. The Treasury proposal is dated April 1, and the committee's public announcement of hearings was published on May 4. While this schedule reflects the committee's desire to complete consideration of H.R. 10, it does not permit ample time for an adequate analysis of the effects of the proposal.

The available material on pension plans is sparse. Usually each plan is tailored to suit the individual company. Wage and salary levels, age distributions, length of service distributions, and ratios of part-time to full-time employees are important factors in the establishment of each individual plan. This situation makes industrywide summaries of pension plans virtually impossible.

For these reasons, we are unable to present to this committee at this time a reliable statement as to the industry's view on the effect of the proposed amendments. Such a statement must be based on a comprehensive study of many representative pension plans now in being for owner-manager corporations. In such an undertaking, we would have to consult with many owner-managers, tax experts, and funding trustees who manage pension plans for these corporations. Even then, we would be severely handicapped by the absence of specific statutory language.

The study would, of necessity, have to be based on the broad principles outlined in the Treasury letter recommending the amendments. This would require many assumptions as to the probable legislative language, assumptions which, regrettably, would be most tenuous. Indeed, we would hesitate to present to any committee of the Congress a statement from our industry with such a foundation.

We believe the Congress should not act on these corporate proposals this year. Whatever undue advantages or disadvantages taxwise which now exist for owner-managers of corporations have existed for some time. The proposals deserve more consideration and study than time permits this year. Enactment of the Treasury's proposals relating to the self-employed, and their employees, would neither disturb nor aggravate this situation.

If such amendments need to be made, we suggest specific statutory language be developed so that our industry will be able to give a comprehensive review of their effect and present constructive testimony to the Congress.

In the American Retail Federation we have had for some years a committee on taxation composed of the finest tax talent in the industry and representing all segments of retailing. We need time, considerable time and, if at all possible, specific statutory language for this industry committee to study the proposals adequately and give the Congress its considered view of their impact on our small and medium sized retail corporations.

We believe this study is necessary if we are to be spared enactment of legislation which may carry heavy penalties for these companies, penalties this Congress does not seek to impose and would not knowingly impose.

The CHAIRMAN. Thank you very much.

Any questions?

Senator CURTIS. I will ask one question.

Do you have any idea how many plans now in operation by your groups are integrated with social security?

Mr. MCCAMANT. No, sir; wo do not. The difficulty is, there are no summaries of these things.

Senator CURTIS. I think generally it is a practice to be frowned on. It puts the management, the operators of the pension plans, in the position of lobbying for higher social security benefits.

And secondly, social security is not insurance, but it is a social welfare program. No one has any right—the act provides that Congress reserves the right to change any part of it at any time. It is a tax almost universaly and pays a social benefit. And I do not know if the Congress is ever going to change it materially—they did once—they have changed it many times, but they took away once a benefit to a certain category of unmarried that had no heirs. They might do it again, and that would upset it.

The CHAIRMAN. You understand that this proposed legislation will not be effective until 1963, so it gives time to study this.

Mr. MCCAMANT. It does indeed.

But there again, as the Treasury representative said yesterday, priorities get established, and maybe the corrections will be in that category, they may get a very low priroity.

The CHAIRMAN. The actual operation will not be effective for 3 years.

Mr. MCCAMANT. We understand that.

The CHAIRMAN. Thank you very much.

The next witness is Mr. A. C. Burrows, Council of Profit Sharing Industries.

STATEMENT OF A. C. BURROWS, COUNCIL OF PROFIT SHARING INDUSTRIES, ACCOMPANIED BY JOHN CARDON, OF LEE, TOOMEY & KENT, LEGAL COUNSEL FOR PROFIT SHARING INDUSTRIES

Mr. BURROWS. Good morning, Mr. Chairman.

I should like to introduce if I may Mr. John Cardon of the firm of Lee, Toomey & Kent, legal counsel for the Profit Sharing Industries.

The CHAIRMAN. Do you have a prepared statement?

Mr. BURROWS. I have, sir.

The CHAIRMAN. You may proceed.

Mr. BURROWS. I am Albert C. Burrows, rear admiral, U.S. Navy, retired. I am president of the Council of Profit Sharing Industries, with offices at 400 West Madison Street, Chicago, Ill.

The Council of Profit Sharing Industries is composed of approximately 600 profit-sharing employers covering approximately 600,000 employees in approved profit-sharing plans. The council had its genesis in the investigation conducted in 1938 by two distinguished predecessors of the members of the Senate Finance Committee, Senator Arthur H. Vandenberg and Senator Clyde L. Herring. This subcommittee, pursuant to Senate Resolution No. 215, 75th Congress, made an exhaustive study of profit sharing with a special view:

(*a*) to the preparation of an authentic record of experience which may be consulted by employers who are interested in voluntarily establishing profit-sharing plans;

(*b*) to the consideration of what advisable contribution, if any, may be made to the encouragement of profit sharing by the Federal Governmen, including the grant of compensatory tax exemptions and tax reductions when profit sharing is voluntarily established;

(*c*) to the consideration of any other recommendations which may prove desirable in pursuit of these objectives.

In the report of this subcommittee, in addition to other highly laudatory observations on the achievement of profit sharing in the economy of our country, is found the following:

> The committee finds that profit sharing in one form or another has been and can be eminently successful, when properly established, in creating employer-employee relations that make for peace, equity, efficiency, and contentment. We believe it to be essential to the ultimate maintenance of the capitalistic system. We have found veritable industrial islands of "peace, equity, efficiency, and contentment" and likewise prosperity, dotting an otherwise and (sic) relatively turbulent industrial map, all the way across the continent. This fact is too significant of profit sharing's possibilities to be ignored or depreciated in our national quest for greater stability and greater democracy in industry.

The council defines its concept of profit sharing as any procedure under which an employer pays or makes available to all regular employees subject to reasonable eligibility rules, in addition to prevailing rates of pay, special current or deferred sums based on the profits of the business. The council is dedicated to the purpose of extending soundly conceived and administered profit sharing in every practical way.

Based largely on the report of the subcommittee previously mentioned, the Revenue Act of 1942 created a healthy tax atmosphere for profit sharing. This legislative environment promoted the growth of the practice and philosophy of profit sharing in our country. Solidly based upon mutual trust and confidence, profit sharing was thus permitted to bring a philosophy to American enterprise which has proved to be a new way of business and industrial life. It has fostered harmonious working conditions and has largely avoided the acrimonious strife of difference and conflict otherwise so prevalent in our industrial scene. Profit sharing has permitted the owners of the tools and the users of them to work together, as partners, with a common purpose to produce the best product and service at the lowest cost. This has redounded to the benefit of the customer, and has added strength to the free enterprise system.

The Treasury alternate to H.R. 10, as referred to in the press release announcing these hearings, proposes to amend existing law by limiting benefits of pension plans covering owner-managers of corporations. We have been advised that this proposal also intends to limit benefits of profit-sharing plans covering owner-managers. While these recommendations are somewhat vague in their application to profit-sharing plans, their overall effect would appear to impose severe restrictions on profit-sharing plans of small companies.

We fear that these limitations, in addition to penalizing presently qualified profit-sharing plans, will do much to discourage the future growth of profit sharing in America. Profit sharing is really a partnership whereby all the employees and owners share and participate in the fruits of their labor and capital. The small company adopting a deferred profit-sharing plan does so with the intention of providing its employees with an interest in the present and a stake in the future.

Today, there are thousands of profit-sharing plans in operation covering millions of employees. Many of these plans are those of small companies covering stockholder-employees along with the other employees. These plans have previously met the qualification standards of the Internal Revenue Code and regulations. These qualification standards prohibit discrimination in contributions or benefits in favor of officers, shareholders, supervisors, or highly compensated employees as against other employees either within or without the plan.

For example, these standards include a test that the plan must be for the exclusive benefit of the employees. If it is designed as a subterfuge for the distribution of profits to stockholders, even though it includes other employees who are not stockholders, the plan will not qualify as a plan for the exclusive benefit of employees.

The Treasury proposed to impose new statutory restrictions on plans which have previously met the nondiscriminatory standards at the time of approval and are continuing to meet them in actual operation. The restrictions are apparently being proposed because of some alleged cases of abuse. We are not aware of how many of these cases involve profit-sharing plans. Nor are we aware whether these cases could be prevented by adequate utilization of the present administrative remedies available to Treasury.

For example, the Internal Revenue Service requires that profit-sharing plans provide the employees with full vested rights after a reasonable length of service.

Further, the income tax regulations prohibit any discriminatory allocation of forfeitures arising from termination of service by employees whose interests have not yet vested. Have cases arisen in which the benefits of the plan ultimately accrue solely to the shareholder-employee by reason of forfeitures by employees whose interests have not become vested?

If so, we can only wonder how these particular plans have managed to retain their qualified status under the present Internal Revenue Code and Regulations. The Internal Revenue Service decides each case on its own facts and circumstances to determine whether a particular plan is discriminatory. If a plan proves discriminatory in actual operation, immediate corrective measures must be taken, or the plan will lose its qualification.

The Council of Profit Sharing Industries cannot condone any practices which utilize a profit-sharing plan for the sole benefit of a shareholder-employee to the exclusion of other employees. When these instances do occur, however, we feel that the orderly process is to determine what caused the breakdown.

A study should be made to determine whether the deficiency stems from a failure to enforce the present available remedies, or whether some type of loophole-closing legislation is required.

We hope the Committee on Finance will not proceeed with hasty revision of the code, which would apparently involve far-reaching changes in the established principles for qualified profit-sharing plans, merely because of isolated cases of abuse which may be relatively few in comparison with the thousands of profit-sharing plans now in existence.

We question, moreover, whether a bill which is concerned solely with the problem of providing pension coverage for self-employed individuals should be expanded to include basic changes affecting millions of employees under profit-sharing plans, however meritorious these changes might seem to be.

While the ultimate scope and effect of the Treasury proposals in the report to the chairman of this committee dated April 1, 1960, can hardly be evaluated upon such brief notice, the acceptance of them by this committee would have a devastating effect. The rules regarding profit-sharing plans have become so well understood, and the advantages of such plans as an incentive to good employer-employee relations have become so widely accepted, that there are today as many new profit-sharing plans being established by employers as there are pension plans.

As the Treasury figures which have been analyzed and summarized in the exhibit to my statement clearly show, the net increase in deferred profit-sharing plans reached an all-time high in 1959, and the net increase in deferred profit-sharing plans actually surpassed the net increase in pension plans during the last 6 months of 1959.

If the well-established rules under a public policy to encourage profit-sharing plans should now be summarily changed, this will surely deter small businessmen from utilizing profit-sharing plans. If the present provisions for profit-sharing plans under section 401 do require some corrective measures, these measures should be taken only after an exhaustive study is made and presented for consideration by this committee. The public should be notified of the specific problems and be afforded ample opportunity to study any recommendations and make comment thereon. These are the orderly legislative processes.

The vague allegations of abuse and the anticipation of additional revenues from ill-defined changes summarized in the Treasury report already have caused grave concern among the thousands of businessmen who have established plans in reliance upon the present code provisions, and among the employee participants in such plans.

As passed by the House of Representatives, H.R. 10 relates only to retirement plans and has no relevance whatsoever to the concept of profit sharing, or to qualified profit-sharing plans under existing law.

The Council of Profit Sharing Industries urges this committee to reject any change in existing law respecting profit-sharing plans in connection with the consideration of H.R. 10.

The CHAIRMAN. Thank you very much, Mr. Burrows.

Are there any questions?

Senator BENNETT. Mr. Chairman, I would like to ask a question if I may.

In your statement, you referred to "approved or qualified" profit-sharing plans. Are you required to get approval of the Internal Revenue Service for a profit-sharing plan?

Mr. BURROWS. Indeed, one wishing to install a profit-sharing plan must obtain the approval of the Treasury Department if he is to obtain the benefits.

Senator FREAR. If you want a deduction?

Mr. BURROWS. If you want a deduction; yes, sir.

Senator BENNETT. In that respect you operate under the same kind of requirement that exists in pension plans?

Mr. BURROWS. To that extent; yes, sir.

Senator BENNETT. In other parts of your testimony you have indicated that profit-sharing plans and pension plans are different, separate. Can you tell us briefly what the difference is between a profit-sharing plan and a pension plan?

Mr. BURROWS. Basically, Senator Bennett, a pension plan is designed to provide in the future an actuarially determined fixed sum of money. There are variations to that, but by and large that is true. It is a fixed amount of money to which a person may look if the payments are made by the company for which he works in accordance with his agreement and understanding. It has no relation at all to the profitability or the overall success of the business in which this man is employed.

In the case of the profit-sharing plan, he benefits directly from the profitability, its overall success, the stability of the company. If it prospers, he prospers, and in a proportion ordinarily known to him before the division of the profits or before the completion of that year of work. Because of that he has a relationship to his employer and to his fellow workers, I might add, of partners. They have a basic self-interest in the success of this company.

In the case again of the pension, when the company makes large profits, the employee understandably wonders why he does not get a part of those. If he sees the published reports he wants more money. It is a mechanism under the pension system where he is frozen. To the younger man essentially the pension plan is pay in the sky, it is something that does not affect him today.

I might add parenthetically that in the Council of Profit Sharing Industries experience we know of no case where a man, because of the knowledge that if he lives to be, say, 65, and if he is in the continuous employ of this company at that time, he is going to get a stipulated dollar pension, will he this day, because of that, be any more intelligently interested or devoted to the interest of his company. It lacks, in other words, all incentive value.

Now, this was brought out very cogently by the subcommittee of this very committee in 1938 and 1939 with an exhaustive survey of American profit sharing. We have no objection to a pension for what it is, as a method of bringing employees, the users of the tools, into partnership, into cooperative endeavor with the owners of the tools. We think they are as the distinguished gentleman from the Treasury, Mr. Lindsay, said yesterday, comparing apples and bananas.

Senator BENNETT. Are there not some plans approved by the Treasury in which the amount of the employer's contribution is determined to some extent by his current profits?

Mr. BURROWS. Well, in a profit-sharing plan——

Senator BENNETT. I am talking about pension plans, plans in which the amount contributed by the employer to the pension trust in any given year has some relation to the profits.

Mr. BURROWS. I should say not, Senator, for this reason: An amount of money certainly should go into a pension fund to provide an amount of money at a certain time in the future. This is determined actuarially. It is a charge on the cost of doing business. It is thus a fixed charge, and the cost of a pension must be passed on to the customer, quite in contradistinction to the method of financing a profit sharing retirement plan.

As to that point, I might mention that when we speak of a profit-sharing retirement plan, we are mentioning merely one of the features of the profit-sharing philosophy. We can put money aside in a deferred plan, in a trust which will provide income upon retirement. But a profit-sharing plan does a great many more things than that.

Senator BENNETT. But it is used for that purpose, and thati s the purpose we are concerned with now.

Mr. BURROWS. I wonder, Senator Bennett, if that is the only purpose with which this distinguished committee is concerned, because of the work it has done 21 years ago.

The documents produced by this committee I think have no counterpart even today in the kind of survey in the Department which was made in our economy as to the effect upon partnership cooperation and sharing in our economy. Those who have read that report in the 20 years and having, as the committee's report directed, "to go now and do likewise," have tried to bring about a harmony. And indeed they have. And we have hundreds of cases, and I wish you gentlemen could visit those plants and see the aura of cooperation.

Senator BENNETT. Our problem here is not with profit sharing, our problem here is with any application of the profit-sharing principle which results in deferred income upon retirement.

Now, am I not correct in assuming that there are some profit-sharing plans in which we derfer the benefits until retirement?

Mr. BURROWS. Indeed you are, sir.

Senator BENNETT. That is the point that I was afraid you were about to destroy a little earlier. Otherwise, I do not see why you would be here.

Mr. BURROWS. Well, the reason that the Council of Profit Sharing Industries has a very deep interest in these hearings is really to remind all of us that we are gradually working toward a substitution of cooperation for conflict in employee relations in this country largely based upon the legislation which permits and fosters—which has now after all of these years amounted, I should say, to public policy—we are here because we are afraid that these fine beginnings might be disrupted.

Senator BENNETT. I just want to make the point that in the framework of these hearings we are concerned only with that aspect of profit sharing which is translated into deferred income so that it serves the same purpose with respect to the employees as any other pension system. And I assume that you are afraid that this legislation might interfere with that function of profit sharing.

I cannot see how it can possibly interfere with the function of profit sharing which produces revenue currently for the employee. Do you?

Mr. BURROWS. When you say "currently," are you speaking of the cash plan, Senator?

Senator BENNETT. As I understand it, there are some profit-sharing plans which produce benefits for the employee in a year or in a period during which the profits are measured, and that there are other plans which allow the employer or require the employer to set certain sums aside out of profits, and these do not become available to the employee until retirement.

Now, it is the situation in the second case that concerns us now, not the first.

Mr. BURROWS. You are quite right in your concept of the cash profit-sharing plan and the deferred profit-sharing plan. But I should like to make the point, in addition to these funds being available at retirement, the profit-sharing plan I think owes a great deal of its success to its flexibility. They are available before retirement. And I thank you for reminding me because the Treasury proposal would place some restrictions on withdrawal of these moneys prior to retirement.

At the present time, many profit-sharing plans are set up to provide loans in emergencies. They are set up to provide partial withdrawals in the case of catastrophic illnesses which are not covered by the ordinary health and hospital plans. They permit an employee to buy a house, to pay off a mortgage. They permit him to do those things, in short, which will contribute to his equity at retirement. But those from the inflexible form of a pension.

Senator CURTIS. Are approved profit-sharing plans available for unincorporated businesses as well as incorporated?

Mr. BURROWS. Yes.

Senator CURTIS. Now, employees sharing profits still remain employees and do not become managers necessarily; correct?

Mr. BURROWS. That is correct.

Senator CURTIS. Now, the profits they receive, are those profits compensation for services, the return on capital, or are they a gift or gratuity?

Mr. BURROWS. I could not imagine a more complex question of both philosophy and ethics than you have asked, sir, but I will attempt it.

Senator CURTIS. I was concerned about the tax status, which has exceeded the point of ethics.

Mr. BURROWS. There is a body of small, I am sorry to say—of classical economic thought which believes that a man who has nothing more than his labor with which he may create capital does so create it.

We feel, in extension of your question, that a share of profits is wholly distinct from the prevailing wage, from the fair wage, the wage which exists in the community and in the industry, and the members of the Council pride themselves that they pay that wage and wherever they can they pay better than that wage, quite aside from a share in the profits.

We look upon the profits shared as those created by the increased industry, the increased thought, intelligence, imagination, innovation on the part of everybody in the production team, profits which would not be there were it not for this extra modicum of thought and effort.

Senator CURTIS. Let's get at it this way. If they were not there working, they would not share in the profits, would they?

Mr. BURROWS. That would follow; yes, sir.

Senator CURTIS. And they do share in the profits even though they do not own part of the business?

Mr. BURROWS Yes, sir; that is true.

Senator CURTIS. And so whether it is an additional enthusiasm or whatever it is, it is for services rendered?

Mr. BURROWS. Well, they are services rendered for supererogation for what one would normally expect for a per diem basis.

Senator CURTIS. But you do not have to own any of the capital to get it?

Mr. BURROWS. You do not.

Senator CURTIS. But you do have to stay there and work?

Mr. BURROWS. Yes.

Senator CURTIS. So it is compensation?

Senator KERR. Would the Senator yield?

Senator CURTIS. Yes.

Senator KERR. I thought the witness was about to try to answer your question, and I was tremendously interested, both in the question and the possible answer.

Now, do you want to eliminate the opportunity for him to answer?

Senator CURTIS. No, sir. He may proceed.

Senator KERR. He never did say whether it was a gift or compensation, or what was the other alternative?

Senator CURTIS. On return on capital.

Senator KERR. Return on capital.

He said it was an interesting question. And I thought it was an interesting question, and if you would yield, I would be glad if he would answer.

Senator CURTIS. I think he has answered that it is compensation.

Senator KERR. Are you trying to refresh his memory or prompt him?

Senator CURTIS. No, I am just arguing with him.

Go ahead and make any further answer you wish. I am sorry if I cut you off.

Mr. BURROWS. I should say that within our concepts you would have to class it as compensation, we have no other word for it. But I do think that one should qualify it and should limit it with the understanding of where it comes from. I think the source of it and how it is generated over and above what we should expect from the ordinary employee on a per diem basis should be thoroughly understood.

Senator CURTIS. It is compensation for going the extra mile?

Mr. BURROWS. That would be a fair way to put it, I should think.

Senator CURTIS. Now, do you have some plans where profit sharing is paid out annually or nearly so?

Mr. BURROWS. The cash profit-sharing system makes every effort to relate the time of payment as close as may be to the work for which it compensates, yes. We have quarterly payments.

Senaor CURTIS. Currently?

Mr. BURROWS. Yes.

Senator CURTIS. What is the tax status to the employee when it is paid out currently?

Mr. BURROWS. That money is current income and must be reported and income tax paid on it as current income.

Senator CURTIS. Now, suppose it is deferred, it is a deduction to the employer——

Mr. BURROWS. To the extent of 15 percent of the total wages or salaries of those participants in the plan, yes, sir.

Senator FREAR. If it is an approved plan?

Mr. BURROWS. Yes, sir.

Senator CURTIS. If the profit sharing does not go beyond that limit, it is a deduction?

Mr. BURROWS. Yes, sir.

Senator CURTIS. And if it is a deferred plan, does the employee pay any taxes at the time it goes into his trust fund, or however it is kept?

Mr. BURROWS. Under the present existing law, Senator, he does not.

Mr. FREAR. If it is approved?

Mr. BURROWS. If it is approved—that is what I am discussing, Senator.

Senator CURTIS. All of this is based on approved plans.

Now, it goes into a fund, a deduction to the employer, and it is not taxable to the employer, and at that time neither pays a tax on it, assuming he does not exceed the limit. How about the earnings on the money in that fund which is profit sharing to be paid out at a later time?

Mr. BURROWS. No tax is paid on the earnings of the money in the profit-sharing trust fund until such time as the funds are paid out to the participants.

Senator CURTIS. Now, you could have an approved plan that would be timed so that in reality it would be a retirement plan?

Mr. BURROWS. Yes.

Senator CURTIS. So in that category, and within the limitation, the employees of an unincorporated business can have all the tax advantages of H.R. 10 now, if they go the route of profit sharing, but the owner of the unincorporated business could not provide for himself a method of acquiring retired income before taxes, could he?

Mr. BURROWS. No, he could not.

Senator CURTIS. And the owner, the fact that he pays himself a salary, he could not also credit himself with profit sharing like another employee if he was unincorporated?

Mr. BURROWS. Senator, if he owns the business, a partner——

Senator CURTIS. Yes.

Senator KERR. He may not be a partner.

Senator CURTIS. But at any rate, the practice, and the law too, is that the owner of an unincorporated business could not share in the deferred part of the profit-sharing plan, that is for the people in the business rather than the owner?

Mr. BURROWS. True.

Senator CURTIS. I think within that area the employees of the unincorporated business have the very thing that the Treasury Department H.R. 10 would give.

That is all, Mr. Chairman.

Senator FREAR. Is it not true that a profit-sharing plan for the management is essential because of its deductibility, if it is an approved plan?

Now, there is no reason why any unincorporated company cannot have a profit-sharing plan unapproved and pay out as a bonus or cash each year and have the same bonus or cash compensation deducted as compensation for labor.

Senator KERR. That is, to the owner.

Senator FREAR. Or to employees.

There is no restriction on giving employees a bonus, which can be the same as profit sharing, is there?

Mr. BURROWS. Well, of course, the basic difference as we see it, Senator, in the bonus is, it carries with it the connotation of, does management want to give it or not?

There are companies that have bonuses where they have a good year and give no bonus, they may have a bad year, and for reasons which are not apparent to the employee, they give a bonus. There isn't a relation from what I do and my part in the success of this business to what I get out of it.

In the plan which is an approved plan and which does follow the regulations—and I certainly hope I make it clear that the council is to foster broad coverage plans, we are not here in any way, shape, or form to protect the chiseler, we want to see good profit sharing fostered, good labor relations, we want to see harmony, we want to see the peace that ought to be.

Senator FREAR. That is true. And I think that is a very worthy cause for management to share in the profits because of the incentive that produces. That is certainly true.

But also, the people who are interested in taxes want to know what the tax involvement may be. But this committee or no other committee under present law can prevent management from giving a bonus to its employees on a current basis and deducting it.

Mr. BURROWS. No, sir; it cannot.

Senator SMATHERS. I would like to ask just one question I am not clear about.

Do you know of any instance, Admiral, where in the profit-sharing plan of the type you have talked about, when the distribution is finally made, that the distribution for tax purposes is treated as other than earned income?

Mr. BURROWS. Well, the deferred income, if he meets the requirements of taking the money upon severance from the company in one lump sum in one taxable year, it is treated as capital gains, sir.

Senator SMATHERS. That is all I wanted to know.

The CHAIRMAN. Any further questions?

[No response.]

The CHAIRMAN. Thank you very much, Mr. Burrows.

Mr. BURROWS. Thank you very much.

The CHAIRMAN. The next witness is Mr. Goldstein of the Pension Planning Co.

STATEMENT OF MEYER M. GOLDSTEIN, PENSION PLANNING CO., NEW YORK

Mr. GOLDSTEIN. Mr. Chairman, I am Meyer Goldstein of the Pension Planning Co. of New York. We are actuaries and consultants in the field of pension and profit-sharing plans.

First, may I express appreciation for the committee working in these hearings at this time in a crowded calendar.

On the subject of profit sharing that was just discussed, I would like this committee to understand that there are many technical differences of opinion among practitioners in this field than those that were expressed by the admiral just now. So that I hate to put in that negative thought, but it is really necessary for the record.

Now, I also will try to make my statement very brief. And so I will just make the observation, where it has already been discussed by someone else, or where I happen to know from reading the statements that are to follow.

On the question of the Treasury's approach to this very difficult technical problem, I have had the privilege of appearing before this committee at the time of the 1942 Code and since that time and working closely also with the Treasury and the Revenue Service over the years, and certainly I believe I understand the really difficult technical problems that are involved in this field. And by this field I am now referring to the qualified pension and profit-sharing and stock bonus plans.

Now, on the general approach, while it is a perfectly sound principle to draw in the tax-qualified pension and profit-sharing concept into this entire subject as it is thrown in through H.R. 10, there are such great difficulties that the Treasury itself needs more time. That was evidenced by the statesmanlike position that Mr. Lindsay took yesterday. But even in the period since April 1 on one of the points in vesting, which I spent considerable time to prove to myself that was unsound, in 6 weeks he proved to himself that was unsound. So we can see that that sort of thing has already evidenced itself.

So the Treasury needs more time, and this committee needs more time. And this committee and the Treasury need more facts.

Here you are asked to pass judgment on long-range implications when the facts have not been presented to you. The Treasury itself does not have the facts yet.

So I would plead, therefore, as a first point, that there should not be any action in connection with the qualified sections.

However, I recognize that that would make the Treasury unhappy because it would put the blessing on the implications of H.R. 10, and therefore I have come to the conclusion—and Senator Smathers, I haven't had the pleasure of talking to you—I have come to the conclusion from what I understand your amendment to be that I should recommend it to this committee. I understand your amendment to be that in order for any self-employed who has three or more employees to get the benefit of H.R. 10 for himself, he has to pay 5 percent of the payroll of his employees into a tax-qualified pension plan which will meet all the requirements of the code now under tax-qualified plans.

Do I understand it correctly, sir?

Senator SMATHERS. Mr. Goldstein, you understand my amendment better than I understand my amendment.

Mr. GOLDSTEIN. Thank you, sir.

Senator KERR. Would the Senator yield?

How about him explaining it to both of us?

Senator SMATHERS. I might say, just speaking for one Senator, that I am very much attracted to the suggestion made by the Treasury, the recommendations which they have made with respect to the self-employed providing for his own employees and the limitations which they have recommended.

Mr. GOLDSTEIN. Well, sir; the reason why I feel that your amendment is better than the Treasury's proposal is because the Treasury's present proposals have not had the time to be adequately studied even by the Treasury.

Now, of course, the Treasury has been studying this field for 18 years, since 1942. Of course, the Treasury has established all these rules to prevent discrimination, et cetera, et cetera. So that we are not back to 1942 where we had to guess about a lot of these things, we had the benefit of 18 years' experience. But their cure is worse than the disease.

Now, what is true about your——

Senator GORE. What is the disease?

Mr. GOLDSTEIN. Well, Senator, the point is that we have——

Senator GORE. I was not asking about the point, I was asking about the disease.

Mr. GOLDSTEIN. The disease—there are 55,000 approximately tax-qualified pension and profit-sharing plans in the United States——

Senator GORE. That is a disease?

Mr. GOLDSTEIN. That is anything but a disease.

Under the free enterprise system, sir, we want to encourage private pension systems as a supplement to the Federal Government's social security which could, under the free enterprise system, be kept essentially at the subsistence level. And free enterprise should be encouraged to do the balance of the job; as I understand the mandate of Congress, ever since we have dealt with pensions, ever since we have had a tax law in 1913, it has been to encourage private pensions, and that is not a disease.

But the suggestions that have been made, sir, by the Treasury are tending to upset long-established principles that they themselves have sponsored. So that we have to go slow on this and get time enough. And come back, if I may, to your amendment, Senator Smathers, the reason why I am for it is because it is simple——

Senator SMATHERS. You are about ending up to be the only man for this amendment. But go ahead.

Mr. GOLDSTEIN. That may be.

It is simple, it is understandable, it doesn't upset any of the long-established experience, not only of the Treasury Department and the Revenue Service and of this committee and of the Congress with what we have been doing for 18 years, but all the different corporations, what they have had to learn in order to conform, all of this is being changed through the back door of this serious technical problem we have. And everybody needs more time.

Now, yours buys that time, your proposed amendment buys the time. It establishes the principle that the Treasury is after, that is, that there wouldn't be anybody given this H.R. 10 all for himself, if he has some employees, he has to have some unselfish attitude and say, all right, in order to for me to get something I am going to take care of my employees too. That is the Treasury position, and it is sound.

But the methods, the technical things—except for the question of time—I have here a list and an analysis that I have made of each of the points, point by point, so that the Treasury methods, I feel, require many more facts and much more time.

Senator SMATHERS. Could you give us an illustration of just one of those methods?

Mr. GOLDSTEIN. Yes. You take the question they worry about of what I call the freezeout game, where they are worried that the only one left to get anything will be this self-employed fellow, and these individual employees, they will come and go, and so he will be the survivor and he will get the jackpot. So the point there is, we have now plenty of not only legislation, but administrative rules that have been time tested that prevent that.

First of all, now under the regulations, in a pension plan all forfeitures have to be used to reduce the contributions of the employer, they cannot sweeten the pension benefits for the survivors, whether he is an owner-manager or anybody else. So if he is entitled to a pension of $3,000 a year, that is all he can get, and the recoveries of people who leave who are not vested have to be used to reduce the contribution.

Senator KERR. Does that system exist by regulation or by law?

Mr. GOLDSTEIN. It exists by regulations.

I am in complete support with many of the Treasury's regulations where what is in the regulation should be put in the code.

Senator KERR. Then you favor their position with reference to legislation to reenforce or replace what is now resting solely on regulations?

Mr. GOLDSTEIN. Positively, Senator.

Senator KERR. Pardon me, Senator Smathers.

Mr. GOLDSTEIN. And there are other areas.

For example, there is now what is called mimeographed 5717. Most of these things were born when this committee and the Treasury were worried about all this problem in 1942, so they have had this timing.

Now, this 5717 in essence says that when you start your plan you list the 25 highest paid people, and then if you don't run your plan for 10 years, and in the running of it if you don't have it on an actuarially sound basis, that then there is a restriction on the benefits that any of the 25 highest paid can take. Now, that is sound, and that should be in the code itself. That is another example of the sort of thing I am talking about.

Senator WILLIAMS. Are those recommendations for changing the code included in the original Smathers bill, or would we have to adopt this part of the Treasury regulations as sent to the committee?

Mr. GOLDSTEIN. You would have to adopt part of the Treasury's regulations.

The thing that disturbs me about giving you a complete yes is that there are part of the Treasury's regulations that I don't think should be put in the code.

Senator WILLIAMS. And you are not necessarily endorsing H.R. 10 without any changes at all?

Mr. GOLDSTEIN. I am not competent to speak to H.R. 10. That is outside of the area of our work, and we just come into that as a general taxpayer who has naturally been very interested in the subject and has followed it and recognized what the pros are and the cons are, but I wouldn't put myself out to be an expert on H.R. 10.

Senator WILLIAMS. That is the Smathers bill.

Mr. GOLDSTEIN. Excuse me. That is the reason I referred to it as the Smathers amendment to H.R. 10, meaning his proposal that, in order for those who have employees to get the benefit of H.R. 10, they have to bring in some other employees and spend 5 percent of the pay for them. That is what I have been referring to.

Senator CURTIS. On that point, can a self-employed person having less than three employees come in?

Mr. GOLDSTEIN. Under the present code, you mean?

Senator CURTIS. No; under this amendment you are talking about which deals with the unincorporated self-employed, if they have less than three employees, could they come in?

Mr. GOLDSTEIN. As I understand the proposed amendments of the Senator, it says that if you have less than three employees you come in, but only under H.R. 10 itself, and you don't have to do anything about bringing in other employees. That division of three is very arbitrary, it doesn't have to be in there.

Senator CURTIS. A self-employed person would have the tax advantage of providing for retirement funds before taxes for himself if he had less than three employees without giving it to those three?

Mr. GOLDSTEIN. That is, as I understand it, the proposed Smathers amendment.

As far as I understand it, I would have no objection to taking out that three limitation. I thought it was merely put in for administrative convenience, and so I went along with it.

Senator CURTIS. Supposing he has two and he puts them in, what is the tax status of the money that goes for those two?

Mr. GOLDSTEIN. If he has a qualified plan for one or more employees that are not self-employed—we have to come under all the requirements of tax-qualified.

Senator CARLSON. Suppose he has no employees?

Mr. GOLDSTEIN. That is the technical problem. He would come under H.R. 10.

Senator KERR. Let me inquire a little more into this Smathers-Goldstein amendment.

Now, if I have understood it correctly, it would augment the language in the proposed bill.

Mr. GOLDSTEIN. Yes, sir.

Senator KERR. Fixing it to where the employer, being self-employed and the owner of the business, setting aside those amounts permitted under the bill as finally passed, up to 10 percent or $2,500, whichever is larger, out of the earned income, and so forth, provided he also set aside or added to the fund or put in a separate fund 5 percent of the wage he paid his employees into the pension fund for the employees; is that right?

Mr. GOLDSTEIN. Not less than 5 percent. I should have added that before.

Senator KERR. Not less than 5 percent. He could add more if he wanted to, but the requirement would not be to put in a similar percentage to that which he set aside for himself?

Mr. GOLDSTEIN. That is correct.

Senator KERR. But he could set aside the amount permitted under the bill for himself, provided he set aside not less than 5 percent for his employees?

Mr. GOLDSTEIN. That is correct.

Senator KERR. Thank you.

Senator GORE. Are you a family man?

Mr. GOLDSTEIN. Yes, sir.

Senator GORE. How old are your children?

Mr. GOLDSTEIN. Well, we have two married daughters, and they each have two children.

Senator GORE. Well, if you can transpose yourself into a younger status when your children were small, you have not been blessed with an accumulation of wealth, but you want to provide for the protection of your wife and children in the event she becomes a widow, but you are unable to buy both a retirement policy for your own benefit and protection for your wife and children if a misfortune should befall you; as a devoted father and husband, which would you prefer?

Mr. GOLDSTEIN. Senator, I heard you yesterday. I thought you made a fine point and presentation, and I thought about it a good deal last night.

If I am a breadwinner, I have to worry about dying, because I can die tomorrow, and I can't become age 65 overnight if I am 35 years of age now. So, therefore, the life insurance has the more immediate need, that is crystal clear to me.

Senator GORE. Would not any father and husband of good will—well, I would not say any—would not what you have just said be true not only of you and me but of an overwhelming proportion of fathers and husbands in the country?

Mr. GOLDSTEIN. The answer is so clearly "Yes"; the life insurance sales prove it.

Senator GORE. I had not thought of the statistics in that regard, but come to think of it, they do prove it.

Now, if one is unable to save for both—I will not press you further on that, you have already expressed yourself—do you think he should have an option to do one or the other?

Mr. GOLDSTEIN. No; that I didn't say.

Senator GORE. I thought you had thought about it all night and come to that conclusion.

Mr. GOLDSTEIN. On the contrary, Senator——

Senator GORE. Now wait a minute. Maybe you had a nightmare instead of a thought.

Mr. GOLDSTEIN. I assure you, Senator, I did.

Senator GORE. You had a nightmare?

Mr. GOLDSTEIN. Yes, sir.

Senator GORE. All right.

Mr. GOLDSTEIN. I came, sir, to the opposite conclusion for this reason: We have here a multiplicity of needs and a multiplicity of problems. And on the surface I completely agree with the logic of free choice. But when you start pinning it down to getting something done, that is where you run into a problem.

Now, here we did know for a fact——

Senator GORE. Wait a minute.

What you have just said is that you do not think you could get the other, but you think you can get this? It is not because you think it is right or just, but because you think you can get it?

Mr. GOLDSTEIN. I think, first, if you can get anything you can get this; and second, if you can get it, it is right.

Now, the point is——

Senator GORE. You have answered to my satisfaction. You may proceed if you like, but as far as my question is concerned you have answered it.

You think the other is just and fair and should have precedence on the part of a decent man, but because you think you can get this and could not get the other, then you prefer this?

That is maybe understandable.

Senator SMATHERS. Is that your reason for thinking it, just because you think you might be able to get a pension——

Mr. GOLDSTEIN. No, sir.

Senator SMATHERS. What is your reason?

Mr. GOLDSTEIN. The point is that we have evolved a concept that as people grow old and become too old to work or too disabled to work, that a system needs to be developed to take care of that problem. Social security does the base. The free enterprise, with the Congress paying half the bill, if we are in the 50-percent corporate tax bracket, is a subsidy for this procedure, instead of the Government doing it all and changing the complex of our Government to more of a State system.

Now, in the social security itself there are a whole area of other benefits. For example, one of these benefits is the death benefits. And the death benefits of the social security system have been estimated for a young man with growing children to have a single sum value equal to about $35,000.

Now, the reason, Senator Gore, why I have come to the conclusion that I did, as to what you said yesterday, is because I know factually that an employee can take a little bit of money and get a big death benefit for his family: he can take a little money and buy a lot of life insurance. He cannot take a little bit of money and buy a lot of retirement protection, because it costs so much more. So that we need the encouragement of this system, and that doesn't say, sir, that you are not on the right track to keep pressing for the extension of this whenever our economy can stand it.

Senator SMATHERS. So it is not a matter of principle with you, it is a matter of amounts.

Mr. GOLDSTEIN. Well, you see you are saying this, that what should come first in a free enterprise system as a supplement to a social security base—for example, should it be death benefits that Congress should encourage or should it be the retirement and the disability benefits?

That is the way I analyze your question.

Senator GORE. I am not saying which should come first. I have suggested that a taxpayer should not be restricted to only one type of insurance policy. It seems to me that if we are to give a deduction from taxable income for investment, that an option should be provided, an option to buy a Government bond which will mature at a given time, an option to buy a health and accident policy which would provide some protection for a man if he becomes disabled.

What I am saying is that if you are going to do it for one particular type of insurance policy, surely it can be just as logically and as reasonably provided for other types, and particularly for the type that provides protection for widows and children.

Mr. GOLDSTEIN. Yes, sir.

Senator, the Senate Finance Committee has to be concerned with taxation, et cetera. But this field cuts across more than taxation.

When you have an employer-employee relationship it becomes the employer's worry and concern and moral responsibility as to what to do with long service people—that is, his employees—when they become too old or too ill to work. So he puts that in his priority, and then Congress comes along and says, "All right, we will help you with that job, because we will subsidize it by your tax deduction."

Now, in addition to that, employers provide group insurance for accident and health, for death benefits, on a contributory basis or not, and Congress also supports that by virtue of the tax deduction.

So all these things are evolving on a step-by-step basis.

And so I think that taking each step and doing a good job is more likely to lead to soundness in trying to do it than trying to do the entire job at one time.

Senator LONG. Let me ask a specific question along this applied to his specific set of facts. I know of this case. I know of a case where a young lawyer about 27 years old had a wife and a child and started to practicing law, just starting in after he came out of the service, working about 16 hours a day and making about $200 a month to show for it, which is not unusual for a youngster starting out, and living right up to his neck because the family needed it. Now, maybe you think a person can live on that $200 because that is all the family exemption he gets, but you and I know that to live decently it requires more.

So he is spending money as fast as it comes in and when it comes to the end of the tax year he finds out that taxes are going to take his whole month's pay, and he does not have the $200 to pay it with. But if that fellow can find some money to provide protection, just as you have stated, he would want to provide to protect the wife and child at age 27 before he provides for his old age at 65. Why should he be denied the same tax advantage by taking out the insurance for his wife and child that he would have it he bought himself a retirement policy?

Mr. GOLDSTEIN. Well, I don't propose to be that much of a tax expert as to indicate the implications that are involved in Senator Gore's suggestion.

I thought Mr. Lindsay hit at it yesterday—maybe he didn't, but I thought he did. So that I believe you will find some serious problems in trying to move into that area of choice at this time under the Revenue Code and what Congress has done up to this time. So that I hope, Senator Gore, you understand—and also Senator Long—that I am in sympathy with the objective, I am just trying to form my own conclusions as to the timing.

Senator GORE. Is that one objective as laudable as the other?

Mr. GOLDSTEIN. Certainly.

Senator GORE. And you and I have agreed that if one's financial circumstances are such that he must make a choice, perhaps his obligation would be first to his wife and children whose danger, as Senator Long has said, is immediate, rather than to his own protection when he is old at 65.

Mr. GOLDSTEIN. You could offer an amendment to H.R. 10 very easily. All you have to do is say that once that money gets in there the individual can choose how he wants it spent for his own family.

Senator GORE. Is this the Goldstein-Smathers amendment or is it the Goldstein-Gore amendment?

Mr. GOLDSTEIN. Thank you, Senator. It is the Gore-Gore amendment.

The CHAIRMAN. Thank you very much.

(Mr. Goldstein subsequently supplied the following for the record:)

STATEMENT OF MEYER M. GOLDSTEIN, EXECUTIVE DIRECTOR, PENSION PLANNING CO., NEW YORK, IN RE TREASURY ALTERNATE PROPOSALS TO H.R. 10

May I thank this committee for arranging these hearings at this particular juncture in a highly crowded calendar.

This written statement, supplementing my oral statement of today will, I hope, be constructively addressed to the vexing problem that faces your committee and, ultimately, the Congress, if your committee adopts the Treasury's alternate proposals to H.R 10.

I. SUMMARY OF OUR POSITION

Summarized, our position is that the Treasury's objectives are sound, but their method of arriving at a solution is unsound and unnecessary.

II. JOINING H.R. 10 AND PENSION CODE IS SOUND

The Treasury's fundamental proposals, namely, to insist that the self-employed who have employees must bring their employees into a tax-qualified pension or deferred profit-sharing plan, in order for the self-employed to obtain the tax advantages of H.R. 10, is sound, and we do recommend this principle.

III. TREASURY METHOD UNSOUND

However, the method by which the Treasury is arriving at its sound objective is unsound, because it poses to this committee the Hobson's choice of curing an inequity against the self-employed by creating a new and serious inequity against small business.

Briefly stated, we find that the Treasury's alternate proposals create, if enacted into law, the following inequities against small business:

A. Vesting would increase pension costs for small business.

B. Denying integration with social security would increase pension cost for small business.

C. Or, vesting and denying integration together would reduce pension benefits and, hence, reduce the ability of small business to attract desirable employees and retire superannuated and disabled employees.

D. Vesting would reduce ability of small business to hold desirable employees.

E. Vesting would be imposed by Congress instead of allowing orderly voluntary negotiating as part of a package at the collective bargaining table in union negotiations.

F. Forbidding investment in employer securities denies small business the opportunity to give their employees a stake in the business.

G. Forbidding investment in employer securities denies small business a source of growth capital which will reduce the ability of small business to expand and create more, and bigger and more secure jobs for its employees.

H. Application of 33⅓ percent stockholder rule to all employees reduces small business ability to encourage stockownership among its keymen.

I. Application of 10 percent-$2,500 rule, or limitation of 33⅓ percent owner-manager rule, requires small business to limit its benefits to self-employed or owner-managers to the restricted and inadequate amounts which such limited employer contributions would provide, thereby weakening the ability of small business to attract and hold key employees, and ultimately gracefully to facilitate their orderly retirement with adequate pensions. This could lead to such small business developing hardening of the arteries and becoming less competitive and, therefore, accelerating the potential death of such small business. The unfortunate effect of the attempt to transfer the money purchase concept of H.R. 10 into the definite pension benefit concept of the pension sections of the code is that it is an attempt to mix "oil and water," which cannot mix. The money purchase pension plan cannot be an effective substitute for a definite benefit pension plan. Money purchase pension plans have been tried and found wanting in the United States. In the 1942 era, they were hotly advocated by a vocal minority of practitioners. But they have since gone the way of all flesh for all practical purposes.

The Treasury and Congress have properly understood this, and the code and administrative procedures have tested discrimination on the basis of pension benefits, and not pension costs. This sound principle of testing discrimination on benefits must continue if our free enterprise concept of supplemental pension benefits is to continue in the United States.

Therefore, if anything has to give, the giving must be on the part of H.R. 10, and not the pension sections of the code. The way it stands now, the Treasury's alternate proposals are having the "small tail wag the big dog." Private pensions is a much broader and wider concept than the problem of the self-employed, and must be given priority in the code and administration. Otherwise, the deterioration process of private supplemental pension plans will begin now, with its impact on small business. Then, just around the corner, there will be a cry to take away the discrimination in favor of big business as against small business. The end of that road will be the impairing of private pensions of all business, and this is not for the good of our country.

J. Full vesting of employer contributions will discourage establishment of profit-sharing by small business.

IV. TREASURY METHOD UNNECESSARY

The Treasury method is unnecessary in order to meet its sound objectives of preventing tax abuses and facilitating its administrative procedures because, happily, there are other methods at hand which will meet the Treasury's sound objectives of minimizing tax abuses and facilitating administration, without introducing the Hobson's choice of harming small business.

V. SMATHERS AMENDMENT TO H.R. 10

We are convinced that the Smathers proposed amendment to the basic H.R. 10, which is now the Keogh-Smathers bill, is the best all-around solution that has been offered to the Hobson's choice dilemma resulting from the Treasury's alternate proposals.

As we understand it, the as yet informal proposed amendment of Senator Smathers would provide the following:

Those self-employed who have 3 or more employees would not be permitted to avail themselves of H.R. 10, unless they also provided for their employees via a qualified pension plan that would cost the self-employed employer not less than 5 percent of the payroll of said employees. This completely meets the Treasury's principle of requiring the self-employed to take care of their employees as a condition of getting the tax advantages for themselves of H.R. 10. But it has the great advantage that it does not in any way interfere with or change the long-established principles and practices of the Revenue Code and the Treasury with reference to qualified pension, profit-sharing annuity and stock bonus plans.

The Smathers proposed amendment also has the advantage of buying time to more thoroughly and carefully consider any tax abuse problems and/or administrative problems which the Treasury has not yet adequately demonstrated either to itself or to this committee. The plain fact is that the Treasury needs more time to do its own homework and research. It has come before this committee inadequately prepared. A simple evidence of this fact is that one of its unsound proposals on vesting, which it included in the Honorable Undersecretary Scribner's letter of April 1, 1960, was removed in the Treasury General Counsel's statement (Mr. David A. Lindsay) of May 11, 1960.

If the Treasury demonstrates that it needs more than the existing code and some present strengthening, which I will hereafter discuss, then it can come before this committee at some later date with proposed language for amendment of the code, adequately documented with data. Then this committee can hold hearings without the current limited time pressure of an adjourning Congress.

Surely no one knows better than this committee the deep roots, and the thousands of small business employers, and the millions of small business employees who would be adversely affected by the Treasury's alternate proposals. This would be a shameful result if it were done, except as the necessity of our country, after adequate facts and careful deliberation and exposure to the searchlight of adequate public hearings would require—none of which has been possible at this time.

VI. CURRENT STRENGTHENING OF THE INTERNAL REVENUE CODE

The Treasury's alternate proposals are not necessary because the present provisions of the Code and its regulations and administrative rulings have been demonstrated as meeting the intent of Congress over a period of 18 years since 1942, by approving some 55,000 plans and, incidentally, by denying approval to a mere handful of plans during this same period.

Nevertheless, assuming that the Smathers proposed amendment, as above stated, to H.R. 10 is adopted, then it would be sound, if there is still time enough to complete and carefully consider the proposed changes in the code, to strengthen the Treasury's ability to control any potential tax abuses by transferring certain presently established administrative rules and regulations to the revenue code itself.

VII. TERMINATION OF PLANS

The Treasury is concerned that the termination of plans by the self-employed. such as a doctor or lawyer, with one or two or three employees, terminating the plan when he retires, and thereby having all the advantages flow to the self-employed owner-manager alone, with nothing in fact for his employees, can be adequately met by putting into the code itself the following changes, some of which the Treasury itself has requested in its letter of April 1, 1960, and statement of May 11, 1960.

These are:

A. Reversion of residue to Treasury

If and when a plan terminates, any excess due to actuarial errors or any other reason cannot revert to the self-employed owner-manager, and will become subject to a 100 percent income tax; in other words, in effect, escheat to the Treasury.

B. Limitation on 25 highest paid

Mimeograph 5717 has long controlled and prevented discrimination in the event of early termination of pension plans within the first 10 years of their establishment. This can be put into the law.

C. Full vesting on termination of plan

The amended code should provide that on the termination of the pension, profit-sharing or stock bonus plan, there would be full vesting of any unvested portions of the accrued employee benefits up to the date of the termination of the plan. Thus, there could not be any recoveries or gains to the self-employed owner-manager at the expense of other employees who did not have vested rights at the time the plan itself terminated.

VIII. DISCRIMINATION

A. Forfeitures

The Treasury is concerned that unless it requires full vesting, a self-employed or owner-manager will, in effect, be the only one to ever get anything out of a plan, because they will be the only ones who might meet the deferred vesting of the pension plan which might, say, require 20 years of service and age 55 as a condition for vesting.

This problem would be adequately met by putting into the code the Treasury's present regulations which require that any recoveries to the pension funds, resulting from forfeitures and severance of employment of those employees who do not have vested rights, must be used to reduce the subsequent cost of the plan to the employer, and cannot be used to increase the pension benefits of the surviving employees, including the self-employed and owner-managers. Thus, for example, if the self-employed or owner-manager was entitled to a $5,000 yearly pension benefit which had already been found to be nondiscriminatory, in accordance with the code, would not increase his $5,000 pension because of lack of vesting in other employees. There are adequate existing controls to prevent discrimination as to benefits under such circumstances.

B. Integration with social security

The Treasury Department, in our opinion, has developed a sound method to not only prevent tax abuses on forbidden tax discrimination, but also to evolve a method for facilitating sound administration on a decentralized basis, through the United States.

Therefore, the Treasury's hand should be strengthened by putting these regulations into the code. In doing so, the Treasury should be given an opportunity to reexamine its evaluation of social security, for tax integration purposes, as determined by the Secretary of the Treasury, or his delegate.

The point is that the Treasury now feels that the existing integration rules may be too liberal.

This problem of continuous revaluation of social security is absolutely essential, because the whole history of social security, especially in an inflationary period, requires constant reexamination. In fact, private pension plans, likewise, must be continuously reintegrated with the changing social security tax base, because the benefits and costs of social security liberalization come out of the same pocketbook of the employer taxpayer as does his cost of the supplemental benefits provided through private pension plans.

Naturally, in the reexamination process, the Treasury will need to give careful weight to the fact that it has already approved the integration under all of the presently existing 55,000 qualified plans. So it may find it necessary to freeze anything that it has allowed up to now to let it catch up to its current thinking by the passing of time and future liberalization in social security itself.

IX. INVESTMENT IN EMPLOYER SECURITIES

We see here another example of the tail wagging the dog. H.R. 10 has in it a provision that would prevent the self-employed from investing in employer securities.

The Treasury now suggest the adoption of the H.R. 10 provisions instead of the present provisions of the code and of the Treasury's administrative rules and regulations dealing with the investment in employer securities. The effect of the Treasury's alternate proposals would be the elimination of any investment in employer securities by any owner-managed corporation. This unhappy result would be another blow against small business which is not sound or necessary.

A. Treasury alternate proposal not sound

It is not sound because it dries up the evolution of the partnership principle by giving employees of small business a stake in the business.

Further, it is not sound, because small business needs additional long-term capital for growth and expansion. Such growth and expansion also helps employees by creating more job security, more jobs, and more opportunity for promotion and higher pay. The pension and profit-sharing funds of small business are a ready source for some of that long-term growth capital.

B. Treasury alternate proposals not necessary

The Treasury proposals of elimination of any investment in employer securities by small business is not necessary because there are already adequate safeguards under the present law and regulations.

If a trust invests in securities of the employer, or if the trust lends trust funds to the employer, the trustee must make full disclosure to the Internal Revenue

Service of the reasons and conditions under which the investments are made. Upon the facts thus submitted, the Revenue Service is enabled to determine whether the trust serves any purpose other than constituting part of the plan for the exclusive benefit of the employees. In order to obtain an advance determination of a proposed trust investment in employer securities, the trustee must file with the Revenue Service detailed financial information, certified by the employer, as to the balance sheets, profit and loss statements, trust fund assets, details of the proposed investment, and the reasons for making same. Among the requisites for favorable Revenue Service determination are, a fair return and sufficient liquidity, and the safeguards of a prudent investor. In addition, the purchase must be at fair market value and bear a reasonable rate of return. These safeguards up to now have been found to be adequate. If not, there would be no more problem in transposing these to the Code itself than there was in connection with section 503(h) with reference to the provisions on investment in employer debentures. Incidentally, this provision itself needs reexamination, because for all practical purposes, it, too, is a discrimination against small business which cannot meet its requirements. Hence, it is not feasible for small business to invest any of its funds in employer debentures, whereas, publicly owned companies can meet the present Treasury tests which are primarily based on liquidity—which small business cannot meet, rather than the value test which small business could meet, the same as big business.

The writer submitted suggestions in this regard as part of his statement before your committee on February 26, 1958 (re sec. 25 of H.R. 8381 of the Technical Amendments Act of 1958, which appeared in your committee hearings, beginning on p. 191), but unfortunately when it was submitted to your committee, it was during equally crowded days and did not get an opportunity to be considered by your committee.

Further, the Congress has introduced additional safeguards for the protection of employee participants by a provision under the Federal Welfare and Pension Plans Disclosure Act (sec. form D-2, pt. III, sec. 31, entitled, "Party in Interest Transactions").

Further, any employee can write to the Labor Department for this information which will tell him, among other things, whether any assets of the fund are invested in securities of the employer, or any loans made to the employer, and, if so, by virtue of the required detailed data (exhibit C) indicate the cost and present value and percentage of the total fund so invested.

The CHAIRMAN. The next witness is Mr. Arends of the Life Insurance Association of America.

STATEMENT OF VERNE J. ARENDS, ON BEHALF OF AMERICAN LIFE CONVENTION AND THE LIFE INSURANCE ASSOCIATION OF AMERICA; ACCOMPANIED BY E. B. SULLIVAN, JR., OF MASSACHUSETTS MUTUAL LIFE INSURANCE CO., SPRINGFIELD, MASS.

Mr. ARENDS. Mr. Chairman and gentlemen, good morning.

I am Verne J. Arends, assistant secretary of the Northwestern Mutual Life Insurance Co. I appear today on behalf of the American Life Convention and the Life Insurance Association of America, 2 life insurance company organizations whose membership is composed of 292 life insurance companies in the United States and Canada, representing 98 percent of the legal reserve life insurance written in the United States.

We are mindful that the current hearings are confined to that part of the Treasury alternate to H.R. 10 which proposes amending existing law by limiting benefits of pension plans covering so-called owner-managers of corporations, and I shall so limit my statement.

The Treasury alternate would extend to the self-employed individual the right to be included in a qualified pension plan if the plan is also available to his employees and meets the requirements of the Internal Revenue Code as to nondiscrimination of benefits and coverage. As a condition, however, Treasury takes the position that certain fundamental changes in existing law are necessary to correct what it considers to be deficiencies in the pension plan system as it applies to small corporations.

Under the Treasury approach, the deductible contribution to a plan for either a self-employed individual or an owner-manager of a corporation would be basically limited to $2,500 a year, or 10 percent of earned income, whichever is less. An owner-manager would be defined as an employee with an ownership interest of as little as 10 percent.

Senator KERR. Do you not mean of 10 percent or less?

Mr. ARENDS. Limited to $2,500 a year, or 10 percent of earned income.

Senator KERR. No; the owner- manager.

Mr. ARENDS. The owner-manager would be defined as one with an interest as little as 10 percent.

Senator KERR. That means if he owns not to exceed 10 percent.

Mr. ARENDS. If he owns less than 10 percent he would not be subject to the limitation on the contributions for owner-managers; yes, sir.

This basic limitation may be exceeded only if the deductible contributions vested in employees other than the owner-managers are at least twice the amount contributed for themselves. Recognizing to an extent the extreme hardship this would impose in the case of the many existing plans covering small companies, the Treasury would allow a 2-year grace period in such instances. Additionally, the Treasury suggests denial of the social security integration rules unless the total annual deductible contributions vested in all employees, who are neither owners nor close relatives, are at least twice the total contributions for self-employed persons or corporate owner-managers.

We recommend that action on these Treasury proposals be deferred pending a complete study of the many problems involved. In our opinion, the Treasury proposal creates an unfair limitation on the pension privileges of many employees of small corporations. The requirement of vesting is unnecessarily burdensome and would discourage small businesses from adopting or continuing pension plans. The plan is unworkable in the case of certain types of pension plans and unduly restrictive with respect to others.

In short, it is our position that the opening of the qualified pension system to the self-employed should be considered on its own merits, and should not be made the vehicle for a hurried reconsideration and overhauling of the complex laws as they have applied for many years to corporation plans, and under which a multitude of small company plans have been established. If there are defects in the existing laws governing qualified pension plans, they should be considered at another time after opportunity for more complete study and more comprehensive legislative consideration.

THE LIMITATION OF CONTRIBUTIONS ON BEHALF OF OWNER-MANAGERS TO 33⅓ PERCENT OF TOTAL CONTRIBUTIONS CONSTITUTES AN UNFAIR LIMITATION ON PLANS OF SMALL EMPLOYERS

The Treasury would limit contributions on behalf of owner-managers to one-half of the contributions vested in all other employees.

Where this test is not met, the maximum of $2,500 or 10 percent of salary is imposed. The 50 percent rule now being advocated is about the same as the old 30 percent rule, applied to all contributions to the plan, declared invalid by the Tax Court in Volckening, Inc., 13 T.C. 723, except that the old rule applied to all contributions under the plan whether vested or not, whereas the proposed rule would apply only to vested contributions on behalf of employees other than the owner-managers.

Senator KERR. That decision had to do with a regulation which had been pubished by the Department; did it not?

Mr. ARENDS. Right, sir.

Senator KERR. Not with reference to anything that has been included in the law?

Mr. ARENDS. No, sir. But the suggestion now, the alternative, is that some similar restrictions be placed in the law.

Senator KERR. Was the adverse decision of the Tax Court based on an inequity in the 30-percent rule, or on the basis that the Department did not have the legal authority to impose the 30-percent rule?

Mr. ARENDS. I am not in a position to answer that specifically, sir, but my recollection is that the Tax Court held that even though the contributions for the stockholder group exceeded 30 percent, it was not discrimination in their favor when you view the benefits and the contributions made for that group.

Senator KERR. Now you have called the committee's attention to the case, apparently, without knowing the basis of the decision. I am not critical in what I say; I am curious.

The impression I had was that the Tax Court held that the regulation had no justification, or basis in law, and did not turn on the merit of the regulations.

Mr. ARENDS. Yes, sir; it did hold that there was no statutory permission for the Internal Revenue Service to make that decision.

Senator KERR. Can our own staff advise us in that regard at this point for the record?

(The staff examined the Tax Court case in question and subsequently reported that the court did not apply the Treasury ruling because the court felt that in the particular case the facts did not show a discrimination in favor of certain employees as provided by the statutes. The effect of the court opinion was to nullify the Treasury ruling because of the absence of statutory authority for it.)

Senator KERR. Is it your position before the committee that, in addition to holding that the Department was not authorized by law to make the ruling, the Tax Court held that it was an inequitable ruling?

Mr. ARENDS. Sir, I would prefer to explore that apart from this meeting and submit a statement for the record.

Senator KERR. I would be happy to explore it, either as part of this meeting or in connection with this meeting, but I would be quite anxious that you put in the record what your interpretation of the decision is with reference to that question.

Mr. ARENDS. We will do that, sir.

(The following was submitted for the record:)

In the *Volckening* case the Commissioner of Internal Revenue argued before the Tax Court that the plan involved was discriminatory because the contributions on behalf of the stockholder employees were in an amount greater than 30 percent of the total contributions to the plan, and pointed to ruling I.T. 3674 as authority for his position. In holding for the taxpayer, the court did note the lack of statutory authority for the 30-percent rule. However, it went further than this on the merits of the 30-percent rule as a test of discrimination and held that it did not constitute a conclusive test. The holding, therefore, stands for the principle that a plan is not necessarily discriminatory in favor of stockholder employees merely because contributions to the plan on their behalf exceed some arbitrary limitation. The court did not directly hold the 30-percent rule invalid, but simply said that it constituted a rule of thumb to be considered with all of the facts in applying the test of nondiscrimination. The new Treasury proposal would make a percentage-of-contribution rule a conclusive test of qualification in addition to the nondiscrimination rule. This is, of course, a different approach than the one the Commissioner of Internal Revenue pursued in the *Volckening* case.

Senator KERR. As I understand it, the matter that the Treasury now brings to the committee is a recommendation for legislation.

Mr. ARENDS. For a rule similar to that one—we referred to the rule merely to show that it was about the same type of limitation.

Senator KERR. I did not know the Department was asking this committee to authorize it to issue a rule by regulation. I thought the Treasury was asking this committee to include language in this bill which would have the dignity of legislation.

Mr. ARENDS. That is right, sir.

Senator KERR. Now, I would frankly think that if the Tax Court held that the ruling was invalid because it was inequitable, that they would be entering a field of jurisdiction which is not given to them, and one which, so far as I am concerned, would not be very persuasive.

Their function is, in my judgment, to decide whether or not the regulation was authorized or consisted of law, not whether it was equitable or meritorious. Is that not your concept of the Tax Court?

Mr. ARENDS. Yes, sir; that is my concept.

Senator KERR. Fine.

Mr. ARENDS. In large corporations, the number of executives or owner-managers is quite small in relation to the total number of employees. Similarly, the salaries of such executives, though individually quite large, are small in relation to the total compensation paid to all employees. In small corporations it is often the case that the major part of the operation of the business is conducted by the owner-managers, with the assistance of only a few other employees. The equity of the limitation proposed by the Treasury disappears when it is seen that in applying the limitation to the small corporation, even a generous pension plan for the other employees will not be sufficient to provide pensions for the stockholder officers anything like those available to employees of larger corporations with comparable salaries, or sufficient to provide a reasonable pension for such small-company officers when they retire.

Senator KERR. With reference to the large corporations, is there not the requirement that the plan not be discriminatory as between the executive personnel and the employees other then executive employees?

Mr. ARENDS. Yes, sir; there is.

Senator KERR. And is that not generally met by applying a percentage of equal amount both to the salary of the executive and the employees?

Mr. ARENDS. A relative amount; yes, sir.

Senator KERR. Is it a relative amount per employee or executive, or a percentage of the salary of the two?

Mr. ARENDS. It would depend on the type of pension plan established. It is not unusual for a plan to determine what the pension benefits shall first be, and that determines the cost and the required contributions for the various participants.

Senator KERR. Is it a usual thing for the percentage of salaries to be less as applied to the employees' salaries than is applied to the executives' salaries, sir, referring to the contribution or the ultimate benefits? The contribution.

Mr. ARENDS. The contribution?

In discussing a fixed benefit plan, the percentage of salary that is paid into the plan for the participant is basically immaterial.

Senator KERR. But as a matter of practice, as a matter of usual custom—you are very familiar with these, I know, in your position—do you find any or many where the percentage of contributions as applied to the employees' salary is less than that applied to the salaries of the executives?

Mr. ARENDS. That is difficult to answer, sir, because most of the plans we see are those plans which determine—which start by determining the amount of pension they wish to provide.

Senator KERR. The amount of benefit?

Mr. ARENDS. The amount of benefit; yes, sir.

Senator KERR. And they adjust the amount which they put in there which actuarially they hope to achieve the results?

Mr. ARENDS. And that percentage of salary which is to be a pension is the same for the officers and the owners as it is for the employees, in fact the Internal Revenue Service under the exercise of the discrimination rules will often require a smaller percentage of salary benefit for the higher paid people in order to qualify the plan.

Senator KERR. That is the reason I asked you if you knew of any or many where the percentages applied to the employees' salaries was less than the percentage permitted under an executive's salary.

Mr. ARENDS. No, sir.

The CHAIRMAN. I am sorry to interrupt you, but we have a rollcall. The committee will be in recess.

(A recess was taken.)

The CHAIRMAN. The committee will come to order.

You may proceed, Mr. Arends.

THE REQUIREMENT OF VESTING IS UNNECESSARILY BURDENSOME

Mr. ARENDS. Mr. Chairman, in the Treasury ruling of 1944, I.T. 3674, setting forth the subsequently rejected 30-percent rule, and in the proposals before the Senate Finance Committee in 1954, the 30-percent rule was to be applied to the total contributions to the plan, and not limited to contributions vested in the employees. It should be noted, of course, that under existing Treasury regulations and the code itself, any contribution by the employer is made irrevocably and vested in the plan. It may not be recovered by the employer. The Treasury would inject a new element by making mandatory for its proposed test the vesting of employer-contributed amounts in the individual employees.

Life insurance and annuities in pension plans by their very nature encourage vesting, and it is probable that vesting is much more common in insured plans than it is in noninsured plans. There are, of course, arguments in favor of vesting after a reasonable waiting period. However, the fact must be faced that immediate or early vesting greatly increases the cost of pension plans, and limits the ability of the small employer, in particular, to provide adequate pension coverages for those faithful employees who remain with him to retirement age.

The requirement for immediate or early vesting in order to permit specified contributions is unworkable under certain forms of pension coverage. For example, under deposit administration contracts of insurance companies and noninsured pension plans, no specific amounts of employer contributions are assigned to specific individuals before retirement. Indeed under most noninsured plans no specific assignment is actually made even at retirement. The funding methods employed may involve actuarial assumptions as to mortality, future salaries, withdrawal rates, and retirement rates in terms of expected average results and thus make it impossible to ascribe a particular dollar amount to each individual employee. Consequently, the rule proposed by the Treasury cannot be applied to many of the existing pension plans and would preclude the use of these two much-utilized funding methods for new plans.

In addition to the fact that the Treasury rule would be unworkable in the case of certain types of pension plans, it would discriminate against a popular form of group annuity contract. Under such a group annuity contract, the employer purchases for each employee a fixed amount of annuity each year, which becomes payable upon retirement. The purchase price of this fixed annuity increases as the employee grows older. Thus when the owner-managers are older than the other employees, their contributions are relatively higher per unit of benefit than the contributions on behalf of the other employees. It follows that the Treasury rule which applies on a year-to-year basis rather than a cumulative basis, when applied to a deferred group annuity plan, would be more restrictive upon the owner-manager than when applied to a plan providing for the payment of level contributions. The effect of the rule would be to discourage employers from adopting the deferred group annuity contract which is one of the most popular methods of funding insured pension plans.

SOCIAL SECURITY INTEGRATION

In the Treasury letter, concern was expressed over possible discrimination in favor of owner-managers who eliminate from pension plan coverage employees who earn not more than $4,800 annually—the amount covered by social security. It seems to us that the Internal Revenue Service has sufficient authority under existing law and regulations to prevent such discrimination in qualified plans regardless of the size or the type of business entity adopted by the employer. Therefore, the current suggestion of Treasury is unnecessary and would only add further complexity to an already involved facet of the pension field.

CHANGES SHOULD NOT AFFECT EXISTING PLANS

The restrictions proposed by Treasury should not in any event be applied to plans already qualified under existing law. A pension plan is necessarily a long-term arrangement relied upon by all covered employees for their future financial security, and in setting up the plan employers have relied on the law as it then existed. The inevitable effect of the enactment of the Treasury proposal as presented on April 1, 1960, would be the termination of many of these plans, unless the changes in law do not apply to them. The loss thus suffered would be borne by lower paid employees even more than by the owner-managers. We do not think that the Treasury-proposed, 2-year grace period would be adequate to overcome these hardships.

THE RESTRICTIONS WOULD ADVERSELY AFFECT SMALL BUSINESS

As we have already indicated, the restrictions proposed by the Treasury are particularly harmful to small business, small employers. They can, of course, have no effect on the plan of the giant corporation with many employees, since the broadly based contribution on behalf of these employees would remove any practical dollar limit on the contribution on behalf of the individual executives, no matter how highly paid they were. It is thus an anomaly of this recommendation that it places upon a pension plan benefit an arbitrary ceiling based primarily on the number of employees covered rather than on the rules of nondiscrimination which have been developed in the past.

Small employers are in competition with larger employers for talented supervisory employees. Lacking the security offered by the large employer, the small employer may offer minority stock interests as incentives for such employees. Yet, under the Treasury proposal, a stock interest of as little as 10 percent makes such a supervisory employee an owner-manager and limits his pension privileges. Obviously, the rule goes entirely too far and would seriously handicap small business in attracting management talent.

CONCLUSION

Under present law and regulations, determinations by the Internal Revenue Service of whether or not a pension plan discriminates in favor of owner-managers are based on a number of factors. The relationship between the cost of benefits for the owner-manager to the plan's total cost is but one such factor. Others, of equal importance, are the age of the owner-manager, his length of service, the amount of his benefit, the type of plan and its funding method, the type of business involved, and the reasonableness of the owner-manager's salary.

To confine the test to a single factor—or to restrict contributions in any year for benefits to so-called owner-managers to a fixed percentage of the plan's total cost for the year—might unduly penalize many small corporation executives in whose favor no actual discrimination would exist, if all applicable factors are considered.

In the past, the system of administering the law governing qualified pension plans along broad regulatory lines has worked reasonably well. Substitution of a single test establishing an arbitrary limit—as proposed by the Treasury—should receive much more detailed and careful consideration. If such a study is to be made, we would be happy to cooperate with the Treasury and the staff of the joint committee in such an undertaking.

That concludes my statement. Thank you, gentlemen.

The CHAIRMAN. Thank you very much, Mr. Arends. Any questions?

(No response.)

The CHAIRMAN. Thank you very much.

The next witness is Mr. John Z. Schneider, of the National Association of Life Underwriters.

STATEMENT OF JOHN Z. SCHNEIDER, NATIONAL ASSOCIATION OF LIFE UNDERWRITERS

Mr. SCHNEIDER. Thank you, Mr. Chairman, for this opporunity to appear.

My name is John Z. Schneider, and I am the chairman of the Committee on Federal Law and Legislation of the National Association of Life Underwriters, as well as a member of that organization's board of trustees.

The National Association of Life Underwriters is a trade association having a membership of 78,000 life insurance agents, general agents, and managers located in all 50 States, the District of Columbia, and Puerto Rico.

In this presentation, Mr. Chairman, I will have to stick close to the script in the early part of my prepared statement because it contains various arithmetical computations for illustrative purposes, but later on, in the interest of time, I will summarize the remainder of the statement.

It is my understanding that in this statement I am to confine my comments to that part of the Treasury Department's alternative to H.R. 10 which proposes amending existing law by limiting benefits provided to owner-managers of corporations under qualified pension plans, including plans already in being.

If I may be permitted to digress for just a moment, I would like to advise your committee that at our midyear meeting in March of this year, my association voted to withdraw its support of H.R. 10. At the same time we also voted henceforth to support legislation which would in effect permit self-employed individuals to set up nondiscriminatory pension plans for themselves and their employees within the framework of the present provisions of the Internal Revenue Code dealing with qualified employee pension plans.

This is the approach embodied in the Treasury's alternative to H.R. 10, as outlined in the letter of April 1, 1960, addressed to the chairman of your committee by Fred C. Scribner, Jr., Under Secretary of the Treasury. However, we are firmly opposed to numerous proposals contained in that alternative, including those which are the subject of these hearings.

Many of the members of my association engage in the sale of insured pension plans to corporate employers. Many, if not most, of their clients and prospects are relatively small owner-managed corporations.

I can assure your committee that adoption of the Treasury's proposals to limit the benefits provided under such plans to the owner-managers of such corporations would not only seriously discourage the creation of new plans, but also have a severely adverse impact on plans already in existence.

Adoption of the Treasury's proposals would, therefore, be a most damaging and discriminatory blow to small corporations, their owner-managers and their employees generally.

On the other hand, the proposals in question would not affect the pension plans of larger corporations in the slightest degree.

To begin with, paragraph 2(a) of the Treasury's proposal would permit a basic yearly employer contribution on behalf of each corporate owner-manager amounting to the lesser of 10 percent of compensation or $2,500. In our judgment this or any other fixed formula or figure would be an utterly unrealistic and discriminatory limitation.

For instance it would clearly discriminate against older owner-managers. To demonstrate this, let us examine the initial cost of providing a pension of 30 percent of salary at age 65. Incidentally, we are using a 30-percent pension in our example even though many pension designers consider this to be a bare minimum pension today.

Assuming that such a pension is funded by a nonparticipating retirement income policy which will provide payments for a guaranteed period of 10 years and for life thereafter, we find that the cost of such a policy at various ages is as follows:

If the participant were age 30—and we are assuming an annual salary of $15,000 for simplicity right on through this example—his 30-percent pension benefit at age 65 would be $4,500 a year. The annual premium for a retirement income policy to insure that benefit of $4,500 a year would be $1,265, so that the premium as a percent of salary in that case would be only 8.4 percent. But if the same policy were bought at age 35, the premium as a percent of salary would increase to 10.4 percent. And so on. It would increase by age for the identical policy, until we find that at age 55 the premium as a percent of salary would be 39.7. So we have in these age groups from age 30 to age 55, in order to provide a yearly pension of $4,500 at age 65, a premium ranging from 8.4 percent of salary to 39.7 percent of salary.

However, the Treasury's proposed 10 percent of salary rule would permit the purchase of the necessary retirement income policy only for an owner-manager less than 35 years of age.

Senator BENNETT. May I interrupt at this point?

Why did you select a 10-year example?

In ordinary pension programs, the pension ends when the man dies, there is no opportunity to carry it over for his family.

Mr. SCHNEIDER. Senator Bennett, the small owner-manager corporation, the organization with 5 or 6 or perhaps 10 men, or maybe even a little larger than that, generally adopts the insured type of pension plan frequently funded by individual retirement income policies in which it is quite common to provide payments for what we call in our parlance a "10-year certain" period.

Senator BENNETT. That is what I call it.

Can you supply us with an example showing these figures with the straight annuity with no certainty?

Mr. SCHNEIDER. Yes, that could be done.

But if you are thinking about the no-death-benefit group annuity, this would not be actuarially practicable for such a small number of people. We have confined our examples to a small group to fit in with what appears——

Senator BENNETT. Are you telling me that you cannot supply me with figures?

Mr. SCHNEIDER. They can be supplied.

Senator BENNETT. Then I would appreciate your securing them for me.

Mr. SCHNEIDER. We will do it.

(The information referred to was subsequently furnished Senator Bennett.)

Mr. SCHNEIDER. One thing occurs to me that might come close to your answer, to what you have in mind. Roughly speaking the premium on an annuity policy which does not provide a life insurance benefit would vary between 5 and 10 percent less than those shown in my statement.

On a strictly no-death benefit, straight life annuity, it could be conceivably even somewhat less.

If I may judge, I don't think such an annuity premium would raise this point at which the Treasury's 10 percent rule would not be violated beyond about age 40. However, we will supply those figures to you.

Senator BENNETT. Thank you.

Senator KERR. If you provide the answer as to the percentage of salary deduction, you are paying $4,500 a year after the age of 65, the retirement age. In your judgment that benefit could not be acquired if applied to the salary of a man of $15,000 a year beginning after 40 years.

Mr. SCHNEIDER. That would be my rough guess, because the required premium would then violate the 10 percent rule.

Senator KERR. As long as you have it, you cannot get it if it begins after 30?

Mr. SCHNEIDER. No, probably at age 34 you could still get it even under the type of retirement income policy I have referred to in my statement.

Now, then, we take another example here and it shows what would happen to these same individuals if we applied the Treasury's proposed 10 percent rule. And there we find the owner-manager of age 30 would be entitled to a yearly contribution of $1,500, which would be 10 percent of salary. We would have $1,500 of contribution to apply to purchase his retirement benefit, which would come out to $5,335 a year at age 65, or 35.5 percent of his salary; at age 35 the same 10 percent contribution would provide a pension benefit of 28.8 percent of salary.

But when we get up into the older owner-managers such as at age 50, 10 percent of salary would buy a pension benefit of only $150 a month, which would be only 12 percent of his salary. At 55 the same 10 percent contribution would buy a pension of only 7.6 percent of salary.

So we think that these examples—and the last example in particular—make it abundantly clear that the proposed 10 percent limitation would result in completely unfair discrimination against older owner-managers.

Now, then, in paragraph 2(b) of the Treasury's proposal——

Senator WILLIAMS. May I ask a question.

Upon what age are you assuming you start payment of this pension?

Mr. SCHNEIDER. Age 65 in each case.

In paragraph 2(b) the proposal provides that regardless of the 10 percent or $2,500 limitation, pension contributions on behalf of each corporate owner-manager could be as much as the largest annual deductible contribution vested in any covered employee who was neither an owner-manager nor a close relative of such an individual.

Small corporations would rarely be in a position to avail themselves of this particular escape hatch. By their very nature such corporations are unlikely to have nonstockholder employees whose positions and compensation tend to be on a par with those of the owner-managers or their close relatives.

We understand that in the Treasury's testimony yesterday they abandoned their paragraph 2(b) proposal.

Finally, paragraph 2(c) of the Treasury's proposal provides that there would be no special limitation on nondiscriminatory contributions for corporate owner-managers—

> if the total amount of such contributions did not exceed one-half of the total annual deductible contributions vested in all employees who are neither owners nor close relatives of an owner.

This admittedly is an attempt on the part of the Treasury to have enacted into law a limitation very closely akin to the old so-called 30 percent rule, which was judicially rejected some years ago.

Senator BENNETT. For the record, it was rejected on the basis that it had no basis in law and not that there was anything essentially wrong with the 30 percent rule?

Mr. SCHNEIDER. Senator Bennett, the only knowledge I have of that now is that in a footnote of Secretary Scribner's letter of April 1 this was stated as a fact, but I have not read the case. It could be——

Senator BENNETT. We would assume that the Secretary would not attempt to mislead the committee.

Mr. SCHNEIDER. I don't think there is any attempt to mislead the committee, sir, but it could be that the equity of the 30 percent rule was not considered.

Senator BENNETT. I have a case before me. It says:

> The respondent IT 3674, as a general rule owning is to be considered with all the facts. We have so considered it and we believe it has no application here.

They did not say they believed that it had any application anywhere.

Mr SCHNEIDER. Did the court in that case consider the facts as to whether the plan was discriminatory or nondiscriminatory?

Senator BENNETT. They did.

Actually, in this case the owner-managers got less than their employees did, and the 30-percent question was not directly involved in the question of discrimination; they simply threw it out because they said it had no basis in the law.

Mr. SCHNEIDER. The corollary would seem to be that if the court had found the plan discriminatory, they would have found a basis for the rule; isn't that correct?

Senator BENNETT. Well, the employers got less in proportion to their employees.

Mr. SCHNEIDER. So the court found that the particular pension plan involved was a nondiscriminatory plan.

Senator BENNETT. That is right.

Mr. SCHNEIDER. And then the court said there was not sufficient statutory authority to permit the Treasury Department to rule.

Senator BENNETT. To rule on the 30-percent limitation?

Mr. SCHNEIDER. Yes, sir.

Actually, the proposed new provision contained in paragraph 2(c) of the Treasury's proposal comes out to be a 33⅓-percent rule, in that the total employer pension contributions on behalf of owner-managers could not exceed one-third of the total contributions on behalf of all covered employees.

So if you test this out with an example, and using as a starting point the example which we have put in our statement of a fixed benefit plan with various ages, various salaries, and so on, we think we can demonstrate that this limitation would also be completely inequitable and unrealistic. Here again we are assuming retirement at age 65 for each of these people, and we are using nonparticipating retirement income contracts and a pension of 30 percent of salary to keep the formula simple.

First, we have owner-manager A, who is a stockholder, of course, with a salary at age 50 of $2,000 per month. His monthly pension at 30 percent of salary would be $600 and for the next 15 years until age 65 the employer contributions on his behalf would have to be $5,980.80 per year.

The next stockholder B, also an owner-manager, is 45 years old, and his salary is $1,500 a month. His pension of 30 percent of salary would be $450 per month, and the employer contributions $3,159 per year.

And then when we come to employees who are nonstockholders. Their ages range from 40 down to 25, and the employer contributions necessary to provide their 30-percent pensions are of course much less than for A and B.

Now, if we take the premiums paid for A and B and add them together, we can compute that they amount to 73.2 percent of the total annual premiums. Under this nondiscriminatory plan, this large percentage of the premiums would have to be paid on behalf of the two owner-managers in order to provide them with the same pension benefits relative to salary, which is permitted under the present law, as were to be provided for the rank-and-file employees of the corporation.

On the other hand, if he were to make this plan meet the requirements of the Treasury's proposed 33⅓-percent rule, then we would drastically reduce owner-manager A's pension to $110 a month, and owner-manager B's pension to $82 a month. As a result each of them would be entitled to a pension of only about 5½ percent of salary, whereas the rank-and-file employees would each be entitled to a pension of 30 percent of salary.

Of course, if we understand the Treasury's proposal correctly, it could be argued that stockholders A and B could take advantage of the limitations provided for under either paragraph 2(a) or 2(b), which in this case would be more liberal than the 33⅓-percent rule.

Actually, the 10-percent limitation under paragraph 2(a) would be more advantageous to A and B in this case, because with A's salary of $24,000, 10 percent of his salary would be $2,400, and for B it would be $1,800. In that event, the resulting pensions would be a little larger. Instead of $110, A would get $240, and B would get $256, or 12 percent of salary in A's case, and 17 percent in B's case.

However, you will note that A's pension would be considerably less than the pension payable to lower salaried B, both in terms of dollars and percentage of salary. This in itself we think would be a most inequitable result to say the least.

It should be noted that in order for owner-managers A and B to be entitled to a pension of 30 percent of their salaries under the proposed 33⅓-percent rule, their corporation, the way we have set it up in our example, would have to employ at least 20 additional rank-and-file employees in the same age and salary groupings as the four rank-and-file employees which we have described in the example.

Now, if you did that, you come up with a big enough total of contributions for rank-and-file employees so that A and B would each get a pension of 30 percent, because then they would not be in violation of the 33⅓-percent rule which is set out in paragraph 2(c).

For many small corporations of the owner-manager type, it not only is unnecessary but also might be impossible to maintain such a relatively large force of rank and file employees. Therefore, application of the 33⅓ percent rule would discriminate not only against small owner-manager corporations as a class, but also between individual corporations in that class.

Now, under circumstances such as we have described above, your committee may be sure that a pension plan would never be set up or that, if it were already in existence, it wouldn't long be maintained. We think, on the other hand, that owners A and B might eventually expect to sell the business and retire on the capital gain realized from the sale. Of course there would be no pensions for their rank and file employees.

Now, in paragraph 2(d) of its proposal, the Treasury recommends that individuals not be permitted to arrange to increase the allowable amounts that can be contributed on their behalf to qualified pension plans by splitting their activities into several businesses, each with a different pension plan.

We can see no reason why an individual who is an owner-manager of several corporations, who contributes in fact to their success, and who draws a salary from each, should be prohibited from participating in their respective pension plans.

My next point has to do with the case where the Treasury says that if the 10 percent rule is to be exceeded, the employees must have vested rights in the employer's pension plan contributions. We believe that the decision as to the degree to which vesting will be provided under any plan should best be left to the employer and the employees, because we think that to make vesting a mandatory requirement in the case of pension plans that are set up by owner-managed corporations, the small ones, would discriminate against such types of corporations.

Our next point deals with paragraph 3 of the Treasury proposal pertaining to the so-called integration of pension plans with the social security program. It is our opinion that the present integration rules, which in themselves are complicated enough, nevertheless make adequate provision for the nondiscriminatory treatment of corporate owners-managers and employees. We think that to subject small corporations to further restrictive rules would have a markedly deterrent effect upon the setting up of such pension plan by many small corporations.

My next point has to do with paragraph 4 of the Treasury's proposal, which would limit employee contributions to contributory pension plans to 10 percent of compensation up to $2,500. We think the point as a practical matter is academic. The avowed purpose is to prevent unwarranted tax advantages. In any event we fail to see how the tax advantages referred to in that paragraph are any more unwarranted in the case of small corporate plans than they are in the case of contributory plans set up by large corporations. But the distinction is nevertheless made by the Treasury.

Finally, in paragraph 9, the Treasury recommends that additional limitations be imposed upon profit-sharing plans covering owner-managers of corporations. We think that to impose these additional limitations only on profit-sharing plans set up by owner-managed corporations would again discriminate against small corporations.

In conclusion, I ask leave to call your attention to the following statement made several years ago by the Senate Special Committee to Study the Problems of American Small Business:

> It is the combined pressure of the income and estate tax structure which forces independent owners of businesses of this size to sell out to larger companies. The Treasury forces these mergers and the Federal Trade Commission complains about them and seeks to set up a legal barrier.

We submit that this sttaement has particular pertinence in the light of the above-mentioned limitations that are now being recommended by the Treasury.

In our opinion, these limitations would be both socially and economically unrealistic and unsound. Their enactment by Congress would single out, we think, small owner-managed corporations for discriminatory income tax treatment which would be adverse to the best interests of such corporations, their owner-managers and their rank and file employees. We therefore urge that your committee reject these limitations.

The CHAIRMAN. Thank you very much.

(The complete prepared statement of Mr. Schneider follows:)

STATEMENT MADE BY JOHN Z. SCHNEIDER OF THE NATIONAL ASSOCIATION OF LIFE UNDERWRITERS

My name is John Z. Schneider, and I am the chairman of the Committee on Federal Law and Legislation of the National Association of Life Underwriters, as well as a member of that organization's board of trustees. The National Association of Life Underwriters is a trade association having a membership of 78,000 life insurance agents, general agents, and managers located in all 50 States, the District of Columbia, and Puerto Rico.

It is my understanding that in this statement I am to confine my comments to that part of the Treasury Department's alternative to H.R. 10 which proposes amending existing law by limiting benefits provided to owner-managers of corporations under qualified pension plans, including plans already in being.

If I may be permitted to digress for just a moment, I would like to advise your committee that at our midyear meeting in March of this year, my association voted to withdraw its support of H.R. 10. At the same time we also voted henceforth to support legislation which would in effect permit self-employed individuals to set up nondiscriminatory pensions plans for themselves and their employees within the framework of the present provisions of the Internal Revenue Code dealing with qualified employee pension plans. This is the approach embodied in the Treasury's alternative to H.R. 10, as outlined in the letter of April 1, 1960, addressed to the chairman of your committee by Fred C. Scribner, Jr., Under Secretary of the Treasury. However, we are firmly opposed to numerous proposals contained in that alternative, including those which are the subject of these hearings.

Many of the members of my association engage in the sale of insured pension plans to corporate employers. Many, if not most, of their clients and prospects are relatively small owner-managed corporations. I can assure your committee that adoption of the Treasury's proposals to limit the benefits provided under such plans to the owner-managers of such corporations would not only seriously discourage the creation of new plans but also have a severely adverse impact on plans already in existence. Adoption of the Treasury's proposals would, therefore, be a most damaging and discriminatory blow to small corporations, their owner-managers, and their employees generally. On the other hand, the proposals in question would not affect the pension plans of larger corporations in the slightest degree.

To begin with, paragraph 2(a) of the Treasury's proposal would permit a "basic" yearly employer contribution on behalf of each corporate owner-manager amounting to the lesser of 10 percent of compensation or $2,500. In our judgment this or any other fixed formula or figure would be an utterly unrealistic and discriminatory limitation. For instance, it would clearly discriminate against older owner-managers. To demonstrate this, let us examine the initial cost of providing a pension of 30 percent of salary at age 65. Incidentally, we are using a 30-percent pension in our example even though many pension designers consider this to be a bare minimum pension today.

Assuming that such a pension is funded by a nonparticipating retirement income policy which will provide payments for a guaranteed period of 10 years and for life thereafter, we find that the cost of such a policy at various ages is as follows:

Fixed benefit plan (30 percent of salary)

Age	Annual salary	Annual pension benefit	Annual premium	Premium as percent of salary
30	$15,000	$4,500	$1,265	8.4
35	15,000	4,500	1,560	10.4
40	15,000	4,500	1,984	13.2
45	15,000	4,500	2,632	17.5
50	15,000	4,500	3,738	24.9
55	15,000	4,500	5,952	39.7

Thus it can be seen that the annual cost of providing this pension benefit of 30 percent of salary would range anywhere from $1,265, or 8.4 percent of salary, to $5,952, or 39.7 percent of salary. However, the Treasury's proposed 10-percent-of-salary rule would permit the purchase of the necessary retirement income policy only for an owner-manager less than 35 years of age.

The following example shows what would happen to these same individuals under the proposed 10-percent rule:

Pension benefits under 10-percent rule

Age	Annual salary	Annual premium	Annual pension benefit	Pension as percent of salary
30	$15,000	$1,500	$5,335	35.5
35	15,000	1,500	4,320	28.8
40	15,000	1,500	3,175	21.2
45	15,000	1,500	2,565	17.1
50	15,000	1,500	1,800	12.0
55	15,000	1,500	1,135	7.6

This example makes it abundantly clear that the proposed 10 percent limitation would result in completely unfair discrimination against older owner-managers.

In paragraph 2(b), the Treasury's proposal provides that regardless of the 10 percent or $2,500 limitation, pension contributions on behalf of each corporate owner-manager could be as much as the largest annual deductible contribution vested in any covered employee who was neither an owner-manager nor a close relative of such an individual.

Small corporations would rarely be in a position to avail themselves of this particular "escape hatch." By their very nature such corporations are unlikely to have nonstockholder employees whose positions and compensation tend to be on a par with those of the owner-managers or their close relatives. The type of nonstockholder employee contemplated by paragraph 2(b) would be the highly paid professional manager who is much more apt to be found working for a large corporation.

Finally, paragraph 2(c) of the Treasury's proposal provides that there would be no special limitation on nondiscriminatory contributions for corporate owner-managers "if the total amount of such contributions did not exceed one-half of the total annual deductible contributions vested in all employees who are neither owners nor close relatives of an owner."

This admittedly is an attempt on the part of the Treasury to have enacted into law a limitation very closely akin to the old so-called 30-percent rule, which was judicially rejected some years ago. Actually the proposed new provision would impose a 33⅓-percent rule in that total contributions on behalf of owner-managers could not exceed one-third of the total contributions made on behalf of all covered employees.

Using as a starting point the example which follows, we shall demonstrate that this limitation would also be completely inequitable and unrealistic. In this example we are again assuming a pension of 30 percent of salary at age 65 funded by nonparticipating retirement income policies.

Fixed benefit plan (30 percent of salary)

Employees	Age	Monthly salary	Monthly pension	Annual premium
A (stockholder)	50	$2,000	$600	$5,980.80
B (stockholder)	45	1,500	450	3,159.00
C	40	1,000	300	1,587.00
D	35	700	210	873.60
E	30	600	180	607.50
F (female)	25	300	90	278.91
Total				12,486.81

Computation will reveal that 73.2 percent of the total annual premiums under this nondiscriminatory plan would have to be paid on behalf of the two owner-managers in order to provide them with the same pension benefits relative to salary as were to be provided for the rank-and-file employees of the corporation. On the other hand, if the plan had to meet the requirements of the Treasury's proposed 33⅓ percent rule, owner-manager A's pension would have to be drastically reduced to about $110 per month and owner-manager B's to approximately $82. Thus they would each be entitled to a pension of only about 5½ percent of salary, whereas the rank-and-file employees would each be entitled to a pension of 30 percent of salary.

Of course, if we understand the Treasury's proposal correctly, it might be argued that A and B could take advantage of the limitations provided for under either paragraph 2(a) or paragraph 2(b), which, in this case, would be more liberal than the 33⅓ percent rule insofar as A and B were concerned. Actually, the paragraph 2(a) limitations would be more advantageous to A and B in this instance since, under these limitations, the contributions on their behalf could be 10 percent of their annual salaries, or $2,400 for A and $1,800 for B.

However, even this choice would not materially help A and B. The resulting monthly pensions for A and B would still be only $240 and $256 respectively, or 12 percent of salary in A's case and 17 percent in B's. Moreover, you will note that A's pension would be considerably less than the pension payable to lower-salaried B, both in terms of dollars and percentage of salary. This in itself would be a most inequitable result, to say the least.

It should be noted that in order for owner-managers A and B to be entitled to a pension of 30 percent of their salaries under the proposed 33⅓ percent rule, their corporation would have to employ at least 20 additional rank-and-file employees in the same age and salary groupings as the 4 rank-and-file employees described in the above example.

For many small corporations, it not only is unnecessary but also might be impossible to maintain such a relatively large force of rank-and-file employees. Therefore, application of the proposed 33⅓ percent rule would discriminate not only against small owner-managed corporations as a class but also between individual corporations in that class.

Under circumstances such as those described above, your committee may be sure that a pension plan would never be set up or that, if already in existence, it would not long be maintained. Rather, owner-managers A and B might be expected eventually to sell the business and to retire on the capital gain realized from the sale. But there unfortunately would be no pensions for their rank-and-file employees.

In paragraph 2(d) of its proposal the Treasury recommends that individuals not be permitted to arrange to increase the allowable amounts that can be contributed on their behalf to qualified pension plans by splitting their activities into several businesses, each with a different pension plan. We see no reason why an individual who is an owner-manager of several corporations, who contributes to their success and who draws a salary from each should be prohibited from participating in their respective pension plans.

At the conclusion of paragraph 2, the Treasury's proposal emphasizes that employer pension contributions on behalf of a corporate owner-manager could exceed 10 percent of his compensation or $2,500 per year only if the pension plan provides vested rights for at least some of the rank-and-file employees. The proposal then attempts to justify this requirement by contending that such vesting will provide "an automatic safeguard" that funds contributed ostensibly on behalf of these employees "will not as a result of forfeitures, eventually accrue to the individuals establishing the plan."

Apropos of this contention we should like to point out first of all that in any pension plan—large or small—forfeitures tend to redound to the benefit of the corporate employer and its stockholders by reducing the cost of the plan. By the same token, if an employer wishes to provide immediate or early vesting he is faced with a choice between paying a materially higher cost for his plan or reducing the benefits provided thereunder. Therefore, we believe that the decision as to the degree to which vesting will be provided under any plan is one which should be left to the employer and employees. To make such vesting a mandatory requirement in the case of pension plans set up by owner-managed corporations would discriminate against such corporations.

In paragraph 3 of its proposal, the Treasury recommends that pension plans providing benefits for corporate owner-managers should be precluded from taking credit for social security payments under the existing integration rules so as to exclude from benefits all other employees. Integration with social security has made it financially possible for many small corporations to establish pension plans which they otherwise might not be able to afford. In our opinion the present integration rules make adequate provision for the nondiscriminatory treatment of corporate owner-managers and their employees. To subject small corporations to further restrictive rules would have a marked deterrent effect upon the setting up of pension plans by many such corporations.

In paragraph 4, the Treasury Department recommends that annual nondeductible contributions made by employees under contributory pension plans covering corporate owner-managers be limited to 10 percent of compensation up to $2,500. The avowed purpose of this recommendation is to prevent "unwarranted tax advantages" through the deferment of tax on the earnings received on the employee contributions. We seriously question the premise that such individuals are likely to be overly interested in tying up their own after-tax earnings for this purpose. In any event, however, we fail to see how the "tax advantages" referred to are any more "unwarranted" in the case of small corporate plans than they are in the case of contributory plans set up by large corporations.

In paragraph 9, the Treasury recommends in effect that various additional limitations be imposed upon profit-sharing plans covering owner-managers of corporations, with a transition period for existing plans. Specifically, the Treasury proposes, among other things, that such plans should (1) provide a definite formula for contributions, (2) grant all covered employees immediate vested rights to employer contributions, (3) not permit contributions on behalf of owner-managers to be lumped in one year through the carryover of unused deductions in prior years, and (4) provide that benefits to owner-managers are not to be paid before age 60, except in the case of earlier disability. None of these limitations is now required. To impose them only upon profit-sharing plans set up by owner-managed corporations would, again, result in unwarranted discrimination against small corporations.

In conclusion, I call to your attention the following statement made several years ago by the Senate Special Committee To Study Problems of American Small Business:

"It is the combined pressure of the income and estate tax structure which forces independent owners of businesses of this size to sell out to larger companies. The Treasury forces these mergers and the Federal Trade Commission complains about them and seeks to set up a legal barrier."

We submit that this statement has particular pertinence in light of the abovementioned limitations now being recommended by the Treasury. In our opinion these limitations would be both socially and economically unrealistic and unsound. Their enactment by Congress would single out small owner-managed corporations for discriminatory income tax treatment which would be adverse to the best interests of such corporations, their owner-managers, and their rank-and-file employees. We therefore urge that your committee reject these proposed limitations.

The CHAIRMAN. The next witness is Mr. Lindquist.

STATEMENT OF JOHN R. LINDQUIST, MEMBER OF THE LAW FIRM OF McDERMOTT, WILL & EMERY, CHICAGO, ILL.

Mr. LINDQUIST. Mr. Chairman, my name is John Lindquist. I am an attorney and member of the law firm of McDermott, Will & Emery. I have a prepared statement to file for the record.

I am not here as a representative of any small business federation, but rather as a representative of a substantial number of smaller corporate clients who have established qualified plans. At the same time, I have a very personal interest in the enactment of any legislation along the lines of H.R. 10, being a self-employed lawyer. I hasten to add that while I suffer from schizophrenia in appearing here, I am not dangerous.

I will direct my attention, however, to the provisions of H.R. 10 and how they would affect our smaller corporate clients. It is regrettable that a number of the committee members are not here to hear the other side of some of the points that have been raised. I refer specifically to the question of whether or not we should go far afield and permit the self-employed individuals who want to buy life insurance or sickness and accident insurance to have a similar tax benefit.

I think the practical answer is that it is already there. Congress has already acted in this area, in that it exempts the proceeds of such policies. The Internal Revenue Code does not permit a deduction to the individual who buys life insurance, but does exempt proceeds his widow receives. So we have merely a question of whether we want to permit the self-employed individual to deduct his premium and then tax the proceeds, or do as we are doing now. I think the latter course is the preferred one. The same also holds true of individual sickness and accident insurance.

We have other means, of course, also to assure that people can afford to buy life insurance. I think Mr. Goldstein mentioned that the statistics prove they are doing so.

I would like now to direct your attention to the specific purpose of the hearings, which was to consider the Treasury Department's alternative proposals to H.R. 10.

I don't think we can consider them properly without taking into account a number of things: First of all, what has Congress declared as its policy; second, the large number of small corporate businesses that would be affected by the proposals; third, the large number of people who are employed by such corporations; and fourth, some of the special operating problems which small business already encounters.

Taking those up in order, I would point out first, that it is the well-established policy of the Congress to encourage the establishment of retirement plans. Again, I can only say statistics prove it. We have section 401–404 of the Internal Revenue Code, which has been made use of, I understand now, by some 55,000 employers.

Secondly, it is the declared policy of Congress—and I would like to quote this:

> * * * that the Government should aid, counsel, assist, and protect, insofar as possible, the interest of small business concerns in order to preserve free competitive enterprise.

That is from title 15, chapter 14A, section 631 of the Small Business Act.

I would point out also that small business conducted in a corporate form constitutes a very important part of our economy. We understand—and there are no precise figures—that the Small Business Administration considers that there are approximately 4½ million small businesses conducted in one form or another—proprietorships, partnerships, and corporations. We also are informed that they feel that about 85 percent are of the proprietor type; that is, partnerships or sole proprietorships, but that the remaining 15 percent are corporations. That makes a figure of somewhere in the neighborhood of 675,000 small corporations in our country today. Those figures are borne out by figures which have been prepared by the Treasury Department. Statistics indicate that in 1956 more than 650,000 corporate income tax returns were filed by corporations having assets of less than $250,000. Other 1956 figures indicate that employers of less than 100 persons employ, in the aggregate, more than 15 million persons.

Available history shows that when we have had the restrictions on benefits which stockholder employees may receive (and I would state here that we should refer to them as stockholder employees rather than owner-managers—the latter is a new term in the trade), the policy of encouraging retirement plans has not been carried out.

In 1949 there were about 12,500 qualified plans in the country. Correcting my written statement, we now understand that there are about 55,000 qualified plans covering more than 18 million employees. In 10 years, a relatively short time, we have had that growth. Prior to 1949, one inhibition on the establishment of qualified plans was the fact that we had the 30 percent rule which has been discussed so frequently today.

Admittedly, since 1950, the growth was stimulated in part by the development of pension plans for industrial union employees through bargaining processes. However we have analyzed some figures in our own office, and we found that out of 193 plans, new ones, established since 1950, 90 were established by corporations which employed less than 100 persons. None of these were established as a result of collective bargaining.

I assure you, gentlemen, that virtually all of them came about for two reasons. There was a large surge of new plans when the 30-percent rule was held to be without statutory authority. Immediately many small employers said, "Now we can establish a plan." There now was no reason why they had to discriminate against themselves, as before. Since the 1954 code, and the elimination of a requirement of a definite formula in profit-sharing retirement plans, additional smaller employers felt they could now set up such plans.

I would like to emphasize that all of these plans first had to be for the benefit of employees generally. The eligibility for, and the benefits themselves, had to be nondiscriminatory. The stockholder-employees could participate only on the basis of the compensation for the services they rendered to the corporation. That compensation was, and is, subject to the test of reasonableness. While I agree that a test such as reasonableness could be hard to administer, I think if you examine the cases you would find that there have been a lot of them challenging reasonableness of salaries. In a lot of them the Treasury Department has been successful.

All the contributions under these plans had to be irrevocably dedicated to the exclusive benefit of the employees. None could come back to the employer. All such plans had to provide for full vesting in the event the employer terminated the plan, or went out of business. In fact, if you had a termination, the Treasury Department reserved the right to see whether or not there would be discrimination because of the termination. And if there was, the stockholder employee had one of two choices: He either would have retroactive disqualification of his plan and loss of tax deductions, or he had to waive the benefits he otherwise would have gotten under the plan and allow them to be reallocated to the other employees.

Small business has many inherent disadvantages in competing. Size itself is an inherent disadvantage. Nevertheless, small business has to compete for the services of individuals. In competing for those services, it can't, for both practical and legal reasons, offer many of the so-called fringe benefits that larger competitors can offer. It can't offer group life insurance in many instances. It can't offer stock option plans. It can't offer liberal sickness and accident plans and supplemental unemployment benefit plans. In fact, by statute in some States, it can't even participate in plans for unemployment compensation if it is too small.

For instance, in some States, I think in Wisconsin, six or more persons must be employed before coverage under unemployment compensation applies.

Fringes are important, and I think the best evidence of that fact is that organized labor has recognized how important they are. It also is evidenced by the fact that out of the total wage bills that employers throughout the country pay today, approximately 25 percent, on the average, is nondirect, and frequently tax free, compensation. This is what small business has to compete with.

A lot of people have done a lot to try to help small business compete in this area. Large financial institutions have tried to help small business solve the problem of investing its pension reserves by setting up common funds. The Treasury Department has recognized those funds as exempt. Insurance company requirements for the number of people who have to be covered under a group contract have come down.

I would like to direct your attenion now to the Treasury Department's specific proposals and hit the highlights of what we feel are the objectionable things about them in the context of what I have just said.

First, we have the 10 percent—$2,500 rule. It seems to me that, as a practical matter, what we are saying to the small businessman is: "Unless you want to discriminate against yourself, you are going to be limited to 10 percent of your compensation for benefits for your employers." I think it is almost axiomatic, human nature being what it is, that we are also saying to his employees, "You may have no more than 10 percent of compensation, or $2,500." In the meantime, the larger competitor rolls merrily along. He can contribute up to 25 percent of compensation under qualified plans for his employees. Right off the bat small business has a competitive disadvantage. The statistics in our office prove that when you have a limit on what the stockholder-employees gets, everybody else's benefits would be similarly limited. I submit that the stockholder-employee shouldn't be compelled to take less than his employees generally are allowed to have.

The Treasury proposals recognize this inherent inequity. The figures Mr. Schneider has given you demonstrate the unworkability and inequitability of the 10 percent—$2,500 rule.

To get around this the Treasury Department says to the small businessman: "You may have more if you will do certain things; namely, vest additional benefits in your employees." I should like to point out that vesting is a form of a benefit in a pension plan. It costs money. It is more expensive to vest people in pensions before retirement than it is to simply provide a naked retirement benefit for the employee who is lucky enough to live to 65.

What we are saying, in substance, to the smaller employer is; "You may have a qualified plan, and you may go beyond the 10 percent—$2,500 limit, but you have got to have a more expensive kind of pension plan."

As a matter of fact, gentlemen, it seems to me that vesting, which is a form of benefit, which is bargained for by unions, is something that should be left for bargaining. It should not be imposed by statute on anyone, let alone the small employer.

Finally, of course, one of the things that the smaller employer hopes to accomplish through his plan, as does the larger employer, is to have his employees stay with him—a stable labor force. What we are saying to the smaller employer is: "We won't let you achieve this benefit from your plan. Vesting tends to keep people with you if it is gradual. We won't let you have that competitive advantage. You must vest your people. Your man who has 5 years, or 3 years, or 2 years, may leave with impunity. It costs him nothing."

At the same time, the larger employer can continue to have gradual vesting, or perhaps even no vesting at all.

The next point I would like to direct your attention to is the question of elimination of integration with social security. I do not understand how the Treasury Department can propose that we shall eliminate the use of integration in pension plans for smaller employers, but we will not eliminate it for larger employers. Social security is a tax that the small employer pays at the same rate as the larger employer.

I suspect the Treasury Department wants to go into the whole question of integration itself, which is a nice, broad question, and couldn't possibly be considered in the time allowed for these hearings. It would take months of study. However, some important things ought to be brought to your attention about social security.

Based on some figures which we prepared, through December 31 of 1959, an employee covered under social security would have contributed a total of $1,146 of capital contributions in this tax. Carrying that forward with interest at 2½ percent, and compounding it annually from each year when made through December 31, 1959, it would have amounted to $1,410.99. His employer similarly would have contributed such an amount. For a person retiring under social security today, with a wife who is also 65, the total benefit is $178 per month. Actuaries inform me that this is worth approximately $26,000. How can we ignore $26,000 worth of benefits which small employers as well as large employers are compelled to provide?

I should like also to direct your attention to the Treasury Department's proposal as to flexibility of small profit-sharing retirement plans. I call it "inflexibility." Basically, the proposals provide: "We must require a smaller employer to have a definite formula for contributions under a profit-sharing plan. We must require immediate vesting in all cases of all employer contributions under a profit-sharing retirement plan. We propose not to let the small employer, who might be unable to contribute enough money this year to get up to the 10 percent, $2,500 limit, to carry forward the amount by which he fell short last year. He must not be permitted to average what the law otherwise would permit him to do."

I am sure this is not intended, but literal interpretation of one of the Treasury's statements in Mr. Scribner's letter is: "We will not let benefits be paid to the stockholder employee or his beneficiary until he attains the age of 60 or becomes disabled."

Does this mean we couldn't even pay it to his widow if he dies? I am sure it is not intended.

For all the reasons stated previously, you shouldn't impose these restrictions with respect to profit-sharing retirement plans on small business.

The whole purpose of H.R. 10 was to eliminate what many people feel is an inequity in today's tax structure. If I may graphically illustrate it, let's suppose that this is a large corporation [referring to objects on table] this is the small corporation, and this is the self-employed or partner. Today we are saying, there is discrimination as between the self-employed person and all corporate employees. H.R.

10 was designed to eliminate that discrimination or inequity. If it were enacted without any new restrictions on qualified plans, it would do so. It would narrow that discrimination.

What is being proposed instead is: "Let's take this small corporation and put it out here, and there will be no discrimination between it and the self-employed." However, a new inequity as between the small corporate employer and the large corporate employer will have been created in the process.

I submit that what H.R. 10, without any amendment, would do would be net progress. On the other hand, all that the Treasury Department's proposals, as applied to small corporations, would do would be to replace one inequity with a new one.

I recognize that I should have something affirmative to offer in lieu of all the things I criticize. It seems to me that the answer is simple. We have had the principle of encouraging private retirement plans since the income tax statute was enacted in 1913. I don't know of any violent abuses that have occurred. It seems to be working fine. Please leave it alone. The Treasury Department furnished us statistics yesterday only with respect to 82 corporations. We don't know what kind of a business they were engaged in. Those statistics were stated in terms of how much the contributions were in relation to the profits. No mention was made of whether the contributions were discriminatory. Presumably they were not. Yet there are thousands of plans in the country, and I don't think you can detect any general abuse of this privilege of saving some money for retirement, either among large corporations or small corporations. You won't have it if you permit it for the self-employed.

Thank you, gentlemen.

The CHAIRMAN. Thank you very much, Mr. Lindquist.

(Prepared statement of Mr. Lindquist follows:)

McDERMOTT, WILL & EMERY,
Chicago, May 10, 1960.

Hon. HARRY F. BYRD,
Chairman, Senate Finance Committee,
Washington, D.C.

DEAR SENATOR BYRD: As individuals, the members of this partnership engaged in the practice of law are vitally interested in the enactment into law of the principles of H.R. 10. Legislative proposals along this line have become perennial, as has the frustration of the millions of people interested in its enactment. Until very recently, except for considerations of loss of revenue, the administration supported legislation in this area in order to correct inequities which exist between the self-employed individuals and employees of corporate entities.

Anxious as million of persons may be for the long-awaited passage of H.R. 10, we are sure that most fairminded persons would agree that enactment of such legislation should not be brought about at the expense of small business operations. Surely, achievement of equity in one area should not beget inequity in aonther area. Yet, in substances, this is precisely the result that would be brought about if the Treasury Department proposals which are to be considered at the hearings of your committee on May 11 and May 12 are accepted by your committee.

BACKGROUND

The effect of the Treasury Department's proposals cannot be appraised properly without considering among other things:

(*a*) Congressional policy already declared in existing legislation;

(*b*) The large number of small corporate businesses which would be affected if the Treasury Department's proposals are enacted into law;

(*c*) The number of persons employed by such corporations; and

(d) The special problems already inherent in operating small businesses and the additional burdens which would be placed on such businesses through the adoption of the Treasury Department's proposals.

At the risk of repeating certain facts of which you and the other members of your committee may already be aware, your attention is respectfully directed to the following:

1. It is the well-established and declared policy of Congress to encourage employers to establish retirement plans for employees (i.e., secs. 401–404 of the Internal Revenue Code and their predecessor counterparts of the Internal Revenue Code of 1939).

2. It is also the declared policy of Congress that "* * * the Government should aid, counsel, assist and protect, insofar as possible, the interest of small business concerns in order to preserve free competitive enterprise * * *" (Small Business Act, title 15, ch. 14A, sec. 631, U.S.C.A.).

"Small business," conducted in the corporate form, comprises a substantial segment of our economy. We are reliably advised that the Small Business Administration considers "small business" to consist of 4,500,000 separate business entities of all kinds, of which about 15 percent, or 675,000, are conducted in the corporate form. We are further advised that all small businesses employ the efforts of nearly 30 million people. For general classification purposes, the Small Business Administration classifies a particular business as "small business" if it employe 500 persons or less. In this connection, it should be noted that in 1956, returns filed with the Social Security Administration indicated that there were a total of approximately million "employers" of less than 500 persons, which employing entities employed approximately 25 million persons. While the 3 million reporting employer units included partnerships, proprietorships, and corporations, in the same year more than 650,000 corporate income tax returns were filed by corporations having assets of less than $250,000.

4. Available history shows that restrictions on benefits which employee-stockholders may enjoy under qualified plans have a direct relationship to the rate of establishment of such plans. At the end of 1949, there were in the neighborhood of 12,500 qualified plans. It is estimated that today there are something in the neighborhood of 49,000 qualified plans. Interestingly, prior to 1950 a limitation on the benefits which could be provided under a qualified plan for persons owning more than 10 percent of the voting stock of a corporate employer was imposed by the Internal Revenue Service. That limitation was held to be without statutory authority in the Tax Court case of *Volkening, Inc.* (13TC, 723). Admittedly, some of the growth in new plans after 1950 was stimulated by collective bargaining on the question of pension benefits following the Supreme Court decision in the *Inland Steel* case and other causes. However, an examination of the number of new plans established since 1950 in which this law firm has had a part discloses that out of a total of 193 such plans, 90 were established by employers of less than 100 persons, and virtually all of these resulted from the elimination of restrictions on benefits for owner-employees and the relaxation of the definite formula requirement in profit-sharing plans, rather than as a result of collective bargaining processes. We think this experience of a single law firm is reflective of the fact that elimination of restrictions on shareholder employees has had a significant effect on the growth of the number of qualified plans since 1950.

It should be emphasized that all these plans had to meet the following requirements in order to qualify:

(a) They had to be for the benefit of employees generally;

(b) Both the eligibility for, and the amount of, benefits had to be nondiscriminatory as between any owner-managers who participated and other employees who were covered;

(c) The owner-managers could participate only on the basis of compensation for services, which compensation, including benefits under the plan, had to meet the test of "reasonableness" as determined by the Internal Revenue Service;

(d) All contributions under the plan had to be irrevocable;

(e) All plans had to provide for full vesting upon termination, and upon any termination the Internal Revenue Service reserved the right to reexamine the operation of the plan to ascertain whether or not any prohibited discrimination had resulted. If discrimination had resulted, the owner-managers either had to relinquish, for the benefit of other employees, any benefits provided for themselves which were found to be discriminatory, or face retroactive disqualification of the plan with its attendant consequences (including disallowance of income tax deductions).

5. Small business has belatedly recognized that it must compete in the marketplace with larger businesses for the services of individuals. In competing for such services, all small businesses operate under certain handicaps. For both practical and legal reasons, small businesses cannot offer prospective employees restricted stock option plans, jumbo group life insurance coverage, liberal sickness and accident plans, and supplemental unemployment benefit plans (to enumerate only a few fringe benefits which their larger competitors can offer). In many cases, those employers may be too small to be covered under State unemployment compensation statutes. That fringes of the type described are important in competing for the services of individuals is attested by the increasing interest on the part of organized labor in such benefits. Much effort has been spent in simplifying the establishment of qualified plans by small businesses. Large financial institutions have created common trust funds for the investment of the contributions of many small employers. The number of covered lives required in order to secure a contract insuring pension plans on a group basis has been gradually reduced. In some cases trade associations have established master plans which small business members could adopt, thereby reducing the legal, actuarial, and other fees for special services insofar as individual small businesses are concerned.

THE TREASURY DEPARTMENT'S PROPOSALS AND THE EFFECT THEREOF ON SMALL CORPORATE BUSINESSES

1. The 10 percent or $2,500 rule

In addition to meeting all of the requirements which all qualified plans must meet, annual contributions under a qualified pension plan on behalf of any stockholder-employee (presumably any stockholder who owns 10 percent or more of the voting stock of the corporate entity) would be limited to the lesser of 10 percent of compensation received by the stockholder-employee for his services to his employer in any year, or $2,500. Without any opportunity to exceed these limits, the small corporate entity immediately would be at a competitive disadvantage when compared with either the larger corporate entity, or the corporate entity which, unaffected by the 10 percent—$2,500 rule, can continue to offer prospective employees tax deferred income under qualified plans in amounts of up to 25 percent of compensation in each year. It is no answer to say that the 10 percent—$2,500 rule does not any way restrict what a small corporate employer may contribute on behalf of nonstockholder employees. While the typical small corporate stockholder-employee has no reason to ask that he be entitled to bigger benefits than the other employees, so long as he is employed in the business there is no good reason why his benefits should be limited to an amount less than those provided for the other employees. His annual compensation, including his pension benefits, always is subject to the test of "reasonableness," as far as income tax deductions are concerned. Any disallowed compensation is taxable to the owner as a dividend. As pointed out above, history demonstrates that establishment of qualified plans by small employers is seriously hampered when restrictions are placed on the benefits which stockholder-employees may enjoy. As a practical matter, we think that few small corporate businesses will establish plans providing benefits in excess of 10 percent of compensation if this is to be the limit on benefits to be received by stockholder-employees. As a matter of fact, this restriction, coupled with the inflexibility described in 4 below, probably will guarantee that many such employers will not establish any plans at all. The effect will be to penalize employees of small corporations as well as the owners thereof. This, of course, will be an additional competitive disadvantage for small businesses.

2. Vesting of benefits

Presumably in recognition of the inherent inequity of the 10 percent—$2,500 rule, the Treasury Department's proposals contemplate that the limits of that rule could be exceeded if the small corporate employer vests interests of other employees. Contributions on behalf of stockholder-employees under a pension plan could exceed the 10 percent—$2,500 rule either:

(*a*) to the extent of the largest annual deductible contribution vested in any covered employee who is not a stockholder; or

(*b*) to the extent they do not exceed 50 percent of the total contributions vested in all employees who are not stockholders.

Vesting of benefits, of course, is a large expense item in maintainig a plan. In effect, the Treasury Department's proposal tells the small corporate employer that he may have a plan, and he may avoid the limitations of the 10 percent—$2,500 rule if he wants to have a more expensive form of pension plan than larger employers are required by statute to have. Further, it is questionable whether "vesting," which is a bargainable issue, should be required by statute for any employer, let alone a small employer. Finally, one of the results hoped for by all employers in the establishment of qualified pension plans is reduction in turnover and an inducement for employees to stay with the particular employer. Part of this inducement consists of possible loss of accrued benefits, or a part thereof, if an employee does not choose to stay to retirement. If the price of benefits comparable to those which can be provided by large employers is to be vesting of those benefits in employees where a small employer is involved, the smaller employer will suffer a new competitive disadvantage.

3. Elimination of integration with social security

The Treasury Department proposes that where a plan is established by a small corporate entity and covers an employee-stockholder, the plan should not be permitted to take into account, either for purposes of eligibility or the amount of benefits, the retirement benefits provided for all employees under the Social Security Act, as amended. Presumably, integration of private plans with social security would be allowed to be continued where larger corporate employers are involved. Insofar as the smaller corporate employer is concerned, the tax rate for social security benefits which he pays is precisely the same as that of the larger entity. The same is true of the tax rate paid by the employee of the smaller employer, as compared with the larger employer. To state that one type of entity would be allowed to continue to take credit for benefits provided under social security, while another would not, is clearly discriminatory against the latter.

The Treasury Department also proposes that, having taken away the privilege of integrating plans of small employers with social security, the committee might want to consider the granting of such privilege at a later date under uniform rules of integration applicable to all employers. A suggested approach is that all employers be allowed to take credit under the integration rules for only the amount of the employer's social security contributions on behalf of employees. The committee should be aware of the fact that an employee covered under the Social Security Act since its inception and earning compensation of the maximum amount taken into account for social security purposes would have contributed through the end of 1959 only a total of $1,146, and that his total contributions each year since 1937, accumulated at the rate of 2½ percent interest, compounded annually, would have amounted to only $1,410.99. For a retiring employee whose spouse is also 65, social security benefits of $178 per month are payable during 1960, the value of which at retirement would require a capital sum of $26,594. While it is true that the employer of such an individual would have similarly laid out $1,146 on behalf of that particular individual, he will also have laid out taxes at the current rates in effect from time to time for all persons who worked for him, whether they chose to make a career of working for him or spent only a brief period of time with him. In this connection, it should also be brought to the committee's attention that conservative withdrawal tables indicate that out of every group of 100 employees who are working for a particular employer at age 20 years, only 15 of them will still be working for that same employer at attainment of age 50. Out of the remaining 85, 5 will have died and 80 will have resigned or been dismissed. Nevertheless, while they worked for him, the employer will have contributed on behalf of such employees, at current tax rates, under the social security system. In integrating pension plans with social security, until 1954 the employer was credited by the Treasury Department with the cost of fifteen-sixteenths of the employee's social security benefits, and the employee was credited with one-sixteenth. Starting in 1954, the ratios were reduced to four-fifths and one-fifth, respectively. Presumably this was done to reflect the increased earnings base to which the taxes applied and the increased rates payable by the employee (which increased rates also were payable by the employer). However, the liberalization of benefits, such as early retirement privileges for females, the introduction of disability benefits, the 5-year dropout of years during which no compensation was earned, etc., more than offset the increased rates payable by employees. In the meantime, of course, employers continued to pay the increased taxes with respect to the covered wages of all employees, regardless of whether they stayed with the particular employer until retirement. If there be any sentiment in the committee toward a change in the rules for integration, it would appear that the weight presently attributed by the Treasury Department to employee contributions under the social security system should be reduced.

4. *The Treasury Department's proposals with respect to "flexibility" of plans maintained by small corporate entities*

With specific reference to profit-sharing retirement plans (which are perhaps the most frequently utilized plans where small employers are involved), further limitations applicable presumably only to small corporate employers and the self-employed would be as follows:

(*a*) A definite formula for contributions would be required;

(*b*) Immediate full vesting of employer contributions in nonstockholder employees would be required;

(*c*) Carryovers of unused allowances (presumably the amounts by which benefits for the stockholder-employee fell below the limits otherwise described above) would not be permitted; and

(*d*) Benefits payable to a stockholder-employee presumably would have to be withheld from him until attainment of age 60 years, other than in the case of an early disability. (NOTE.—While we are certain it was not intended, a literal interpretation of the Treasury Department's proposals would require that limited benefits otherwise payable to stockholder-employees could not be paid even upon death while employed, but rather would have to be deferred for some time after death.)

For all of the reasons pointed out earlier, imposition of the foregoing requirements only on plans maintained by smaller corporate entities is both unwarranted and unfair. For instance, perhaps more so than the larger corporate entities, the small corporate entity needs the flexibility of contributions afforded since 1954 under qualified profit-sharing retirement plans. Lack of readily available capital to meet current needs of the business and to enable continued growth is one of the chief problems encountered by small businesses. Congress itself has recognized this fact through the passage of the Small Business Investment Act of 1958. Demands for capital in such businesses frequently are sudden and unanticipated. For this reason such businesses can ill afford to commit themselves to a predetermined portion of a single year's profits under a profit-sharing plan. Accordingly, a degree of flexibility as to when contributions must be made and the amount thereof is essential to such businesses. Requiring such employers to have a formula undoubtedly would further inhibit the establishment of such plans by small businesses. Again, experience proves that the dispensation of the definite formula requirement since 1954 (which requirement, incidentally, was never imposed by Congress but rather by Treasury Department regulations), smaller corporate entities have been more favorably inclined to adoption of qualified plans covering not only the owner-managers, but also most, if not all, other employees.

CONCLUSION

Even under present law a substantial number of small employers probably will not adopt qualified plans, primarily because of the complexities of the present law, the necessity for filing annual reports with respect to the plan with the Treasury Department under the Federal Disclosure Act and under State disclosure acts, the additional accounting problems involved in maintaining a plan and satisfying reporting requirements, and other complexities already inherent in a qualified plan. The adoption of the Treasury Department's proposals will further complicate an already complex law, and make it impossible for the average layman, or even the average lawyer, to determine precisely whether a particular plan comes within the law and its permissible limits. Additional complexities seem wholly unnecessary in order to achieve the objectives of H.R. 10 and of the Treasury Department's proposals.

A simple solution in all cases would be the adoption of H.R. 10 with a provision for extending its benefits not only to the self-employed but also to any employee whose employer does not have a qualified plan. The loss of revenue under this alternative should be no greater than under the Treasury Department's proposals. This alternative would be simple to administer and understand and would be equitable to everyone concerned.

We strongly urge that the present law, applicable to both large and small corporate employers alike, not be disturbed. Admittedly, it is not a simple law.

In fact, many attorneys and their clients are only now beginning to be familiar with the law and its pitfalls. To inject new and additional complexities into the law is wholly unnecessary.

The principle of encouragement of private retirement systems has been in the income tax law since its adoption nearly 50 years ago. It has worked well, and its continuance should make unnecessary, or in any case minimize, repeated increases in social security, and should relieve the many pressures for forms of Government benefits for those in need.

It should also be pointed out that because of the fact that when a pension plan is adopted, past service benefits must be funded and contributions under such plans therefore tend to be substantially greater in the earlier years of the plan than in subsequent years. If statistics were available, we think it would be found to be true that the peak of contributions has been reached in the past few years, and that contributions under such plans will tend to level out or decline as the past service liabilities under existing plans become funded. Declining contributions under these plans should mean increased revenues which, to a substantial degree, should offset any loss of revenue that might be engendered by H.R. 10 if it is adopted with the modifications which we have suggested above. Even though enactment of H.R. 10 without the adoption of the Treasury Department's proposals (and with or without the additional modifications we have suggested above) would still leave some inequities between self-employed individuals and employees not covered by qualified plans on the one hand and stockholder-employees of corporate entities on the other hand, a long step will have been taken toward the reduction of such inequities without the creation of new inequities as between small corporations and larger corporations. This would constitute "net progress." The same cannot be said if the Treasury Department's proposals are adopted.

Respectfully submitted.

McDermott, Will & Emery.

The Chairman. Mr. Leonard Ackermann.

The Chair is very reluctant to state that we will have to adjourn at 1:30. I would appreciate it if some of the statements can be inserted in the record instead of being read. They will receive full consideration.

STATEMENT OF LEONARD E. ACKERMANN, ATTORNEY, OF WENCHEL, SCHULMAN & MANNING, WASHINGTON, D.C.

Mr. Ackermann. I would like to thank the committee for appearing here today, and I shall try to be brief.

I will not read any statement, therefore, but just talk about a few examples.

(Prepared statement of Mr. Ackermann follows:)

Statement by Leonard E. Ackermann

My name is Leonard E. Ackermann. I am an attorney at law and a partner in Wenchel, Schulman & Manning of Washington, D.C. My appearance here today is not on behalf of any particular client but as an attorney who has had considerable experience in working on profit-sharing plans for both small and large corporations.

My purpose in making this statement is to express my deep conviction that certain of the Treasury proposals now under consideration would qualify discriminate against many small corporations and would be decidedly contrary to the public policy of encouraging small business. In particular, I am convinced that the proposals put forth by the Treasury to prevent undue benefits from accruing to owner-managers of small corporations would have most unfortunate side effects not visualized by the Treasury.

I refer to the Treasury proposals which would place limitations on the contributions made on behalf of owner-managers of corporations. In brief, such a contribution would be limited to 10 percent of a stockholder's earned income or $2,500, whichever is less. As an alternative, the Treasury would permit a contribution in behalf of all owner-managers limited to one-half of the amount which is contributed for all employees who are not owners (or members of the immediate families of owners).

In listening to the testimony presented by Mr. David A. Lindsay, General Counsel of the Treasury Department, I was particularly impressed by one fact: Virtually every example used by Mr. Lindsay to illustrate possible undue benefits accruing to owner-managers of corporations involved firms with only one stockholder and few, if any, other employees. However, the simple truth is the proposal presented by the Treasury would tend to work to the advantage of single owner corporations in contrast to companies having several owner-managers.

Let me cite a hypothetical example which is a composite of several cases with which I am familiar.

A corporation, which I will refer to as the Smith Engineering Corp., a small electronics manufacturing concern, was started by one man who at the outset was the sole stockholder. After the corporation had been operated for some time, Mr. Smith decided to adopt a profit-sharing plan. This was a nondiscriminatory, fully vested plan which satisfied all the requirements of the Internal Revenue Code.

At that time, in addition to Mr. Smith, the corporation employed four highly trained engineers and a number of other employees who handled mechanical, clerical, and other nonprofessional work. The payroll was then the following:

Smith		$30,000
Engineer A	$22,000	
Engineer B	20,000	
Engineer C	20,000	
Engineer D	18,000	
Other employees	50,000	
		130,000

Had the Treasury proposal been in effect at the time the plan was adopted, under the alternative limitation 15 percent of all salaries could have been contributed to the profit-sharing trust on behalf of Mr. Smith, as well as all other employees.

A few years passed, and the corporation continued to grow. The salaries of the top employees were increased, but even so, Smith Engineering Corp. began to feel the pressure of larger corporations which constantly are seeking highly trained engineers. These corporations not only could offer high salaries but could also provide such other inducements as stock purchase arrangements and other benefits, in addition to a pension or profit-sharing plan.

Therefore, in an effort not only to keep his most important employees but also to provide greater incentive for them, Smith decided to permit each of the top four men to purchase at fair market value at 10-percent stock interest in the business. At this time, the salaries paid were the following:

Smith	$50,000
A	36,000
B	34,000
C	32,000
D	28,000
Total stockholder-employees	180,000
Other employees	90,000

The effect of the proposed Treasury rule in this situation is quite clear. Under the Treasury proposal, each stockholder's allocation would have been limited to $2,500. The alternative limitation would have produced even a smaller figure.

The point I wish to emphasize is that if the stock had not been sold to the four employees, the alternative proposal would have permitted all employees, including Smith, to receive full allocation. The salaries of nonstockholder employees would have totaled $210,000 and the salary of the owner-manager was $50,000. Assuming that the profit-sharing contributions were based on 15 percent of salary, the set-aside would have been as follows (in contrast to the

$2,500 amount which the Treasury proposal would allow to them in their capacity as stockholders):

Smith	$7,500
A	5,400
B	5,100
C	4,800
D	4,200

In other words, under the Treasury proposal, so long as Smith held all the stock himself, he and all other employees could share proportionately in the benefits of a profit-sharing plan. But this would not hold true if Smith permitted other employees to own stock.

In the circumstances cited, Smith and his topflight employees would all have suffered by the sale of the stock, and it seems likely that the engineers simply would have left Smith to join some larger company not subject to the highly artificial type of restriction which the Treasury seeks to impose.

As seen by the above, the rule proposed by the Treasury would favor large corporations against small corporations—and in addition, would frequently favor single ownership, as compared with multiple ownership, of a small company's stock. Whether or not the proposed Treasury limitations would apply may depend on factors having nothing whatever to do with the basic fairness or other nondiscriminatory features of a particular plan.

Surely, it does not seem right that the Congress should approve a proposal which would discriminate against a corporation of the type above mentioned or which would discourage the type of program which it adopted, a program which permitted competent employees to share in the growth of their company through equity ownership and which helped their company to grow and prosper.

I wish to emphasize that the above example, though hypothetical, is a typical case and not at all unusual. Under the proposed limitation, many small, aggressive, farsighted companies, of the type that the Congress should most encourage, would be forced to curtail the benefits and incentives offered their key personnel, with the result that the future of these concerns would be placed in grave danger.

Such results are both unwarranted and unnecessary to meet the possible abuses cited by Mr. Lindsay, virtually all of which centered around corporations with only one owner-manager. Indeed, if the committee believes that action is advisable to minimize these possible abuses, the corrective legislation should be limited to that particular problem.

To accomplish this, I suggest consideration of an amendment whereby the 10 percent-$2,500 limitation on pension and profit-sharing contributions would be applied only to cases where the contribution on behalf of any single owner-manager amounts to more than 50 percent of the total contribution made on behalf of all nonowner employees. The difference between this proposal and the Treasury proposal is that the Treasury suggestion would lump together the contributions made on behalf of all owner-managers and apply the 50 percent test to the group total, whereas I am suggesting that the test be applied on the basis of the contribution made on behalf of each individual owner-manager.

In my opinion, this suggestion would eliminate the abuses criticized by the Treasury, but it would permit small businesses to diversify their ownership, encourage their talented personnel to share in the risks and benefits of corporate ownership without penalty, and thereby add to the growth and health of these valuable smaller firms.

I wish to point out, gentlemen, that even without any amendment there are already rules on the books which prevent abuse. Pension and profit-sharing plans are examined by the Internal Revenue Service which must be satisfied that they do not discriminate in favor of officers, shareholders, or other key employees. Furthermore, the salaries paid to stockholders, particularly in closely held corporations, are periodically checked and are disallowed when found to be excessive. This also acts as a curb on excessive allocations to stockholder-employees.

These powers provide Treasury with flexible tools. They permit the disapproval of plans where rejection is necessary, but they also enable Treasury to approve plans where approval is justified.

In my opinion, therefore, additional legislation relative to corporate pension plans actually is not needed. Certainly the Treasury proposals as presented should be rejected. The Treasury plan would favor the big companies against little companies. Even among small companies, the Treasury proposal in effect would favor single ownership companies over companies having several stockholder-employees. The Treasury proposals are definitely discriminatory.

If the committee believes that further limitations are needed to prevent abuses, clearly the legislation should be pinpointed at the abuses along the lines of my suggestion. In so doing, Congress would be assuring the preservation of the same basic standards which are fair and equitable for all corporations, both large and small.

Mr. ACKERMANN. Mr. Lindquist has made a good deal of my case for me. But I wanted to point out that there are situations of the type that Mr. Lindsay referred to as the owner-manager group which are quite different from many small corporations. Virtually every example used by Mr. Lindsay to illustrate possible undue benefits accruing on owner-managers involve firms with only one stockholder and few, if any, other employees.

Now, in our experience we have run into some small corporations which started out with one stockholder and few employees, but then they took on some more. And we have got together a hypothetical example which is a composite of several cases with which we are familiar. The corporation which I will refer to as the Smith Engineering Corp., a small electronics manufacturing concern, which was started by one man who at the outset was the sole stockholder. After the corporation had been operating for some time, Mr. Smith decided to adopt the profit-sharing plan. This was a nondiscriminatory, fully vested plan which satisfied all the requirements of the Internal Revenue Code.

At that time, in addition to Mr. Smith, the corporation employed four highly trained engineers and a number of other nonprofessional employees. At that point Mr. Smith had a salary of $30,000, the four engineers had salaries ranging between $21,000 and $22,000, and the other employees had salaries of $15,000.

So that we had the owner-manager with a salary $30,000 and salaries for the other employees of $130,000. There would be no problem under the proposed Treasury limitation in that respect. However, a few years passed and the corporation continued to grow.

The salaries of the top employees were increased; but even so, Smith Engineering Corp. began to feel the pressure of larger corporations which constantly are seeking highly trained engineers. These corporations not only could offer high salaries, but could also provide such other inducements as stock-purchase arrangements and other benefits, in addition to a pension or profit-sharing plan.

Therefore, in an effort not only to keep his most important employees, but also to provide greater incentive for them, Smith decided to permit each of the top four men to purchase at fair market value a 10-percent stock interest in the business. At this time Smith was making $50,000, his four other employees were making salaries ranging between $28,000 or $36,000 a year, or a total of $180,000 for the now stockholder employees, while the other employees were receiving $90,000.

The effect of the proposed Treasury rule in this situation is quite clear. Under the Treasury proposal, each stockholder's allocation would have been limited to $2,500. The alternative limitation would have produced even a smaller figure.

The point I wish to emphasize is that if the stock had not been sold to the four employees, the alternative proposal would have permitted all employees, including Smith, to receive a full allocation. The salaries of nonstockholder employees would have totaled $210,000 and the salary of the owner-manager was $50,000. Assuming that the profit sharing contributions were based on 15 percent of salary, the set-aside would have been as follows, in contrast to the $2,500 amount which the Treasury proposal would allow to them in their capacity as stockholders.

Smith would have received $7,500, and the other amounts varying between $4,200 and $5,400, again as compared with $2,500.

In other words, under the Treasury proposal, so long as Smith held all the stock himself, he and all other employees could share proportionately in the benefits of a profit-sharing plan. But this would not hold true if Smith permitted other employees to own stock.

In the circumstances cited, Smith and his topflight employees would all have suffered by the sale of the stock, and it seems likely that the engineers simply would have left Smith to join some larger company not subject to the highly artificial type of restriction which the Treasury seeks to impose.

As seen by the above, the rule proposed by the Treasury would favor large corporations against small corporations, and in addition, would frequently favor single ownership, as compared with multiple ownership, of a small commany's stock. Whether or not the proposed Treasury limitations would apply may depend on factors having nothing whatever to do with the basic fairness or other nondiscriminatory features of a particular plan.

Surely it does not seem right that the Congress should approve a proposal which would discriminate against a corporation of the type above mentioned or which would discourage the type of program which it adopted, a program which permitted competent employees to share in the growth of their company through equity ownership and which helped their country to grow and prosper.

I wish to emphasize that the above example, though hypothetical, is a typical case and not at all unusual. Under the proposed limitation, many aggressive, farsighted companies, of the type that the Congress should most encourage, would be forced to curtail the benefits and incentives offered their key personnel, with the result that the future of these concerns would be placed in grave danger.

Such results are both unwarranted and unnecessary.

As other people have shown, there are many rules on the books which permit the Treasury to examine and to examine carefully—and they do it—to see that there is no discrimination, that these plans are not adopted for the benefit of merely the owners. The plans must be for employees generally, and the Treasury, I think, has done a very good job in doing that.

In my opinion, therefore, additional legislation relative to corporate plans is not needed. However, if the Treasury feels that there is some such limitation, I suggest consideration of an amendment whereby the 10 percent, $2,500 limitation on pension and profit-sharing contributions would be applied only to cases where the contribution on behalf of any single owner-manager amounts to more than 50 percent of the total contribution made on behalf of all nonowner employees.

The difference between this proposal and the Treasury proposal is that the Treasury's suggestion would lump together the contributions made on behalf of all owner-managers and apply a 50 percent test to the group total, whereas I am suggesting that the test be applied on the basis of the contribution made on behalf of each individual owner-manager.

This should take care of the type of case that the Treasury cited so often in its presentation, the case where there is one owner-manager and one or maybe two employees.

Thank you.

The CHAIRMAN. Thank you.

The next witness is Mr. J. H. Lackey, of the W. H. McCoy Co., Detroit.

STATEMENT OF JOSEPH H. LACKEY, OF THE WILLIAM H. McCOY CO., EMPLOYEE BENEFIT PLAN CONSULTANTS, DETROIT, MICH.

Mr. LACKEY. Thank you for the opportunity to appear. I shall try to be brief, because I know a number of my points have been covered by the preceding witnesses.

I am appearing here as a partner in the William H. McCoy Co., employee benefit plan consultants, Detroit, Mich., and as an attorney at law enrolled to practice before the Treasury Department.

Our firm specializes in the design and administration of section 401 corporate pension and profit-sharing plans, principally for small corporations and for the salaried employees of those corporations, who, of course, include their owner-managers. As such, we represent the interests of a number of small businesses.

We do not feel that H.R. 10 should be used as a vehicle for the restrictions and revisions proposed by the Treasury in the section 401 corporate pension field, since in general we feel that there are adequate restrictions and safeguards in the present law and regulations.

In two or three instances, as we well know, further restrictions have been suggested that we feel, as did many of the other witnesses, would seriously deter the establishment of corporate pension plans by small businesses, consequently depriving the employees of such corporations of pension benefits.

Now, items 1, 4, 5, 6, 7, and 8 in the Treasury's proposal would not substantially affect section 401 corporate pensions in our judgment, since the restrictions cited therein are generally inherent in the present law, regulations, and rulings.

Most of my remarks will be confined to item 2, which recommends a limit on employer pension contributions of 10 percent of salary up to $2,500 per year. I have an example that is very similar to one used by a previous witness that assumes a pension benefit of 30 percent of salary under a retirement annuity contract purchased at ages 30 through 55. My assumed annuity contract does not provide for the payment of pension benefits for any period certain after retirement, nor does it provide any life insurance protection prior to retirement.

In this example, we find that under the proposed 10-percent rule a person must be less than 40 years of age to have purchased for him an annuity contract providing a pension of 30 percent of salary at age 65.

May I ask Mr. Bennett if that was what he was interested in with the prior witness, namely, eliminating any period certain feature and the insurance element?

Senator BENNETT. Yes, because it is obvious that a man who retires on an ordinary pension does not have any 10-year certain program for his survivors.

Mr. LACKEY. Would this type of example suffice to give you the information that you were interested in having the previous witness supply?

Senator BENNETT. Well, I would not like to say it would, but offhand I would say it would.

Mr. LACKEY. To repeat, we find in this example that the corporate owner-manager would have to be less than 40 years of age to have purchased for him an annuity providing a 30-percent-of-salary pension benefit. Now, if his salary were twice as much or $30,000 a year, the limitation on the employer contribution would be $2,500 a year, an amount that would provide a pension benefit of 30 percent of salary only if he were 35 years of age or less when the annuity was issued.

I think that this example indicates the unrealistic approach to providing a basic limit on contributions, when we consider the actual cost of providing pension benefits, and I believe that no one can say that 30 percent is an excessive pension benefit.

I am not even going to comment on item No. 2(b), because I understand that the Treasury also has rejected that as probably unworkable.

I, too, have an example here with regard to the so-called 33⅓ percent rule, and here again we are using nonparticipating retirement annuity policies with no insurance protection prior to retirement and no provision for payment of benefits for any period certain after retirement. This is one of the simplest possible ways of financing pension benefits. In this particular example, where there are nine employees, two of whom are stockholders, we find that in order to provide a 30 percent pension benefit, it takes 62.3 percent of the total premiums for stockholders A and B to provide them with the same 30 percent pension benefit that their other salaried employees would get.

Now, with an artificial 33⅓ percent rule, A's benefit would have to be reduced to $181.50 a month and B's to $136.13, a reduction to a pension of just 9.1 percent of their salaries, while their employees would still get 30 percent.

If the 33⅓ percent rule were increased to 50 percent so that the stockholders could get as much as the other employees, the pension benefits for A and B still would be increased only to 18.2 percent of salary, or just a little more than 60 percent of the relative benefits available to their other employees.

Now, we think it is apparent that the 33⅓ percent rule, standing by itself, would probably deter such a company from ever establishing a plan. But if we revert to the basic $2,500-10 percent rule, would the situation be much improved? Not appreciably.

A's permissible percentage would rise to 14.4 percent of salary as his pension benefit, and B's to 20.6 percent, both in comparison to the 30 percent that they were providing their other employees. It is more than likely that the employees who are not corporate owner-managers would also suffer in the final analysis, either by a lowering of their own benefits through a reduced pension formula, or by having to forego a pension plan completely.

Thus we have attempted to show that to legislate percentages such as this can lead to such distortion that it would be a deterrent to the establishment of plans by small corporations. There would be no problem for larger corporations. Thus this would be a discrimination against small businesses.

Now, as one of the other witnesses has said, a review of the history of the growth of corporate pension plans will show that the period of greatest growth among such plans has occurred in the last decade, after the revocation of the Treasury's former 30 percent rule.

In the interest of time I will eliminate commenting on item 2(d), because that has been covered in somewhat the same way by prior witnesses.

Just a few words about items 3 and 9. We think that integration with social security presents special problems as it relates to the self-employed. However, the present social security integration regulations provide adequately for nondiscriminatory treatment as it concerns corporate owner-managers and their employees. To promote further undue restrictions on small corporations in the establishment of integrated pension plans would be a deterrent to the setting up of such plans. Integration with social security has made it financially possible for many small corporations to establish pension plans they otherwise could not afford.

With reference to the provisions of item 9 of the Treasury's proposal dealing with profit-sharing plans, here again we see an example of further restrictions that could be a deterrent to the establishment of such plans by small corporations.

In conclusion, gentlemen, I would like to reiterate the premise upon which this testimony is based, namely, that the Treasury proposals, if enacted as legislation, would provide a number of serious obstacles to the management of small corporations desirous of establishing section 401 corporate pension plans, not to mention the many problems inherent in such gradual conformity as might be required of existing plans. We feel that such discrimination against small businesses would not seem to be in the public interest, and that it is beyond the scope of a bill dealing with the retirement problems of the self-employed to attempt to impose the restrictions and revisions recommended by the Treasury in the corporate pension field.

Thank you.

The CHAIRMAN. Thank you very much, Mr. Lackey.

(Prepared statement of Mr. Lackey follows:)

STATEMENT BY JOSEPH H. LACKEY, C.L.U., PARTNER, WILLIAM H. McCOY CO., EMPLOYEE BENEFIT PLAN CONSULTANTS, DETROIT, MICH.

Subject: That part of the Treasury alternate to H.R. 10 which proposes amending existing law by limiting benefits covering owner-managers of corporations.

Gentlemen, your witness appears before you as a partner in the William H. McCoy Co., employee benefit plan consultants, Detroit, Mich., and as an attorney at law enrolled to practice before the Treasury Department. Our first specializes in the design and administration of section 401 corporate pension and profit-sharing plans, principally for small corporations and for the salaried employees of those corporations, which, of course, include their owner-managers. As such, we represent the interests of a number of small businesses.

We do not feel that H.R. 10 should be used as a vehicle for the suggested restrictions and revisions in the 401 corporate pension field. We do feel there are adequate restrictions and safeguards in the present law and regulations pertaining to 401 corporate pension plans. But in two or three instances, further restrictions have been suggested that would seriously deter the establishment of corporate pension plans by small businesses, thus depriving the employees to be covered by such plans of pension benefits.

Items 1, 4, 5, 6, 7, and 8 would not substantially affect 401 corporate pensions since the restrictions suggested therein are generally inherent in the present law, regulations, and other rulings pertaining to the corporate pension field. While their enactment into a bill for the self-employed would put the latter on a par with corporate owner-managers, I shall reserve comment on their applicability to the self-employed, without implying they are not applicable to them.

Item 2: (Most of my remarks will be confined to this important item.) The limits on contributions suggested herein for stockholder-employees would be a serious deterrent to the establishment of corporate pension plans by small businesses. It is admitted in the Treasury's letter that: "Moreover, while the estimates are difficult to make at this time, as noted below, applying these limitations to pension contributions on behalf of stockholder-employees would over the years provide some offset to the cost of extending similar pension coverage to self-employed people."

Appropriate limitations are suggested as follows:

"(*a*) A basic employer contribution on behalf of each self-employed individual or corporate owner-manager would be permitted, amounting to 10 percent of earned income, or $2,500, whichever is less. Such contributions, however, could not be discriminatory in favor of the owners as compared with employees."

Are there realistic limitations? Let us examine the cost of providing a pension benefit of 30 percent of salary at various ages, assuming, for purposes of simplicity, the use of a nonparticipating retirement annuity at 65 policy:

Age	Annual salary	Annual pension benefit	Annual premium	Premium as a percent of salary
30	$15,000 ($1,250 per month)	$4,500 ($375 per month)	$993.75	6.6
35	do	do	1,250.25	8.3
40	do	do	1,618.13	10.8
45	do	do	2,182.13	14.5
50	do	do	3,135.00	20.9
55	do	do	5,088.75	33.9

Under the above example, the corporate owner-manager would have to be less than 40 years of age to have purchased for him a pension of 30 percent of salary, since the maximum contribution for his benefit would be 10 percent of his salary of $15,000, or $1,500. If his salary were twice as much, or $30,000 a year, the limitation would be $2,500 a year, an amount that would provide a benefit of 30 percent of salary only if he were 35 years of age or less.

Thus, we can see how unrealistic is the basic limit on contributions approach, when we consider the actual cost of providing pension benefits. Certainly no one can say that 30 percent is an excessive benefit.

"(*b*) Nevertheless, nondiscriminatory contributions on behalf of self-employed individuals and corporate owner-managers would be permitted to exceed this basic amount under certain conditions where there are substantial contributions made on behalf of other employees. Regardless of the 10 percent-$2,500 limit, pension contributions on behalf of each self-employed individual or owner-manager of a corporation could be as much as the largest annual deductible contribution vested in any covered employee who is neither an owner nor a close relative of an owner."

This is an unrealistic approach because in a small corporation, it is unlikely that there would be another covered employee who is neither an owner nor a close relative of an owner who would have sufficiently high compensation to match those of a stockholder-employee or relative. A hired manager, someone usually characteristic of big business, would be the only one likely to meet this requirement, thus permitting adequate contributions for those persons responsible for the success of the business.

"(c) Moreover, there would be no special limitation on nondiscriminatory contributions for self-employed persons and corporate owner-managers if the total amount of such contributions did not exceed one-half of the total annual deductible contributions vested in all employees who are neither owners nor close relatives of an owner."

Herein, the Treasury suggests a limitation roughly similar to the so-called 30-percent rule, but with the limitation increased to 33⅓ percent. We have seen under (a) and (b) above, the impracticality of the limits on contributions approach. Here the possibilities for distortion are substantial. Consider the following example (here we are also assuming the use of nonparticipating retirement annuity at 65 policies):

Salaried employee	Age	Monthly salary	Monthly pension benefit at 30 percent of salary	Annual premium
Stockholder A	50	$2,000	$600	$5,016.00
Stockholder B	45	1,500	450	2,618.55
Plant manager	40	1,000	300	1,294.50
Office manager	35	700	210	700.14
Salesman C	40	800	240	1,035.60
Salesman D	35	650	195	650.13
Secretary E (female)	35	400	120	464.16
Secretary F (female)	30	300	90	276.21
Stock clerk	30	250	75	198.75
Total				12,254.04

The percentage for the two shareholders under this completely nondiscriminatory plan is 62.3 percent. Even if there were no stockholder B, it would take 52.1 percent of total contributions to provide stockholder A with the same benefit as his other salaried employees get. With an artificial 33⅓ percent rule, A's benefit would have to be reduced to $181.50 per month and B's to $136.13, a reduction to a pension of just 9.1 percent of their salaries, while their employees get 30 percent!

(Even if the 33⅓ percent rule were increased to 50 percent, the permissible percentage in the above example for A and B would still be only 18.2 percent, a benefit of just a little more than 60 percent of that available to their other employees.)

It is apparent that the 33⅓ percent rule standing by itself would probably deter such a company from ever establishing such a plan. But if we revert to the basic $2,500—10 percent rule, will the situation be much improved? Not appreciably—A's permissible percentage rises to 14.4 percent of salary as his pension benefit, B's, to 20.6 percent, both in comparison to the 30 percent they are providing their other employees. It is more than likely that the employees who are not corporate owner-managers will suffer, either by a lowering of their own benefits or having to forgo a pension plan completely.

Thus it can be seen that any attempt to legislate percentages can lead to such distortion that it will be a deterrent to the establishment of such plans by small corporations. There would be no problem for larger corporations. Thus, such a suggestion discriminates against small businesses. A review of the history of the growth of corporate pension plans will show that the period of greatest growth among such plans for small corporations has occurred in the last decade—after the revocation of the 30 percent rule.

"(d) Individuals should not be permitted to arrange to increase the allowable amounts that can be contributed on their behalf to qualified pension plans merely because they split their activities into several businesses."

If an individual contributes to the success of several businesses and draws salaries from each of them, it would seem he ought to be able to participate in their respective pension plans, to the extent of his compensation from each.

The Treasury suggests a requirement for vested rights for employees if contributions made on behalf of a self-employed individual or an owner-manager of a corporation could exceed 10 percent of his earned income or $2,500 a year.

While not suggesting that vested rights should not be included, it is well to reflect upon the advisability of legislating the degree of vesting.

Just a few words about items 3 and 9:

Item 3. Integration with social security presents special problems as it relates to the self-employed. The present social security integration regulations provide adequately for nondiscriminatory treatment as it concerns corporate owner-managers and their employees and to promote further undue restrictions in the establishment of integrated pension plans for small corporations would be a deterrent to the setting up of such plans. Integration with social security has made it financially possible for many small corporations to establish pension plans it otherwise could not afford.

Item 9. Here the Treasury Department is suggesting certain restrictions in connection with the establishment of profit-sharing plans for self-employed individuals be extended to corporate owner-managers. Here again we see an example of discrimination against small corporations, since none of the restrictions are now required.

In conclusion, gentlemen, I would like to reiterate the premise upon which this testimony is based, namely that the Treasury's proposals, if adopted into legislation, would provide a number of serious obstacles to the management of many small corporations desirous of establishing 401 corporate pension plans, not to mention the many problems inherent in such gradual conformance as might be required of existing plans. Such discrimination against small businesses would not seem to be in the public interest. We feel that it is beyond the scope of a retirement bill for the self-employed to attempt to use it as a vehicle for the suggested restrictions and revisions in the corporate pension field.

The CHAIRMAN. The next witnesss is Mr. Marcus D. Grayck, of New York University Law School.

STATEMENT OF MARCUS D. GRAYCK, OF NEW YORK UNIVERSITY LAW SCHOOL

Mr. GRAYCK. Mr. Chairman, I appreciate being granted this opportunity to present my views with respect to that part of the Treasury's alternative proposal to H.R. 10 that deals with limitations on benefits from pension plans covering owner-managers of corporations. My interest in this area is twofold.

First, as a tax attorney I necessarily come to grips with the tax consequences of pension plans.

Second, in an academic sense this area is of interest to me for I lecture on the law of taxation at the graduate division of the School of Law of New York University. It is there that I conduct a tax seminar on qualified pension and profit-sharing plans.

I had previously written to the members of this committee with respect to what I feared as a great flaw in H.R. 10, that is, that it did not cover the employees of the self-employed. Sometimes afterward the Treasury proposal embodied this suggestion of mine and has already worked it to a point beyond recognition for my original proposal.

If the Treasury's alternative had stopped at requiring compliance with section 401 of the code, I would be in full agreement with it. However, the Treasury's alternative has gone far beyond requiring compliance with the established qualification procedure, and from my viewpoint it seeks to retreat back to the situation at hand prior to 1949.

It was in that year that the so-called 30 percent rule which maintained that no more than 30 percent of the total employer contributions under a qualified pension, profit sharing or stock bonus plan could be used to finance benefits for stockholder-employees (Volkening, Inc., 13 T. C. 723).

Instead of bringing the self-employed to a point of parity with the present position of owner-managers, the Treasury's alternative seeks to diminish the position of those already gifted with the ability to plan for future retirement and then to parcel out this same shrunken benefit to the self-employed. Thus, I believe that the Treasury's alternative places before this committee not the genesis of much needed remedial legislation, but instead an invitation to the wake for many pension plans covering small and medium-sized corporations.

In brief, the Treasury's alternative proposal seeks to limit the benefits to be derived by an owner-manager and the self-employed to that which can be purchased by contributions set forth in the Treasury's counterproposal. Thus, where either an owner-manager in the corporate situation or a self-employed individual has no rank and file employees, then only 10 percent of earned income but not more than $2,500 can be used to fund retirement benefits.

As an aside, I would like to point out that I find it difficult to parcel out earned income, earned, let's say, of a storekeeper who has a shop, or who has, let's say, merchandise on his shelves. How are we to differentiate that part of his income which comes from investment, the stock on the shelves, and that part which comes from his personal services?

How the Treasury presently poses to slice that up, I do not know.

In any event, where rank and file employees exist, the maximum contribution limitation of 10 percent or $2,500 still would be applicable to financing of retirement benefits for the owner-manager except where vested rights are given to the other employees and where either (1) an excess contribution would be necessary to match the contribution attributable to a rank and file employee—as I understand it, the Treasury has now dropped that alternative.

The one still remaining is where the contributions for the owner-manager does not exceed one-third of the total annual contribution.

It is my belief these limitations will kill off recourse to qualified pension plans for the typical small businessman and will bring the state of the law back to where it was prior to the *Volkening* decision.

Assume, if you will, that a closed corporation has its stock owned by two individuals, each of whom are 55 years of age and full-time employees of that corporation. They have a small plant employing, say, eight other employees of an average age of 25. Assume each of these two fictional owner-managers draws an annual salary from the corporation of $15,000. The remaining eight employees draw annual total salaries, exclusive of overtime, of $40,000.

Under the Treasury's proposal, $1,500 a year, or a total of $15,000, could be contributed for each of the owner-managers by the time retirement age is reached. Under this same proposal, each rank and file employee would have had $20,000 contributed for him by the time he reaches retirement age. Thus the owner-manager would be the beneficiary of $5,000 less in contributions than his average hired hand.

Few businessmen would consider installing a plan if such were to be their reward. Yet this fact situation is quite typical of many small businesses that have either recently established pension plans or are currently considering the installation of a pension plan.

Much of the difficulty arises because management in the typical small corporate business is on the average older than the rank and file employees. An owner-manager would generally have less time within which to fund his retirement plan since he is usually much closer to retirement age 65 when the plan is first installed. Thus any system which limits contribution for an owner-manager to an absolute amount, as does the Treasury's proposal, threatens the owner-manager's position. Since it is he who must be convinced to install the plan in the first place, I believe a bit more meat is needed on the bone than is placed there by the Treasury's proposal.

Pointedly, the difficulty with the Treasury's proposal is that it considers limitations on contributions, whereas the meaningful factor in any retirement plan is not the amount contributed but instead the amount of benefits.

A fixed and arbitrary limitation on contributions without recognizing the effect on ultimate benefits is what the Treasury proposes. If limitation is needed against discriminatory tendencies on the part of owner-managers, and I believe reasonable limitations are necessary, I submit that these limitations be geared to the ultimate benefits and not to the contributions required to fund benefits. Thus, if a limitation were to be enacted which would limit the funding of a pension plan to, say, 30 percent of compensation, this would be meaningful to not only the owner-manager but also to his other employees.

Under this approach the owner-manager in the hypothetical would be assured of an income after retirement of $4,500 per annum. The average employee in the hypothetical would be entitled to a pension of $1,500 per annum. These pensions would be in addition to benefits to be derived from social security. Contributions in whatever amounts actuarially necessary to fund these benefits should be allowed.

This method, by its very nature, would take into account the inflationary trend which has for so long been a part of the American scene. Similarly, any deflationary trend would automatically be taken into account for as wages would decline so would the amount of pension benefits.

As a further guard against the owner-manager group "loading the gun" in its favor, all compensation would be subjected to provisions of section 162 of the Internal Revenue Code. Thus if an owner-manager were already drawing a salary which reached the outer limits of being ordinary, necessary, and reasonable, then any additional compensation by reason of funding pension benefits would be excessive and nondeductible to the corporation. This would serve as an inner brake against an owner-manager loading the gun in his favor.

Such a limitation is reasonable and is readily understandable to the average businessman. He has lived with section 162 and the requirement that the sum total of all his compensation must be within the bounds of section 162 will not outrage the businessman.

I would like to sum up by submitting that the Treasury's proposal falters because it fails to consider ultimate benefits and instead concentrates on limiting contributions for the owner-manager group. This approach would discriminate against the older age group in most closed corporations.

I further submit that a method of limiting benefits, and allowing contributions actuarially necessary to fund such benefits, would be a better solution to the problem. In that way discrimination against any group would be prevented.

Thank you.

Senator FREAR. Do I gather from your testimony that you are in favor of H.R. 10?

Mr. GRAYCK. There are aspects of H.R. 10 that cause me to hesitate to give a yes or a no answer.

Senator FREAR. If H.R. 10 were amended to include employees, would it be more inducement?

Mr. GRAYCK. Yes; it would, Senator.

I think also that if we were to view a single proprietorship or a partnership that we are speaking about here as if it were a corporation, and to allow the proprietor or the partner to derive that amount which would be reasonable if this proprietorship were a corporation, to derive that amount and defer compensation benefit such as pension plans, we would have a method whereby the noncorporate form of doing business, or the single proprietorship, would be at a par with the corporation, and all effort to either become a partnership or to become a corporation would be meaningless for tax purposes.

The CHAIRMAN. This concludes the hearings. The record will be held open until 4 p.m. Friday.

Thank you, gentlemen.

(By direction of the chairman the following is made a part of the record:)

WASHINGTON, D.C., *May 11, 1960.*

Senator HARRY F. BYRD,
Chairman, Finance Committee,
U.S. Senate, Washington, D.C.

We are satisfied with Treasury proposal which will put self-employed people on equal footing with corporate employees in setting up retirement plans.

JEROME O. HENDRICKSON,
Executive Secretary, National Association of Plumbing Contractors.

NEW YORK, N.Y., *May 11, 1960.*

Senator HARRY F. BYRD,
Chairman, Senate Finance Committee,
Senate Office Building, Washington, D.C.:

Urgently request you and your associates on the Finance Committee to act favorably on either H.R. 10 or the alternative approach advanced by the Treasury Department as it relates to the self-employed.

JOHN L. CAREY,
Executive Director, American Institute of Certified Public Accountants.

CHICAGO, ILL., *May 11, 1960.*

Senator HARRY F. BYRD,
Chairman, Senate Finance Committee,
U.S. Senate, Washington, D.C.:

The American Veterinary Medical Association ready to accept Treasury proposal Keogh bill, H.R. 10, as it relates to the self-employed.

H. E. KINGMAN, Jr.,
Executive Secretary, American Veterinary Medical Association.

NEW ORLEANS, LA., *May 11, 1960.*

Senator HARRY FLOOD BYRD,
Senate Office Building, Washington, D.C.:

H.R. 10, now being considered by the Senate Finance Committee, with respect to the proposed approach by the U.S. Treasury. This latest suggestion by the Treasury Department will be satisfactory to the members of this organization.

J. D. HENDERSON,
National Managing Director, American Association of Small Business, Inc.

CHICAGO, ILL., *May 11, 1960.*

Hon. HARRY F. BYRD,
Chairman, Committee on Finance,
U.S. Senate, Washington, D.C.:

The American Dental Association has consistently supported the principle embodied in H.R. 10. The proposal submitted by the Treasury Department as it relates to pension plans of the self-employed is within this principle and is therefore acceptable to this association.

FLOYD W. PILLARS, D.D.S.,
Chairman, Council on Legislation, American Dental Association.

WASHINGTON, D.C., *May 11, 1960.*

Senator HARRY FLOOD BYRD,
Senate Office Building, Washington, D.C.:

On behalf of National Association of Real Estate Boards strongly urge your favorable consideration of H.R. 10 in either original form or as amended by Treasury substitute relating to self-employed persons.

JOHN C. WILLIAMSON,
Director, Department of Governmental Affairs.

NATIONAL SMALL BUSINESS MEN'S ASSOCIATION,
Washington, D.C., May 13, 1960.

Hon. HARRY F. BYRD,
Chairman, Senate Finance Committec, Senate Office Building, Washington, D.C.

DEAR SENATOR BYRD: Due to the illness of our scheduled witness during hearings on the owner-manager portion of the Treasury Department alternate proposals on H.R. 10, we have taken the liberty of enclosing a portion of the statement our witness was to have given at that time.

The National Small Business Men's Association in previous testimony before your committee (July 15, 1959) strongly endorsed the self-employed individual retirement bill because we believe it would remove a discrimination which exists under present law against some 10 million small businessmen, farmers, and professional people. The attached statement relates to the adverse effect on small business of the Treasury alternate proposals to H.R. 10.

Thank you in advance for your courtesy in placing the attached memo in the record.

Sincerely,

JOHN A. GOSNELL, *General Counsel.*

STATEMENT OF NATIONAL SMALL BUSINESS MEN'S ASSOCIATION BEFORE THE SENATE FINANCE COMMITTEE HOLDING HEARINGS ON THE SMATHERS-KEOGH-SIMPSON BILL, MAY 13, 1960

The adoption of the Treasury alternate proposals to H.R. 10 will adversely affect small business as follows:

(1) In competing for the services of individuals, small business will have to either (*a*) incur increased costs of pension benefits because of required vesting or (*b*) provide smaller pension benefits at the same cost.

(2) Small business will have greater pension costs because it will not be permitted to take credit for benefits on the first $4,800 of earnings provided under social security.

(3) In any event, regardless of cost, small business will be at an extreme competitive disadvantage in holding key people because the Treasury's requirements for vesting will enable these key employees to leave small business without forfeiting their benefits.

(4) By requiring vesting, the small business will be forced by the Treasury proposal to give up one substantial element at the collective bargaining table which his larger competitor is not required to do.

(5) Small business will be prevented from giving their employees a stake in the business through investment of the trust funds in employer securities.

(6) Small business will lose a source of growth capital, which will still be available to other taxpayers) because of the prohibition of the investment of any portion of the trust funds in employer securities.

(7) In the case of qualified deferred profit-sharing retirement plans the proposals for a definite formula for contributions, immediate vesting of employer contributions, and rejection of carryover of unused allowances will effectively discourage the use of such plans by small businesses.

1. THE 10 PERCENT OR $2,500 RULE

(Par. 2(a) of Mr. Scribner's letter of Apr. 1, 1960)

In addition to meeting all of the requirements which all qualified plans must meet, annual contributions under a qualified pension plan on behalf of any stockholder-employee (presumably any stockholder who owns 10 percent or more of the voting stock of the corporate entity) would be limited to the lesser of 10 percent of compensation received by the stockholder-employee for his services to his employer in any year, or $2,500.

Without any opportunity to exceed these limits, the small corporate entity immediately would be at a competitive disadvantage when compared with either the larger corporate entity, or the corporate entity which, unaffected by the 10-percent ($2,500) rules, can continue to offer prospective employees tax-deferred income under qualified pension plans in the amounts which could cost the company as much as 25 percent of the compensation of such employee in each year. It is no answer to say that the 10-percent ($2,500) rule does not in any way restrict what a small corporate employer may contribute on behalf of nonstockholder employees. While the typical small corporate stockholder-employee has no reason to ask that he be entitled to bigger benefits than the other employees, so long as he is employed in the business there is no good reason why his benefits should be limited to an amount less than those provided for the other employees. His annual compensation, including his pension benefits, always is subject to the test of reasonableness, if it is to be an allowable deduction to the corporation under section 162 of the code. Any disallowed compensation is generally taxable to the owner as a dividend.

History demonstrates that establishment of qualified plans by small employers is seriously hampered when restrictions are placed on the benefits which stockholder-employees may enjoy. As a practical matter, few small corporate businesses will establish plans providing benefits in excess of 10 percent of compensation if this is to be the limit on benefits to be received by stockholder-employees. As a matter of fact, this restriction (coupled with the restrictions suggested by the Treasury (par. 9 of Mr. Scribner's letter of Apr. 1, 1960) with respect to profit-sharing retirement plans) probably will guarantee that many such employers will not establish any plans at all. The effect will be to penalize employees of small corporations as well as the owners thereof. This, of course, will be an additional competitive disadvantage for small businesses.

2. VESTING OF BENEFITS

(Par. 2(c) of Mr. Scribner's letter of Apr. 1, 1960)

Presumably in recognition of the inherent inequity of the 10-percent ($2,500) rule, the Treasury Department's proposals contemplate that the limits of that rule could be exceeded if the small corporate employer vests the interests of other employees. Contributions on behalf of stockholder-employees under a pension plan could exceed the 10-percent ($2,500) rule to the extent they do not exceed 50 percent of the total contributions vested in all employees who are not stockholders. This, in effect, limits the total annual contributions made on behalf of all the stockholder-employees to 33⅓ percent of the total annual vested contributions made on behalf of all the other employees.

Vesting of benefits, of course, is a large expense item in maintaining a plan. In effect, the Treasury Department's proposal tells the small corporate employer that he may have a plan, and he may avoid the limitations of the 10-percent ($2,500) rule if he wants to have a more expensive form of pension plan than larger employers are required by statute to have. Conversely if he puts in the same amount of money then, under a vested plan, he must provide lesser benefits than the corresponding funds would buy under a nonvested plan. Once again this puts him at a competitive disadvantage with the larger employer in attracting and keeping employees.

Furthermore it is questionable whether "vesting," which is a bargainable issue, should be required by statute for any employer, let alone a small employer.

Finally, one of the results hoped for by all employers in the establishment of qualified pension plans is reduction in turnover and an inducement for employees to stay with the particular employer. Part of this inducement consists of the possible loss of accrued benefits, or a part thereof, in an employee does not choose to stay in retirement. By requiring vesting of benefits in the nonstockholder employee the latter has no inducement to stay but can "pick up his marbles" and go to another job. The same is not true of the larger employer who need not and generally does not, give the immediate full vesting required by the Treasury proposal in order to fund adequately its pension benefits. Whatever the sociological arguments are for or against vesting, the fact is that the Treasury proposal discriminates against the small corporation. If the price of benefits comparable to those which can be provided by large employers is to be vesting of those benefits in employees where a small employer is involved, the smaller employer will suffer a new competitive disadvantage.

3. ELIMINATION OF INTEGRATION WITH SOCIAL SECURITY

(Par. 3 of Mr. Scribner's letter of Apr. 1, 1960)

The Treasury Department proposes that where a plan is established by a small corporate entity and covers an employee-stockholder, the plan should not be permitted to take into account, either for purposes of eligibility or the amount of benefits, the retirement benefits provided for all employees under the Social Security Act, as amended. Presumably, integration of private plans with social security would be allowed to be continued where larger corporate employers are involved. Insofar as the smaller corporate employer is concerned, the tax rate for social security benefits which he pays is precisely the same as that of the larger entity. The same is true of the tax rate paid by the employee of the smaller employer, as compared with the larger employer. To state that one type of entity would be allowed to continue to take credit for benefits provided under social security, while another would not, is clearly discriminatory against the latter.

A pension, such as provided by social security, of $125 per month at age 65 for an employee alone plus $62.50 per month for his spouse over 65 has a capital value of in excess of $26,000. It would be harshly discriminatory against the small corporate business to require him to ignore benefits of such significance in establishing the pension program for his employees.

4. THE PROPOSALS WITH RESPECT TO PROFIT-SHARING RETIREMENT PLANS

(Par. 9 of Mr. Scribner's letter of Apr. 1, 1960)

With specific reference to profit-sharing retirement plans (which are perhaps the most frequently utilized plans where small employers are involved), the Treasury has suggested the following further limitations applicable presumably only to small corporate employers and the self-employed:

(a) A definite formula for contributions would be required;

(b) Immediate full vesting of employer contributions in nonstockholder employees would be required;

(c) Carryovers of unused allowances (presumably the amounts by which benefits for the stockholder-employee fell below the limits otherwise described above) would not be permitted; and (*d*) Benefits payable to a stockholder-employee presumably would have to be withheld from him until attainment of age 60 years, other than in the case of an early disability.

Imposition of the foregoing requirements only on plans maintained by smaller corporate entities is both unwarranted and unfair.

For instance, perhaps more so than the larger corporate entities, the small corporate entity needs the flexibility of contributions afforded since 1954 under qualified profit-sharing retirement plans. Lack of readily available capital to meet current needs of the business and to enable continued growth is one of the chief problems encountered by small businesses. Congress itself has recognized this fact through the passage of the Small Business Investment Act of 1958. Demands for capital in such businesses frequently are sudden and unanticipated. For this reason such businesses can ill afford to commit themselves to a predetermined portion of a single year's profits under a profit-sharing plan.

Accordingly, a degree of flexibility as to when contributions must be made and the amount thereof is essential to such businesses. Requiring such employers to have a formula undoubtedly would further inhibit the establishment of such plans with small businesses. Again, experience shows that with the elimination of the definite formula requirement in 1954 (which requirement, incidentally, was never imposed by Congress but rather by Treasury Department regulations), smaller corporate entities have been more favorably inclined to adopt qualified plans covering not only the owner-managers, but also most, if not all, other employees.

As to the vesting point, the arguments are the same as those made under point 2. If anything it is worse in the case of the Treasury's proposal with respect to profit-sharing plans since it requires immediate and full vesting.

The proposal with respect to the elimination of carryovers is also highly inequitable. For, according to the Treasury, if an employer cannot afford to put in money in a given year, he cannot make up that deficiency in subsequent years.

5. INVESTMENT IN EMPLOYER SECURITIES

(Par. 8 of Mr. Scribner's letter of Apr. 1, 1960)

The Treasury now suggests complete elimination of any investment in employer securities by any owner-managed corporation by proposing the adoption of the investment rules of H.R. 10.

Under the present law and regulations, such investments are permitted subject to certain specified limitations. Accordingly, the Treasury now has effective control on investments of qualified plans in employer securities and so far no abuses have been shown to exist in that area.

Additional safeguards are provided by the Federal Welfare and Pension Plans Disclosure Act which requires full and adequate disclosure to be made to all employees with respect to investments in employer securities.

Moreover, the investment by qualified plans in employer securities enhances the partnership principle and permits employees to acquire in this manner a stake in the employer's business.

Furthermore, the small corporation has considerable difficulty security additional capital for growth and expansion. Its own pension or profit-sharing fund could be a ready source for that capital. The Treasury's present controls make certain that if a qualified fund invests in the employer's securities, it must do so on terms no less favorable than those which outsiders would require. Nor will the Treasury approve the investment of a disproportionate amount of the fund in the employer's securities.

With these existing safeguards, to cut off this source of expansion capital and to prohibit the employees from securing a stake in the employer in the case of the small company, as proposed by the Treasury, represents another discrimination against small business.

(Whereupon, at 1:35 p.m., the committee adjourned.)

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