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SELF-EMPLOYED INDIVIDUALS TAX RETIREMENT ACT OF 1961

SEPTEMBER 13, 1961.—Ordered to be printed

Mr. SMATHERS, from the Committee on Finance, submitted the following

REPORT

together with

MINORITY VIEWS

[To accompany H.R. 10]

The Committee on Finance, to whom was referred the bill (H.R. 10) to encourage the establishment of voluntary pension plans by self-employed individuals, having considered the same, report favorably thereon with an amendment and recommend that the bill as amended do pass.

I. SUMMARY OF BILL

Your committee's bill, which is in the form of a substitute for the House bill, is designed to encourage the establishment of voluntary retirement plans by self-employed persons by allowing self-employed individuals to be covered by qualified plans and by extending to them some of the favorable tax benefits present law now provides in the case of qualified retirement plans established by employers for their employees. To accomplish this purpose, self-employed persons are treated for retirement plan purposes as the employers of themselves. This was the fundamental concept of the House bill and it is retained in your committee's substitute. As employers, self-employed individuals are permitted, like other employers, to deduct contributions (within specified limits) made to pension or profit-sharing plans for the benefit of themselves and such other employees as may be covered under the plan. As employees, as with other employees, they are not taxed on such contributions made for their benefit, or the income thereon, until they receive the funds upon retirement or otherwise. Benefits for the self-employed individual may not, under either

the House bill or your committee's substitute, begin before age 59½ (except in case of early disability or death) nor later than age 70½. The retirement income credit will apply to retirement benefits distributed to self-employed individuals.

By treating self-employed individuals as employees under retirement plans there are brought into play (although with material modification) most of the statutory and administrative rules presently applicable to such plans. In addition, your committee's substitute also establishes additional rules to govern retirement plans which cover self-employed individuals.

Generally, a self-employed person who owns more than a 10-percent interest in his business (described as an owner-employee by the bill) is allowed under this bill to contribute each year to a retirement plan for himself up to 10 percent of his earned income for that year or $2,500, whichever is smaller. However, not all of the amount actually contributed for a self-employed person may be deducted for tax purposes. Rather, the first $1,000 so contributed and 50 percent of the contribution in excess of $1,000 may be deducted each year. This means that an owner-employee who makes the maximum annual contribution of $2,500 may deduct $1,750 of that amount. In order for an owner-employee to participate in a retirement plan under your committee's bill, it is necessary that he provide retirement benefits for his employees if he has any. The plan may not exclude any employee (other than part-time, seasonal and temporary employees) who has at least 3 years of service. Contributions for employees must meet the nondiscriminatory rules of existing law, and for this purpose a self-employed person is considered an employee. Thus, the plan ordinarily could not permit a greater proportion of covered earnings to be contributed for a self-employed person than for his employees. Another requirement of your committee's substitute is that contributions for employees must be nonforfeitable at the time they are made. These are tighter rules than under existing law, but your committee is convinced they are essential in order to prevent retirement plans of owner-employees from becoming purely income-averaging devices and to insure that contributions made for their employees do not inure to the benefit of owner-employees. Moreover, since a self-employed person would be treated as an employee under the bill, and would be covered by an employee's retirement plan, your committee believes it is fair that he be required also to cover all his employees under the same plan and to give them the same vested rights to contributions made for them as he in fact has with respect to amounts contributed on his behalf.

If the self-employed person is a partner who does not own more than a 10-percent interest in the business (and thus is not an owner-employee), the bill does not limit the amount which the partnership may contribute for him under a retirement plan, provided contributions or benefits for him are not discriminatory under the plan formula. Nonetheless, the amount of this contribution which he may deduct for tax purposes is limited by the same rule as applies to owner-employees. Under this rule the self-employed individual could deduct the full amount of the first $1,000 of his contribution plus 50 percent of the remainder. If the plan does not cover any owner-employee (in other words, if no partner owns more than a 10-percent interest in capital or profits) the new requirements of the bill with respect to coverage of

employees, and vesting, will not apply. However, in such a case the plan would have to meet the conditions of existing law as to coverage and nondiscrimination.

The retirement fund which this measure allows self-employed persons to establish may be lodged with a bank as trustee (or as custodian if contributions are invested in stock of an "open-end" regulated investment company or in policies issued by an insurance company); it may be invested in nontransferable annuities with an insurance company or in nontransferable face amount certificates; or it may be invested in a new series of U.S. Government bonds authorized for this purpose. These new bonds will be nontransferable, nonredeemable before age 59½ (except in case of disability or death) and issued only in the names of individuals. They are intended to provide a convenient and simple form of investment for retirement funds.

More than 7 million self-employed persons who pay income taxes would be permitted to establish retirement plans under this bill. Because self-employed persons generally have only a limited number of employees, their retirement plans will ordinarily be much smaller in scope than most of the corporate plans already in existence. Thus they would, if present law rules were not supplemented, offer somewhat greater opportunities for abuse than do corporate plans covering many employees. For this reason, tighter rules for retirement plans covering owner-employees are believed to be necessary. Several such rules were included in the House bill but they applied only where there were more than three employees. Your committee has accepted the suggestion of the Treasury Department that these rules be applied to all plans covering owner-employees. Thus, owner-employees are required to cover all of their employees who have more than 3 years of service if the owner-employee desires to participate in a retirement plan. Under existing law, some employees could be excluded under a nondiscriminatory classification and the plan could exclude all employees who had less than 5 years of service. Also, contributions made for employees of owner-employees must be nonforfeitable at the time they are made.

In addition, a new rule for coordinating retirement plans with social security is provided if an owner-employee is covered by the plan. Under this rule, the owner-employee will take into account only the employer portion of the social security tax. Under the more liberal provisions of existing law, the employer generally may take into account social security benefits not attributable to the employee portion of the social security tax.

The following chart compares the principal provisions of the House bill and of your committee's substitute.

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SUMMARY COMPARISON OF PRINCIPAL PROVISIONS OF HOUSE BILL AND FINANCE COMMITTEE SUBSTITUTE

House bill	*Finance Committee substitute*
1. Basic concept	
Self-employed persons generally would be treated as employees for retirement plan purposes and are eligible for coverage in qualified plans. All separate businesses controlled by a self-employed person would be considered as one business for his retirement plan purposes.	Same as House bill.
2. Coverage for employees of self-employed individuals	
Self-employed persons establishing pension plans for themselves would be required to cover employees in the plan only if they have more than three employees. In this case all full-time employees, with more than 3 years of service would have to be covered under nondiscriminatory retirement plans set up under the rules of present law with certain modifications to cover self-employed individuals. Seasonal, part-time, and temporary employees could be excluded. Applicable only to more-than-10-percent owners.	Self-employed persons establishing retirement plans for themselves would be required to cover all full-time employees with more than 3 years of service. Seasonal, part-time, and temporary employees could be excluded. Applicable only to more-than-10-percent owners.
3. Base for deduction	
Self-employment earnings. This term means net earnings from trade or business of a self-employed person, including return on capital invested in the trade or business, as well as income for personal services.	Earned income. This term means professional fees and other compensation for personal services. Where both capital and personal services are material income-producing factors, the term means 30 percent of the income from the business or up to $2,500 whichever is greater.

4. Amount deductible annually by self-employed individuals

(*a*) Ten percent of self-employment earnings or $2,500, whichever is less, in the case of self-employed individuals with three or fewer employees. Applicable only to more-than-10-percent owners.

(*b*) An amount proportional to contributions made for employees, in the case of self-employed persons who have had more than three employees in any year. No maximum dollar limitation. Applicable only to more-than-10-percent owners.

(*c*) A self-employed person who does not own more than 10 percent of his business could contribute and deduct any amount determined under a nondiscriminatory plan formula.

(*a*) A self-employed person who is a more-than-10-percent owner could contribute to a retirement plan 10 percent of his earned income or $2,500, whichever is the lesser. He could deduct the full amount contributed, up to $1,000 and 50 percent of the amount over $1,000 which may be contributed. Maximum deduction would be $1,750.

(*b*) A self-employed person who does not own more than 10 percent of his business could contribute to a retirement plan any amount determined under a nondiscriminatory plan formula. He could deduct the full amount contributed up to $1,000 and 50 percent of the amount over $1,000. No maximum dollar limitation imposed.

5. Vesting

(*a*) In plans covering self-employed persons with more than three employees, immediate vesting would be required. Applicable only to more-than-10-percent owners.

(*b*) In plans covering self-employed persons with three or fewer employees, no provision.

In plans covering self-employed persons immediate vesting would be required with respect to amounts contributed for employees. Applicable only to more-than-10-percent owners.

6. *Coordination with social security*

House bill	*Finance Committee substitute*
(*a*) Coordination would be permitted for plans covering self-employed persons with more than three employees if contributions for such self-employed persons do not exceed one-third of the total deductible contributions. Plan is given credit only for actual social security contributions made by the employer. Applicable only to more-than-10-percent owners. (*b*) In case of self-employed persons with three or fewer employees, no provision.	Coordination would be permitted for plans covering self-employed persons if contributions for self-employed persons do not exceed one-third of the total contributions. Plan is given credit only for actual social-security contributions made by the employer. Applicable only to more-than-10-percent owners.

7. *No capital gains treatment*

House bill	*Finance Committee substitute*
Special averaging provided instead of capital gains treatment with respect to lump-sum distributions received by self-employed persons.	Same as House bill.

8. *Estate and gift-tax exclusions*

House bill	*Finance Committee substitute*
Self-employed individuals not eligible for estate and gift-tax exclusions.	Same as House bill.

9. *Limitation on time of payment of benefits*

House bill	*Finance Committee substitute*
Benefits could not be payable to more-than-10-percent owners before age 59½ (except in the case of permanent disability or death) but must begin before age 70½.	Same as House bill.

10. *Face-amount certificates*

House bill	*Finance Committee substitute*
Investment in nontransferable face-amount certificates permitted.	Same as House bill.

11. Custodial account

Custodial account in a bank is permitted in lieu of trust if investments are solely in regulated investment company stock.

Custodial account in a bank is permitted in lieu of trust if investments are solely in regulated investment company stock or life insurance policies. In this connection the committee included in the term "bank" various institutions regulated by State banking authorities.

12. Bond purchase plan

Direct deductible investment in special issue of nontransferable retirement bonds would be permitted.

Same as House bill.

13. Attribution rules

No provision.

Contains provision designed to prevent an individual from avoiding the special rules applying to owner-employees by fragmenting ownership interests among his spouse, descendants, and ancestors.

14. Effective date

Taxable years beginning after December 31, 1961.

Same as House bill.

II. Reasons for the Bill

The primary reason for the House bill (as amended by your committee) is to give self-employed persons access to retirement plans on a reasonably similar basis to that accorded corporate stockholder employees. It thus tends to correct a discrimination in present law under which self-employed individuals—sole proprietors and partners—are prevented from participating in retirement plans established for the benefit of their employees although owner-managers of corporations may do so. Self-employed individuals have contended for many years they are treated unfairly under present law.

Several House-passed bills referred to your committee in prior Congresses would have allowed self-employed individuals to deduct amounts contributed by them toward the purchase of a "restricted retirement policy," or to a "restricted retirement trust," for their own benefit without requiring them to provide any retirement benefits for their employees. These measures did not treat self-employed persons as if they were employees, but were designed to equate, roughly, the tax benefits allowed qualified employee retirement plans under present law. In 1960, at the request of your committee, the Treasury Department submitted an approach to the retirement problem of self-employed persons which was different from earlier legislative proposals. In effect the approach submitted by the Treasury Department would have granted self-employed individuals tax treatment comparable to that received by employees now covered by qualified pension plans by permitting them to participate in pension plans in much the same manner as employees. This approach, however, not only would have imposed additional restrictions on the participation of self-employed persons in qualified pension plans but also would have imposed similar restrictions on the participation of corporate owner-managers in such plans. Neither the House bill nor your committee's substitute would restrict participation by owner-managers in retirement plans established by a corporation. With this exception, your committee's substitute substantially adopts the approach presented last year by the Treasury Department.

The bill allows contributions to retirement plans to be a deduction for income tax purposes at the time these contributions are made, but requires that retirement benefits when received be subject to taxation. Your committee's substitute, like the House bill, thus allows deferment of tax on certain forms of savings set aside for retirement, but limits the amount of these retirement savings of self-employed persons which are so treated. Since the self-employed person is viewed as both an employer and as an employee, this deferral is consistent with present law, under which employers are permitted to deduct contributions to qualified pension plans for their employees, while employees are not required to include in their incomes such contributions, or the income thereon, until they are received as benefits under the plan.

Your committee, like the Committee on Ways and Means of the House, is of the opinion that extending the coverage of individuals under voluntary retirement plans is in the public interest. The bill will make self-employment somewhat more attractive than at present compared to employment with a corporation, and will thus help to keep small business strong and independent professional practice

thriving. In many cases, self-employed individuals are prohibited by State law from operating their trade or business in the form of a corporation. Thus, in these cases, there is no possibility that a self-employed person could obtain the benefits of a retirement plan under existing law by forming a corporation to conduct his trade or business and becoming its employee. Although a number of States recently have enacted new legislation to eliminate some of the obstacles to professional corporations and associations, your committee believes it desirable to provide by Federal legislation that a self-employed individual may participate in employee retirement plans without becoming an artificial employee of his own corporation. Thus, professional individuals could continue to practice their profession in the traditional manner; that is, as self-employed individuals. Moreover, this legislation would ease the pressure on State legislatures to enact special professional corporation laws.

III. Present Law

Present law accords favorable tax treatment to pension and profit-sharing plans established for the exclusive benefit of employees or their beneficiaries. Employees covered under qualified plans are not taxed currently on contributions made on their behalf to these plans by their employers nor on the income from amounts so contributed. Instead, the employees generally include the benefits from such plans in taxable income only in the year they are received or made available.

The deferment of tax on retirement benefits until ultimate distribution applies whether or not the employee has vested (nonforfeitable) rights in the contributions made on his behalf. Typically, under corporate plans the employee does not have immediate vested rights to all such contributions, although plans vary considerably; they range from immediate vesting to vesting after attaining a certain number of years of service or attaining a specified age, or upon actual retirement.

The income of trusts established to administer qualified pension plans is exempt from income tax. Similarly, the Life Insurance Company Income Tax Act of 1959 granted exemption to income on insurance reserves established in connection with qualified pension plans. In addition, under present law, employers are permitted to take tax deductions (within specified limits) for their contributions to qualified plans. The law grants this favored tax treatment only to retirement plans which do not discriminate as to coverage, contributions, or benefits in favor of employees who are stockholders, officers, or supervisors, or employees who are highly compensated.

A qualified retirement 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; if thus integrated, the proportion of social security benefits not attributable to the employee's own contributions is taken into consideration in determining whether the

contributions or benefits paid by the private plan meet the nondiscrimination test. Under the law and administrative rules the benefits of the higher paid employees, after being combined with a designated portion of social security benefits, must not be larger in relation to salary than the similarly combined benefits of lower paid employees.

Under existing law more than 66,000 corporate pension plans have been established. These plans cover more than 20 million employees and have, at the present time, somewhat more than $40 billion in assets. Corporations contribute more than $4 billion per year to qualified retirement plans.

IV. Revenue Effect

The revenue loss under your committee's bill is estimated to amount to $65 million for fiscal year 1962 and $180 million in a full year of operation. The estimated cost of H.R. 10 as passed by the House was $125 million for fiscal year 1962 and $325 million to $358 million in a full year of operation.

The lower cost of your committee's bill is due primarily to the following factors: (*a*) The basis for the retirement contribution deduction for the self-employed is earned income, while under the House bill the basis was net earnings from self-employment; (*b*) for those self-employed individuals electing coverage all full-time employees with more than 3 years of service would have to be covered, whereas under the House-passed bill only owner-employees with more than three employees were subject to this requirement; and (*c*) the amount of retirement contributions for self-employed which may be deducted is limited to 100 percent of the first $1,000 contributed and 50 percent of the remaining contribution permitted, and the maximum allowable deduction for owner-employees is $1,750; under the House bill self-employed persons with three or fewer employees were permitted to contribute, and deduct, up to 10 percent of self-employment earnings or $2,500, whichever was smaller, while for self-employed persons with more than three employees, there was no dollar limitation provided the ratio of contributions for the self-employed to their self-employment earnings did not exceed the ratio of contributions to wages for any of their employees.

V. Effective Date

Your committee's substitute, like the provisions of the House bill, are made applicable to taxable years beginning after December 31, 1961.

VI. General Explanation of Bill

A. SELF-EMPLOYED PERSONS AS OWNER-EMPLOYEES

The bill as reported by your committee provides a series of special requirements for qualification of retirement plans which cover self-employed individuals (sole proprietors and partners) having more than a 10-percent interest in the business with respect to which the plan is established. Under your committee's substitute, as under the House bill, such self-employed individuals are characterized as "owner-employees". In the case of a partnership where no partner owns more than 10 percent of the business, the self-employed indi-

viduals are also permitted to participate in pension plans, but because they are not owner-employees, plans covering them will, in general, be governed by the nondiscriminatory rules of present law, except where the bill imposes additional restrictions on self-employed individuals generally. In some situations, the bill imposes reactions upon all self-employed persons regardless of their percentage of ownership. (For example, limitation on the amount of contribution which may be deducted, denial of capital-gains treatment on lump-sum distribution, and the denial of the estate and gift tax exclusions.)

B. SELF-EMPLOYED RETIREMENT PLANS

Subject to limitations, your committee's bill would allow self-employed individuals (including partners) to be covered in qualified retirement plans. This would permit self-employed individuals to secure the benefits of current tax deductions, plus a tax-free buildup of pension fund investments, by establishing a plan which meets the requirements of the Internal Revenue Code. The bill treats plans covering self-employed persons under additional new rules established for that purpose.

Under your committee's bill, in the case of an owner-employee, the plan must provide retirement benefits for all employees (except part-time and seasonal employees) who have more than 3 years' service and contributions for such employees must be vested at the time they are made. Although the present law provides that some employees may be excluded from pension plan coverage on the basis of a "reasonable classification," and specifically provides that a plan may cover only salaried or clerical workers, your committee believes it desirable to require an owner-employee to cover all of his employees except seasonal, temporary, and part-time workers, and full-time employees who have less than 3 years of service. With these exceptions employees must be covered whether they are salaried employees or wage earners, and whether or not they work in different departments or enterprises. Under present law, retirement plans can exclude employees with up to 5 years of service, and contributions for employees are not required to be vested. If there are no employees, a self-employed individual would be permitted to establish a retirement plan for himself.

Your committee understands that some self-employed individuals have established pension plans for their employees under existing law (although they, themselves, cannot participate under them). The self-employed individuals would become "employees" upon enactment of this bill, and in most cases they would be "owner-employees". In the absence of specific provision for these cases, plans covering owner-employees would be required to meet all the tests of this bill or lose tax-favored status. These plans were created with no thought of coverage of their self-employed creators and it may be that for reasons of their own, the self-employed owners would not desire to be covered by their plans. In such cases, it would be unjust to impose the restrictions of this bill upon these plans. Thus, your committee has provided that owner-employees must "consent" to be covered by their plans before the special rules of this bill will apply.

C. EARNED INCOME

The measuring rod for deductible contributions for self-employed persons under your committee's bill is "earned income". This means that contributions by or for a proprietor or partner may be made under a qualified retirement plan only if he performs personal services. Since the objective of such a plan is to provide retirement benefits based on personal services, inactive owners who derive their income entirely from investments would not be allowed to participate. This concept of earned income is designed to place proprietors and partners on the same basis as corporate shareholders who can participate in a qualified retirement plan under present law only if they are employees of the corporation. Contributions to a retirement plan for self-employed individuals who are engaged in activities involving significant capital investment are based only on that part of the business income which is attributable to personal services. Thus, under the bill, "earned income" is defined generally as income from self-employment, but where such income is derived from a trade or business in which both capital and personal services are material income-producing factors, the term means not more than 30 percent of the net profits from the trade or business or $2,500, whichever is the greater, except that where net profits of a proprietor or partner from his trade or business are $2,500 or less, the entire amount of such profits is deemed to be earned income.

Under this concept of "earned income" the entire amount received by a self-employed individual as professional fees or commissions will be treated as earned income if the taxpayer is engaged in the practice of a profession, such as medicine or law, even though he employs assistants to perform part or all of the services, provided the patients or clients are those of the taxpayer and look to him as the person responsible for the services rendered. Your committee's bill permits doctors and ministers as well as certain people who perform services for compensation in their own homes and commissioned salesmen (other than full-time life insurance salesmen who are treated under present law as employees for pension purposes) to participate even though they do not have self-employment income within the meaning of the Internal Revenue Code.

The following illustrations indicate the determination of earned income in various situations:

1. A doctor has net profit of $40,000 from professional services. His patients look to him as the person responsible for the services rendered. The full amount of this net profit constitutes earned income.

2. A self-employed grocer has net profit of $40,000 from his wholly owned retail grocery business. Both capital and personal services are material income-producing factors. His earned income is $12,000 (30 percent of $40,000).

3. A gasoline service station operator has net profit from his wholly owned unincorporated service station of $2,400. Both capital and personal services are material income-producing factors. Under the bill, the entire amount of such net profit is deemed to be earned income since it does not exceed $2,500.

4. A contracting partnership composed of three partners who share equally in its profits has partnership net profit of $22,500. Both

capital and personal services are material income-producing factors. Of the $7,500 attributable to each partner, $2,500 constitutes earned income (30 percent of $7,500, or $2,500 whichever is greater, where each partner's share of net profits exceeds $2,500).

5. A and B are partners in a stock brokerage firm. A supplies all necessary capital but performs no personal services. B has no capital interest, but performs all personal services required by the firm. They share profits equally. Both capital and personal services are material income-producing factors. The firm has net profit from brokerage commissions of $50,000 and total net profit from all sources of $70,000.

A has no earned income from the partnership since he performed no personal services.

B has earned income of $10,500 (30 percent of $35,000).

D. LIMITATIONS ON CONTRIBUTIONS AND DEDUCTIONS FOR SELF-EMPLOYED

The bill restricts the amount of deductible contributions which may be made by or for a self-employed individual covered by a plan.

Owner-employee.—If the owner-employee has employees, in order for him to make any contribution for his own retirement needs he must provide nonforfeitable retirement plan coverage for all his employees who have more than 3 years' service. Having established a qualified plan for himself and his employees, an owner-employee under the bill is permitted to contribute for himself up to 10 percent of his earned income or $2,500, whichever is the lesser, provided that contributions for himself are not discriminatory as compared to contributions for his employees under the plan formula. However, under your committee's bill he is not permitted to deduct the full amount allowed to be contributed. Rather, the deductible portion is subject to additional limitations. These limitations provide that amounts actually contributed, up to $1,000, may be deducted in full, but that only 50 percent of allowable contributions in excess of $1,000 which are made may be deducted. Thus, in the case of an owner-employee who makes the maximum allowable contribution of $2,500 the deductible amount is limited to $1,750 (100 percent of $1,000 plus 50 percent of $1,500, or $750).

The following examples illustrate the application of these limitations in the case of an owner-employee:

Example 1: A commission salesman has earned income of $23,000. He has no employees. Under the bill he establishes a qualified retirement plan under which he will be the only beneficiary. The plan calls for contributions of 10 percent of earned income. The salesman contributes to the plan $2,300 (10 percent of $23,000). Of this amount he may deduct $1,650 (100 percent of the first $1,000 contributed plus 50 percent of the remaining $1,300 contributed, or $650).

Example 2: A real estate broker with four full-time employees has earned income of $30,000 from commission selling. He anticipates that it will continue at or above that level. All employees have more than 3 years' service. Two of the employees earn $4,000 each, the other two earn $10,000 each. He establishes a qualified retirement plan which calls for nonforfeitable contributions for each employee who has more than 3 years' service of 10 percent of his earnings and

for contributions for owner-employees of 10 percent of earned income. Thus, for his employees, the owner-employee would contribute, and deduct, $2,800 (10 percent of $28,000). And, for himself, he would contribute $2,500 (the lesser of $2,500 or 10 percent of $30,000). Of this amount, he would deduct $1,750 (100 percent of the first $1,000 contributed and 50 percent of the remaining $1,500 which he is permitted to contribute).

If, under the circumstances described above, the real estate broker had established a plan calling for that contribution percentage which, when applied to his earned income would ordinarily produce the maximum contribution for himself at the lowest cost, the plan would call for nonforfeitable contributions for himself and for each employee of 8⅓ percent of earnings. Thus, for his employees, the owner-employee would contribute, and deduct, $2,333 (8⅓ percent of $28,000). And, for himself, he would contribute $2,500 (the lesser of $2,500 or 8⅓ percent of $30,000) and deduct $1,750 (100 percent of the first $1,000 contributed and 50 percent of the remaining $1,500 which he contributed).

Self-employed individuals who are not owner-employees.—Self-employed individuals who do not own more than a 10-percent partnership interest in their trade or business are limited as to the amount of contributions they may make (through the partnership) to a qualified retirement plan only by the requirement that contributions must not be discriminatory under the plan formula. Thus if such a self-employed individual has sufficient earned income in a taxable year to permit a contribution in excess of $2,500, it may be made. However, your committee's bill imposes the same limitations as to deductibility of such contributions as those applied to contributions made by owner-employees; that is, the first $1,000 of actual contributions may be deducted in full but only 50 percent of contributions in excess of $1,000 may be deducted.

The following examples illustrate the application of these limitations in the case of a self-employed person other than an owner-employee:

(1) A owns a 10-percent interest in a partnership in which only personal services are a material income-producing factor. He derives earned income of $30,000 a year from the partnership. The partnership has established a qualified retirement plan which calls for nonforfeitable contributions for employees of 10 percent of their salary and contributions for owner-employees and other self-employed individuals of 10 percent of their earned income. The partnership contributes for A $3,000 under the plan (10 percent of $30,000). A deducts $2,000 (100 percent of the first $1,000 actually contributed plus 50 percent of the remaining $2,000).

(2) B owns a 10-percent interest in a partnership in which both capital and personal services are material income-producing factors. His income from the partnership amounts to $30,000. His earned income is $9,000 (30 percent of $30,000). The partnership establishes a qualified retirement plan which calls for nonforfeitable contributions for employees of 10 percent of their salary and contributions for owner-employees and other self-employed individuals of 10 percent of their earned income. The partnership contributes for B $900 under the retirement plan (10 percent of $9,000) and B deducts the entire amount.

E. VESTED BENEFITS

The bill, as approved by your committee, adds new requirements to the statute relating to vesting of benefits or contributions made for employees.

In the case of owner-employees with employees, contributions for employees with more than 3 years' service must be nonforfeitable at the time they are made under a plan. This requirement is made a condition governing the qualification of a plan covering such owner-employees, and unless a provision for vesting is included in the terms of the plan a contribution for owner-employees would not be allowable nor would it be deductible. Your committee believes that because an owner-employee always has a vested right to contributions he makes to a retirement plan for his own benefit, it is only fair and equitable that he provide similar vested rights for his employees.

Your committee has provided a single, conditional exception to these vesting rules in the case of retirement plans covering owner-employees. This exception provides that the vesting requirement will not apply if the result upon termination of the plan is to provide discriminatory benefits for certain highly paid employees or owner-employees. This is an exceptional situation and your committee believes it would be appropriate to provide this special exception in order to prevent abuses.

If a plan does not cover any owner-employee, the special requirement as to vesting will not apply. In such a case where a partnership is composed of partners, none of whom owns more than a 10-percent interest, the rules of present law would apply and the plan could provide for complete vesting, partial vesting or no vesting until retirement.

F. INTEGRATION WITH SOCIAL SECURITY

Under your committee's bill, as under the House bill, retirement plans covering owner-employees may be integrated, or coordinated with social security under special rules provided by the bill. Under such integration, or coordination, the overall cost of a retirement plan might be materially reduced. Under present law as applied to qualified pension plans integration is permitted under rules which assume that the employer has paid for that portion of the social security benefit for which the employee himself has not paid.

Under this bill, if an owner-employee with employees establishes a retirement plan which meets the prescribed requirements and if allowable contributions (upon which the deduction is based) for owner-employees are not more than one-third of the total allowable contributions made under the plan, owner-employees, if they take into account the self-employment tax paid on their own behalf (or which would be paid except for the fact that such owner-employee is not covered by social security), may also take into account the employer portion of the FICA tax paid on behalf of covered employees. The method of coordinating such a pension plan and social security payments under your committee's bill is different from the method permitted by Treasury rulings under the provisions of present law. Under this bill the owner-employee may take into account only the amount of social security taxes actually paid by him for his employees

whereas the rules under present law, in effect, permit the employer to take into account social security benefits not attributable to employee taxes. The following example illustrates the application of this rule.

A and B, equal partners in a contracting business in which capital is a material income-producing factor, have five employees, each of whom has more than 3 years' service. A retirement plan is established under which employees with more than 3 years' service will be given immediate nonforfeitable rights to contributions made on their behalf. The plan calls for contributions of 10 percent of gross wages for covered employees, and of 10 percent of earned income for owner-employees, with provision for coordinating the plan with social security. Wages of employees and net profits of the partners appear in the following schedule, along with other pertinent information.

	Net profits or wages		Contribution		
	Per person	Total	10 percent of wages of employees and 10 percent of earned income of owner-employees	Credited self-employment tax and FICA tax paid by employer [1]	Net contribution under integrated plan
2 partners	[2] $25,000	[2] $50,000	$1,500	$451.20	$1,048.80
3 employees	6,000	18,000	1,800	450.00	1,350.00
1 employee	6,800	6,800	680	150.00	530.00
1 employee	3,170	3,170	317	99.06	217.94
Total, partners		[2] 50,000	1,500	451.20	1,048.80
Total, employees		27,970	2,797	699.06	2,097.94
Total, partners and employees		77,970	4,297	1,150.26	3,146.74

[1] Self-employment tax, 4.7 percent of employer's self-employment earnings up to $4,800; FICA tax, 3⅛ percent of employee earnings up to $4,800.
[2] Earned income would be 30 percent of this amount.

Thus, since contributions for owner-employees after coordination with social security ($1,048.80) do not exceed one-third of net contributions under the plan ($3,146.74), social security and self-employment taxes may be taken into account. After coordination, $3,146.74 must be contributed under the plan, of which $1,048.80 is attributable to owner-employees and $2,097.94 is attributable to employees as shown in the schedule.

The coordination rule is further illustrated in the following table for several levels of partnership earnings (net profits). The table shows in column (6) the level of employee payroll at and above which a partnership with the earnings set forth in column (1) would be permitted to coordinate its retirement plan contributions with its social security contributions, assuming 80 percent of the total payroll is subject to social security taxes.

Level of employee payroll at and above which social security coordination would be permitted in 1962 for selected levels of partnership earnings under Senate Finance Committee substitute for H.R. 10

Derivation of contribution for owner-employees					Derivation of contribution for employees				Total contribution	
Partnership earnings [1]	Partnership earned income [2]	10 percent of partnership earned income [3]	Self-employment tax [4]	Net contribution under integrated plan	Total employee payroll	10 percent of employee payroll	FICA tax on employee payroll [5]	Net contribution under integrated plan	Total net contribution	Total deductible contribution
(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	(11)
$5,000	$5,000	$500	$235.00	$265.00	$7,066.67	$706.67	$176.67	$530.00	$795.00	$795.00
10,000	5,000	500	451.20	48.80	1,301.33	130.13	32.53	97.60	146.40	146.40
15,000	5,000	500	451.20	48.80	1,301.33	130.13	32.53	97.60	146.40	146.40
20,000	6,000	600	451.20	148.80	3,968.00	396.80	99.20	297.60	446.40	446.40
25,000	7,500	750	451.20	298.80	7,968.00	796.80	199.20	597.60	896.40	896.40
50,000	15,000	1,500	451.20	1,048.80	27,968.00	2,796.80	699.20	2,097.60	3,146.40	3,146.40
66,667	20,000	2,000	451.20	1,548.80	41,301.33	4,130.13	1,032.53	3,097.60	4,646.40	4,646.40
100,000	30,000	3,000	451.20	2,548.80	67,968.00	6,796.80	1,699.20	5,097.60	7,646.40	[6] 7,372.00
150,000	45,000	4,500	451.20	4,048.80	107,968.00	10,796.80	2,639.20	8,097.60	12,146.40	[6] 11,122.00
166,667	50,000	5,000	451.20	4,548.80	121,301.33	12,130.13	3,032.53	9,097.60	13,646.40	[6] 12,372.00
[7] 200,000	60,000	5,000	451.20	4,548.80	121,301.33	12,130.13	3,032.53	9,097.60	13,646.40	[6] 12,372.00
[7] 333,333	100,000	5,000	451.20	4,548.80	121,301.33	12,130.13	3,032.53	9,097.60	13,646.40	[6] 12,372.00

[1] Assumes 2 partners sharing equally in the earnings.

[2] Actual earnings of owner-employees with actual earnings up to $2,500; $2,500 for owner-employees with actual earnings between $2,500 and $8,333; 30 percent of actual earnings for owner-employees with actual earnings of $8,333 and over.

[3] With contribution ceiling of $2,500 per owner-employee; it is assumed that capital is a material income-producing factor.

[4] 4.7 percent of each partner's self-employment income up to $4,800.

[5] 3⅛ percent of FICA taxable payroll; FICA taxable payroll assumed to be 80 percent of total employee payroll.

[6] Figure in previous column less ½ of the net contribution for each owner-employee which falls between $1,000 and $2,500.

[7] Although the data in this line were developed on the basis of a contribution percentage of 10 percent with a $2,500 ceiling, the possibility should be noted that the owner-employees, when the earned income ascribed to each exceeds $25,000, might establish a plan calling for a lower contribution percentage designed to produce precisely the maximum contribution permissible on their behalf—8⅓ percent for an earned income of $30,000 each and 5 percent for an earned income of $50,000 each. If these latter percentages had been used, the payroll levels, which equate the net contribution on behalf of the owner-employees with twice that on behalf of the employees, would be $155,959 and $363,904, respectively.

G. METHODS OF FUNDING

Trusteed plans and employee annuity plans.—As with qualified plans under present law, qualified retirement plans covering self-employed individuals or self-employed individuals and their employees may be funded either through contributions to a trust or by purchase of annuity contracts (including variable annuity contracts) directly from an insurance company. Self-employed individuals establishing such plans for themselves, or for themselves and their employees, could, if they chose to do so, use associations to pool their separate funds for investment purposes.

Custodial accounts.—In addition, your committee's bill permits the use of a custodial account, in lieu of a trust, if its investments are made solely in stock of a regulated investment company which issues only redeemable stock, or solely in life, endowment, or annuity contracts issued by an insurance company. Although a custodial account may be utilized by a retirement plan, whether or not it includes an owner-employee, it will be particularly beneficial to small owner-employee-type plans because of its lesser costs. Such lesser costs result from the fact that the bank would not be required to assume the duties and responsibilities of a trustee, but would serve only as a mere custodian of amounts contributed under retirement plans or of the policies deposited with it.

Face amount certificates.—Your committee has also made it plain that retirement funds may be invested directly in nontransferable face-amount certificates, which would be treated for retirement plan purposes as annuities. Such certificates may presently be purchased by a trusteed plan under existing law, but not under nontrusteed annuity plans. Your committee's bill makes it clear that such certificates may in the future be purchased in the same manner as annuities. In this respect your committee's bill includes a requirement that annuity contracts purchased by a qualified retirement plan generally must be nontransferable. This requirement applies to all pension plans whether or not an owner-employee is covered.

Bond purchase plan.—A completely new form of retirement plan involving direct investment in a new series of Government bonds is authorized by your committee's bill. The principal features of the bond purchase plan are explained in section J below.

H. CONTRIBUTORY PLANS

Under the bill, retirement plans permitting or requiring additional contributions by employees, as well as those to which the employer alone makes contributions, may be established by an owner-employee with employees. If employees who are not owner-employees are permitted to make nondeductible contributions to the plan, such an owner-employee also may make nondeductible contributions on his own behalf up to 10 percent of his earned income or $2,500, whichever is the lesser; however, the rate of such contributions must not exceed the rate permitted for employees. In no event may such contributions by an owner-employee exceed $2,500. Such contributions will not be deductible either by employees or by owner-employees, but must be made out of income that has already been taxed. The making of such nondeductible contributions is beneficial, however, because

the income earned thereon will not be taxed until it is received from the fund, upon retirement or otherwise. While a similar tax-free buildup can be obtained by anyone purchasing a private life insurance, endowment or annuity contract, it is likely that the return under a qualified retirement plan would be somewhat greater or premiums somewhat lower because of the special deduction allowed life insurance companies with respect to their qualified pension plan reserves which may be passed on to policyholders.

The committee bill permits voluntary nondeductible contributions to be made by owner-employees at the same rate as by employees. Owner-employees who have no employees may not establish contributory retirement plans. Thus, if an owner-employee establishes a qualified retirement plan which calls for nonforfeitable contributions of 10 percent of salary of employees and 10 percent of earned income in the case of owner-employees and other self-employed individuals and if the plan permits voluntary contributions of 10 percent of salary to be made by employees, owner-employees and other self-employed individuals would be permitted to contribute on a voluntary basis 10 percent of their earned income up to a maximum of $2,500. If, in this case for example, the owner-employee has earned an income of $25,000 or more, he would deposit $2,500 as the maximum allowable "employer's" contribution and would be permitted to deposit an additional $2,500 as a voluntary nondeductible "employee's" contribution. Of course, as previously explained, only $1,750 of the allowable "employer's" contribution of $2,500 would be deductible.

I. PROFIT-SHARING PLANS

Your committee's bill does not limit participation of self-employed individuals to fixed-percentage contribution pension plans. Rather, it also permits them to participate in profit-sharing plans paying retirement benefits, under which contributions may be made in profitable years, but there would be no obligation to make contributions in years of little or no profit. To avoid the abuse of making larger or smaller contributions in years when surtax rates are lower or higher, the bill requires a definite formula for determining the amount of contributions to be made on behalf of employees who are not owner-employees. Because of the special limitations on allowable and deductible contributions which may be made by owner-employees covered under a profit-sharing plan, a definite formula would not be appropriate with respect to them. Consequently, in order for an owner-employee to participate in such a plan, it must provide a definite formula only for contributions for employees.

J. BOND PURCHASE PLANS

As an alternative form of investment which will be of particular interest to small businesses contemplating pension plans, direct investment in U.S. Government securities of a new series is authorized both by the House bill and your committee's substitute. These new bonds, which must be issued in the names of the individual employees (including owner-employees) on whose behalf they are purchased (and thus will be nonforfeitable), will be nontransferable and may not be cashed until the individual in whose name the bonds

are issued has attained age 59½ (insurance age 60) or has become disabled or deceased. In order to prevent these bonds from being used for purposes other than retirement, the bill provides that interest on them must stop within 5 years after the death of the bond owner. This period corresponds generally to other provisions of the bill requiring disposition of a deceased owner-employee's interest in a retirement plan within a specified period of time after his death. The purpose of direct bond purchases under a qualified retirement plan is to avoid the expense of establishing a trust to administer the retirement fund assets. The new series of Government securities may also be purchased by the trustee of an existing pension plan if it is desired to make that form of investment.

Where a pension plan has invested in these retirement bonds, the bill provides that no income will be realized by the employee at the time the bonds are distributed to him; rather, the principal and interest on the bonds will be included in the employee's income at the time they are redeemed. Although these new bonds may be purchased by anyone, their cost will be deductible for income tax purposes only if they are purchased under a qualified bond purchase plan or by a qualified retirement plan. The amount deductible is to be determined in the same manner as if the cost of the bond were a contribution to a qualified retirement trust, except that the special rules relating to excess contributions in the case of owner-employee type plans do not apply. Those rules are considered inappropriate to qualified bond purchase plans not only because the special bonds might be purchased by anyone (and not solely for retirement purposes) but also because the denominations in which the bonds might be issued will not necessarily correspond to the amount which might be contributed and deducted by an owner-employee. Under the bond purchase plan as passed by the House and approved by your committee, income realized on the redemption of the special bonds (principal and interest where the cost of the bond was deducted, interest only in other cases) will always be taxed at ordinary rates. Moreover, there would be no capital gains treatment on a lump-sum distribution of these special bonds to an individual covered by a qualified pension trust. By making the earliest redemption date for these bonds age 59½, except in the case of death or disability, these bonds will generally be unattractive to ordinary investors because they may hesitate to freeze their capital for long periods of time.

K. EXCESS CONTRIBUTIONS

The bill as reported by your committee provides certain penalties where excess contributions are made under a pension plan on behalf of an owner-employee. Generally, under the bill, an excess contribution is an amount greater than the total of (1) allowable contributions, upon which the deductible amount is based, and (2) permitted voluntary contributions which in no case are deductible. The bill requires that any such excess contributions must be returned to the owner-employee on whose behalf it was made, together with income earned on the excess contribution. The income so returned will be taxable to the self-employed person for whom the contribution was made. If an excess contribution is not repaid within 6 months after notification has been received that the contribution was excessive, the plan

is temporarily disqualified (until the excess is returned) with regard to the person on whose behalf the excess contribution was made and he is taxed on the annual income earned by the entire fund in the plan which is attributable to his interest. Where an excess contribution is willfully made, however, the entire interest of the individual on whose behalf it was made in all plans in which he participated as an owner-employee (including the corpus allocated to his account) is required to be distributed to him, and he is further disqualified from participating in any pension plans as an owner-employee for a 5-year period. Furthermore, no opportunity is given to repay a willful excess contribution and escape the consequences.

Your committee has added an exception to the foregoing rules under which an owner-employee (but not a self-employed individual who is not an owner-employee) would be permitted to purchase annuity or life insurance or endowment policies on his life from an insurance company at level premiums without fear of making an excess contribution. Under this exception, an owner-employee would be permitted to contribute each year toward the purchase price of his policy up to an amount equal to the amount he would have been allowed to contribute on the basis of his average earned income for 3 years preceding issuance of the last such policy under the plan. Thus, for example, if an owner-employee who has earned income of $10,000 per year for a 3-year period contracts for a life insurance policy on his own life, and the annual premium thereon is $1,000, he may continue to contribute the amount of the premium annually even though his earned income falls below $10,000. Moreover, under this amendment if his earned income subsequently were to increase to an average of $15,000 per year for a 3-year period he could purchase additional policies calling for annual premiums of $500. Thereafter, he could continue to pay the premium of $1,500 per year despite a future drop in his earned income. However, amounts contributed under this exception will be deductible only to the extent that they are related to earned income for the taxable year. Thus, for example, while an individual under this rule may be permitted to purchase an annuity contract for a level premium of $1,000 a year, none of that purchase price would be deductible if the self-employed individual actually had no earned income for the taxable year. As previously explained, amounts contributed under a qualified bond purchase plan are not subject to the excess contribution rules. For reasons similar to those there stated, your committee is of the opinion that exception from the excess contributions rules in the case of life insurance, endowment or annuity contracts issued on the life of an owner-employee also is desirable. Moreover, this exception is limited so that under no circumstances could the owner-employee obtain under one or more retirement plans level-premium policies requiring annual payments of more than $2,500. If he does so, he forfeits the benefits of this exception and the entire amount of the premiums (not merely the amount in excess of $2,500), would be subject to the excess contribution rules.

L. PAYMENT OF BENEFITS TO OWNER-EMPLOYEES

Your committee's bill, like the House bill, requires that retirement plans established by owner-employees for their own benefit, or for

the benefit of themselves and their employees, may not begin paying retirement benefits to owner-employees before they reach age 59½ (insurance age 60) except in the event of death or disability. Under your committee's bill an individual is considered disabled if he is unable to engage in any substantial gainful activity because of a medically determinable physical or mental impairment which can be expected to result in death or to be of long-continued and indefinite duration. Distribution of retirement benefits, however, must begin not later than 70½ (insurance age 70) in the case of owner-employees, and not later than age 70½ or the year in which he retires in the case of employees and self-employed individuals other then owner-employees. If an owner-employee dies, his remaining interest in the retirement plan must be (1) distributed to beneficiaries within 5 years from the date of his death or, if later, the death of his spouse, (2) used within 5 years to purchase an immediate annuity which will be payable over the beneficiary's life or over a period no longer than the beneficiary's life expectancy or (3) paid out under a plan of distribution already commenced, over a period no longer than the life expectancy of the employee or the joint life expectancy of the employee and his spouse.

If the distribution is made under alternative (1), above, and is completed within 1 taxable year of the beneficiary, the distribution would be treated under the special rules of the bill relating to lump-sum distributions and the special 5-year-averaging devise would apply. (See subdivision Q.) On the other hand, if the distribution is made as permitted by alternative (2), above, there would be no tax due upon distribution to the beneficiary of the annuity contract, but he would be taxable at ordinary income tax rates on amounts received by him under the annuity contract. Distributions under alternative (3), above, would be taxable at the time payments are received by the beneficiary under the annuity contract.

Your committee added the third alternative in order to eliminate the needless cancellation of one annuity contract and the issuance of another one which would pay out over the same period as the original.

M. PREMATURE DISTRIBUTIONS

A tax penalty is imposed by the House bill, and by your committee's substitute, in cases where a premature distribution of all or part of the retirement fund is made before the owner-employee reaches age 59½ or becomes disabled. Under both bills, in these cases, if the premature distribution amounts to $2,500 or more, the tax imposed would not be less than 110 percent of the increase in tax that would have resulted if the income had been received ratably over the 5 years ending with the year of distribution. If the premature distribution amounts to less than $2,500, the tax due would be 110 percent of the increase in tax resulting from inclusion of the entire amount of the premature distribution in gross income for the current year. In either event, the taxable income for the year in which the distribution occurs is treated as being not less than the excess of the amount of the distribution includible in gross income over the deductions allowable for personal exemptions. Any resulting increase in tax can be reduced only by the credit for withheld taxes. As a further penalty in case of a premature distribution, the owner-employee is disqualified from

participating in a retirement plan on his own behalf for 5 years following the year in which the distribution is made. These penalties are imposed in order to prevent retirement plans from, in effect, becoming income-averaging plans under which deductible contributions would be made to the plan in high-income, high-tax years and the assets would be drawn down in low-income or loss years when little or no tax would be due. It is the purpose of this bill to provide means for financing retirement; these penalties are designed to insure that retirement plans will not be used for other purposes.

N. TWO OR MORE BUSINESSES

An owner-employee (or a group of two or more owner-employees) who controls more than one business would be required under the bill to group together all controlled business activities, and coalesce them, for the purpose of determining whether all employees of the owner-employee are covered by a retirement plan, and also for the purpose of insuring that the limitations on contributions are not exceeded. Under this requirement, an owner-employee could not make contributions under two or more retirement plans, which, when totaled together, would exceed $2,500, nor could he deduct more than $1,750 in any taxable year. Thus, an owner-employee may not exceed the limitations on deductible contributions by splitting his activities among two or more businesses and establishing retirement plans in each, nor could he divide his businesses and set up a retirement plan in one business in which, for example, he is the only employee.

The bill also provides that an individual who is an owner-employee in a business (whether or not he controls the business) and is also an owner-employee of another business which he controls may not be covered under the plan of the first business unless he has established a plan for the employees of the business which he controls. The plan for the business which he controls must provide contributions and benefits for employees which are at least as favorable as the contributions and benefits provided for owner-employees under the plan of the first business.

O. CONSTRUCTIVE OWNERSHIP

Your committee's bill includes rules (not included in the House bill) which attribute to a self-employed individual ownership interests in a trade or business which are held by his spouse or minor children. The bill also provides that an individual who owns any interest in a business or is an employee of the business is to be attributed with ownership interests in the business which are owned by his ancestors or lineal descendants. This will insure that no individual will be able to avoid the special requirements of the bill by arguing that he is not an "owner-employee," but merely an employee of a business owned by these close relatives. For example, although other provisions of law permit formation of valid family partnerships, by donation of ownership interests under which income will be taxed to the various family partners rather than to the donor of the ownership interests, your committee believes that for retirement plan purposes, such a donor should be treated as continuing to own the interests he has given to these close relatives.

P. ANNUITY TREATMENT FOR DISTRIBUTIONS

As under present law and under the House bill, retirement benefits under your committee's bill, when paid to individuals as annuities under qualified plans would be taxable as ordinary income except to the extent that they have been financed by nondeductible contributions in which case benefits would be taxable under existing rules which allow individuals to recover their capital invested in a retirement contract free of tax.

Q. ESTATE AND GIFT TAX EXEMPTION

With respect to the estate and gift tax exemption in the case of retirement plan benefits, your committee's bill, like the House bill, does not change present law as it applies to ordinary employees, including owner-managers of corporations. However, the bill does not extend these exemptions to the self-employed (whether or not they are owner-employees) insofar as contributions were made to the plan by or for the individual while he was a self-employed person. The estate and gift tax exclusions will continue to apply with respect to any employer contributions made while the individual was not a self-employed person.

R. LUMP-SUM DISTRIBUTIONS

While your committee's bill does not extend to self-employed individuals (whether or not they are owner-employees) capital gains treatment on certain lump-sum distributions from retirement plans, such treatment is not denied to employees of the self-employed, who are treated in the same manner as employees of corporations. Under both the House bill and your committee's substitute, a self-employed individual will receive capital gains treatment on that portion of a lump-sum distribution which is attributable to any employer contributions made on his behalf while he was not a self-employed person. Capital-gain treatment is not allowed for lump-sum distributions derived from contributions as a self-employed person, but a special averaging device provides for the taxing of such lump-sum distributions received by self-employed individuals after age 59½ or received before age 59½ because of disability or death. Under the bill, the tax on such a distribution is five times the increase in tax resulting from adding 20 percent of such distribution to other taxable income, or by treating 20 percent of the distribution (reduced only by personal exemptions for the year) as taxable income. In this way some protection from the graduated rates of the individual income tax is given to those individuals who receive such a lump-sum distribution.

S. PROHIBITED TRANSACTIONS

The bill tightens the prohibited transaction rules of present law with respect to trusts forming part of pension plans covering owner-employees who control the business by means of a more than 50-percent ownership interest. Substantially identical rules were contained in the House bill. In these situations, since the owner-employee is, in effect, dealing with himself, your committee has pro-

vided that the owner-employee may not borrow from a trust he has established, may not buy from or sell property to that trust, and may not charge any fees for services he renders to the trust. It may be extremely difficult to review the activities of the large number of small trusts that may be established under this bill, and for these reasons your committee's bill prohibits owner-employees from engaging in any transaction with their own retirement trusts.

T. SUMMATION OF REQUIREMENTS FOR OWNER-EMPLOYEE PLANS

In summary, retirement plans covering owner-employees must meet the following requirements or qualifications in addition to those which present law requires of all retirement plans:

(1) If it is a trusteed plan, the trustee must be a bank or similar institution with fiduciary powers, but another person (who may be the employer) may be given power to control investments of the trust fund.

(2) In the case of owner-employees, benefits may not be payable before the owner-employee reaches age 59½, except in the case of severe disability or death, and benefit payments must begin before he reaches age 70½; in the case of self-employed individuals other than owner-employees, and employees of self-employed individuals benefits must be payable at age 70½ or retirement whichever is later Benefits in the foregoing cases may, under regulations, be payable over a period no longer than the life expectancy of the employee (including owner-employees) or the life expectancy of the employee and his spouse.

(3) In the case of plans of owner-employees with employees, contributions for employees must be nonforfeitable at the time they are made.

(4) In the case of a profit-sharing plan, a definite formula for determining employee contributions must be provided.

(5) Plans covering owner-employees must provide contributions for each full-time employee who has 3 years of employment.

(6) An owner-employee must consent to be covered by the plan.

(7) No excess contribution may be made.

(8) Where an owner-employee has employees, the plan may be coordinated with social security (under special rules) only if allowable contributions for him are not more than one-third of the total contributions made under the plan.

(9) If an owner-employee dies, his entire interest must within 5 years be (*a*) distributed to designated beneficiaries, (*b*) used to provide immediate annuities for them, or (*c*) paid out, under a plan of distribution already commenced, to a beneficiary over the life expectancy of the owner-employee or over the joint life expectancy of the owner-employee and his spouse.

(10) Excess contributions, if made, must be returned to the person who made them, and income earned by the plan which is attributable to the interest of an owner-employee with respect to whom an excess contribution was not timely returned must be taxed to the owner-employee.

(11) For purposes of qualifying the plan and determining what limitations are applied to contributions for owner-employees, two or

more businesses controlled by an owner-employee or by a group of owner-employees must be considered as a single business.

(12) Contributions on behalf of any owner-employee must be determined on the basis of his earned income from the trade or business with respect to which the retirement plan is established.

VII. Provisions of Bill Made Applicable to All Retirement Plans

Vesting on termination of plan; forfeiture.—The bill adds two new paragraphs to section 401(a) of the code which have the effect of codifying certain regulations and administrative practices of the Internal Revenue Service. These new paragraphs will apply to all pension plans, not merely those which cover self-employed persons, but because these practices have been in effect for many years, it is understood that no existing employee retirement plans would be invalidated by the addition of these rules to the statute.

The first of these new paragraphs requires that, upon termination of the plan or complete discontinuance of contributions thereto, the rights of all employees then covered by the plan must be nonforfeitable.

The second of these two new paragraphs imposed upon all retirement plans makes it plain that forfeitures of nonvested funds must not be used to increase the benefits any employee would otherwise receive under the plan.

Face amount certificates.—Under the bill nontransferable face amount certificates may in the future be purchased by nontrusteed retirement plans (including plans established by corporations). The present rules permit trustees to invest in such certificates, unless prohibited by local law. Because such certificates so closely resemble term-certain annuity contracts, your committee believes they should be permissible investments in the same manner as annuity contracts.

Nontransferable annuity contracts.—Your committee has added a provision to the bill under which annuity contracts issued under a qualified retirement plan after 1961 must be nontransferable, except where it is owned by a trustee of a qualified plan.

Custodial accounts.—Custodial accounts in a bank may be employed as a medium for funding qualified retirement plans of corporations, as well as plans covering self-employed persons. This provision of your committee's bill requires that funds in the custodial account must be invested either in stock of a regulated investment company or in annuity, endowment, or life insurance policies issued by an insurance company. This provision will enable many retirement plans to reduce their costs of administration since the bank will not have to perform the duties and accept the responsibilities of a trustee.

VIII. Miscellaneous Provisions of the Bill

The bill permits self-employed individuals to qualify for the retirement-income credit on the basis of distributions from qualified retirement plans. However, it does not permit self-employed persons to qualify either for the $5,000 death-benefit exclusion or for the sick-pay exclusion. Those provisions were enacted for the benefit of employees as contrasted to the self-employed and it is not the purpose of this bill to treat self-employed individuals as employees

except for retirement-plan purposes. However, the bill does allow a self-employed individual to exclude from his gross income under section 104 of the code amounts received through accident or health insurance for personal injuries or sickness, to the extent that such amounts are attributable to his own nondeductible contributions.

Where pension contributions take the form of the purchase of annuities, any loans against these contracts by an owner-employee are treated as distributions and any repayments of such loans are treated as contributions. In addition, if any portion of a trust or of a contract is assigned or pledged by an owner-employee that portion is also treated as a distribution from the trust or under the plan. Without these rules, an owner-employee could, in effect, obtain premature access to a substantial portion of the pension funds being accumulated for his retirement.

The bill makes it plain that the deduction for contributions made to a retirement plan by a self-employed individual on his own behalf may not be used to create or increase a net operating loss, and that owners of unincorporated businesses which elect to be taxed as corporations may participate in qualified retirement plans only in their capacity as self-employed persons. The bill also makes it clear that amounts contributed to a qualified retirement plan by a self-employed individual which are deductible, are treated as deductions from gross income in computing adjusted gross income. Thus, a self-employed individual may take this deduction and still qualify for the standard deduction.

IX. Technical Explanation

1. SECTION 1. SHORT TITLE

The first section of the bill provides that the act may be cited as the "Self-Employed Individuals Tax Retirement Act of 1961."

2. SECTION 2. QUALIFICATION OF PLANS

Section 2 of the bill amends section 401 of the Internal Revenue Code of 1954 to provide that self-employed individuals may be covered under qualified pension and profit-sharing plans. In addition, section 2 amends section 401 to add additional requirements which must be met in order for a trust forming part of a plan covering self-employed individuals who own more than 10 percent of the business to qualify under section 401. There are also added to section 401 two additional requirements which must be met by all qualified trusts and plans and one additional requirement which must be met by qualified trusts and plans covering self-employed individuals.

Section 401(a)

Existing section 401(a)(5) of the code provides that a plan shall not be considered discriminatory merely because the contributions or benefits under the plan bear a uniform relationship to the "total compensation, or the basic or regular rate of compensation," of the employees covered under the plan. Paragraph (1) of section 2 of the bill amends section 401(a)(5) to provide that, for purposes of that section and section 401(a)(10), the total compensation of a self-employed individual is such individual's earned income (as defined in sec. 401(c)(2)), and that the basic or regular rate of compensation of such

an individual is that portion of his earned income which bears the same ratio to his total earned income as the basic or regular compensation of the employees (other than self-employed individuals) benefited under the plan bears to their total compensation. This ratio is to be computed in accordance with regulations prescribed by the Secretary or his delegate.

Existing section 401(a) of the code sets forth the requirements which a pension, profit-sharing, or stock bonus trust must meet in order to constitute a qualified trust. Paragraph (2) of section 2 of the bill adds additional requirements (new pars. (7) to (10), inclusive).

The new paragraph (7) of section 401(a) provides that a trust will not qualify unless the plan of which it is a part provides that, upon its termination or upon complete discontinuance of contributions under the plan, each employee benefited under the plan will have an immediate vested right to so much of his benefits under the plan as have accrued and have been funded at the time of the termination or discontinuance or, in the case of a money purchase plan, will have an immediate vested right to the amounts credited to his account as of the date of the termination or discontinuance. This provision is not to be applicable, however, to benefits or contributions which, pursuant to regulations prescribed by the Secretary or his delegate to preclude discrimination, may not be used for designated employees in the event of early termination of the plan. For example, this provision would not require vesting when certain officers or highly compensated employees are, at the inception of the plan, within a few years of retirement age and the granting of vested rights to such employees upon termination of the plan shortly after they reach retirement age would result in the plan being discriminatory in favor of such officers or highly compensated employees.

The new paragraph (8) of section 401(a) provides that a trust forming part of a pension plan will not qualify unless the plan of which it is a part provides that forfeitures must not be applied to increase the benefits any employee would otherwise receive under the plan. Therefore, if the plan calls for future contributions, the forfeitures must be used to reduce such contributions.

The new paragraph (9) of section 401(a) provides that, in the case of a plan which provides contributions or benefits for employees some or all of whom are employees within the meaning of section 401(c)(1), a trust will not qualify unless, under the plan of which it is a part, the entire interest of each employee either (A) will be distributed to him not later than his taxable year in which he attains the age of 70½ years, or, in the case of an employee other than an owner-employee (as defined in sec. 401(c)(3)), in which he retires, whichever is the later, or (B) will be distributed, commencing before the close of such taxable year, (i) over the life of such employee or over the lives of such employee and his spouse, or (ii) over a period not extending beyond the life expectancy of such employee or over the life expectancy of such employee and his spouse. For these purposes, the Secretary or his delegate is to issue regulations prescribing the specific conditions under which these requirements will be considered to be met.

The new paragraph (10) of section 401(a) provides that, in the case of a plan which provides contributions or benefits for any owner-employee (as defined in sec. 401(c)(3))—

Section 401(a)(3) and the first and second sentences of section 401(a)(5) shall not apply, but—

(i) such plan shall not be considered discriminatory within the meaning of section 401(a)(4) merely because the contributions or benefits of or on behalf of employees under the plan bear a uniform relationship to the total compensation, or the basic or regular rate of compensation, of such employees, and

(ii) such plan shall not be considered discriminatory within the meaning of section 401(a)(4) solely because under the plan contributions described in section 401(e)(3)(A) which are in excess of the amounts which may be deducted under section 404 (determined without regard to sec. 404(a)(10)) for the taxable year may be made on behalf of any owner-employee.

In addition, subparagraph (B) of the new section 401(a)(10) provides that a trust forming part of a plan covering a self-employed individual owning more than a 10-percent interest in the business must, in order to qualify under section 401, also meet the new requirements of section 401(d).

Section 401(c)

Paragraph (3) of section 2 of the bill adds a new subsection (c) to section 401(a) of the code, which contains certain definitions and rules relating to self-employed individuals and owner-employees.

(1) *Definition of "employee."*—Under the present law, a qualified plan can cover only those individuals who are employees under common law. Paragraph (1) of the new subsection (c) defines the term "employee" to include, for any taxable year, a self-employed individual who has earned income (as defined in sec. 401(c)(2)) for the taxable year.

To the extent provided by regulations of the Secretary or his delegate, the term "employee" also includes, for any taxable year—

(A) an individual who would be an employee within the meaning of the first sentence of section 401(c)(1) but for the fact that the trade or business carried on by such individual did not have net profits for the taxable year, and

(B) an individual who has been an employee within the meaning of the first sentence of section 401(c)(1) for any prior taxable year.

(2) *Definition of "earned income."*—Paragraph (2) of the new subsection (c) contains a definition of "earned income." Subparagraph (A) provides that such term means the net earnings from self-employment (as defined in sec. 1402(a)) to the extent that such net earnings constitute earned income as defined in section 911(b) but determined with the application of subparagraph (B) of the new subsection (c)(2), but such net earnings and earned income shall be determined with certain modifications. The first of these modifications provides that doctors and certain ministers, who are not subject to the tax on self-employment income, shall be treated, for this purpose, as being engaged in a trade or business from which net earnings from self-employment are derived. The second modification provides that certain individuals described in section 3121(d)(3) who are not employees but who are not subject to the tax on self-employment income shall be

similarly treated. The third modification provides that amounts which are not otherwise includible in gross income shall not be included in an individual's net earnings from self-employment.

Subparagraph (B) of the new subsection (c)(2) provides that, in applying section 911(b) of the code for purposes of determining the "earned income" of a self-employed individual who is engaged in a trade or business in which both personal services and capital are material income-producing factors and with respect to which the individual actually renders personal services on a full-time, or substantially full-time, basis, so much of his share of the net profits of such trade or business as does not exceed $2,500 shall be considered as earned income. Such subparagraph (B) also provides that, in the case of any such individual who is engaged in more than one trade or business with respect to which he actually renders substantial personal services, if with respect to all such trades or businesses he actually renders personal services on a full-time, or substantially full-time, basis, there shall be considered as earned income with respect to the trades or businesses in which both personal services and capital are material income-producing factors (A) so much of his share of the net profits of such trades or businesses as does not exceed $2,500 reduced by (B) his share of the net profits of any trade or business in which only personal services is a material income-producing factor. When a self-employed individual is engaged in two or more trades or businesses in which both personal services and capital are material income-producing factors, the $2,500 must be allocated among such trades or businesses, but in no case shall the individual be considered to have earned income from a trade or business in excess of his share of the net profits of such trade or business.

Section 911(b) provides that, in the case of a taxpayer engaged in a trade or business in which both personal services and capital are material income-producing factors, such individual's earned income from such trade or business shall not exceed 30 percent of his share of the net profits of such trade or business. Subparagraph (B) provides that its provision shall not be construed to reduce the amount of an individual's earned income below that which he would be considered to have under section 911(b). The application of subparagraph (B) may be illustrated by the case of an individual who is engaged on a full-time basis in a trade or business in which both personal services and capital are material income-producing factors and whose net profits from the trade or business for the taxable year are $6,000. Under section 911(b), such individual would be presumed to have received not more than $1,800 of earned income from such trade or business (30 percent times $6,000). However, under subparagraph (B) such individual is considered to have received $2,500 of earned income from such trade or business.

(3) *Definition of "owner-employee."*—Certain of the provisions of the bill are applicable only to owner-employees or to plans covering owner-employees. Paragraph (3) of the new subsection (c) defines the term "owner-employee" to mean an employee who—

(A) owns the entire interest in an unincorporated trade or business, or

(B) in the case of a partnership, is a partner who owns more than 10 percent of either the capital interest or the profits interest in such partnership.

To the extent provided in regulations prescribed by the Secretary or his delegate, the term owner-employee also means an individual who has been an owner-employee within the meaning of section 401(C)(3).

(4) *Definition of "employer."*—In order to qualify under section 401, a plan must be a plan of an employer. Paragraph (4) of the new subsection (c) provides that, for this purpose, an individual who owns the entire interest in an unincorporated trade or business shall be treated as his own employer. Similarly, a partnership shall be treated as the employer of its partners.

(5) *Rules of constructive ownership.*—Paragraph (5) of the new subsection (c) provides rules of constructive ownership for determining who is an owner-employee and for determining in certain other situations an individual's ownership interest. Under such paragraph (5), an individual shall be treated as owning any interest in an unincorporated trade or business which is owned, directly or indirectly, by his spouse or minor children. This rule is applicable whether or not such individual himself owns any interest in the trade or business. In addition, when an individual owns any interest in an unincorporated trade or business or is an employee of such trade or business, he shall also be treated as owning any interest in such unincorporated trade or business, which is owned, directly or indirectly, by his ancestors or by his lineal descendants. Paragraph (5) provides, however, that any interest treated as owned by any individual by reason of such paragraph shall not be treated as owned by him for the purpose of applying such paragraph in order to make any other individual the constructive owner of such interest. For the purpose of paragraph (5), a legally adopted child or an individual is treated as a child of such individual by blood.

Section 401(d)

Paragraph (3) of section 2 of the bill also adds a new subsection (d) to section 401, which sets forth additional requirements which must be met in order for a trust-forming part of a pension or profit-sharing plan providing contributions or benefits for any owner-employees to qualify under section 401.

(1) *Trustee must be a bank.*—Paragraph (1) of the new subsection (d) provides that, in the case of a trust which is created on or after the date of the enactment of the bill, or which was created before such date but is not exempt as a qualified trust on the day before such date, the trustee must be a bank. However, paragraph (1) provides that a person (including the employer) other than a bank may be granted, under the trust instrument, the power to direct the investment of the trust funds. Paragraph (1) is not applicable to a trust created or organized outside the United States before the date of the enactment of the bill if, under section 402(c), such trust is treated as exempt from tax under section 501(a) on the day before such date. Such paragraph (1) defines the term "bank" to mean (A) a bank as defined in section 581, and (B) a corporation which under the laws of the State of its incorporation is subject to supervision and examination by the commissioner of banking or similar officer, and (C) in the case of a foreign trust, a bank or trust company, wherever incorporated, exercising fiduciary powers and subject to supervision and examination by governmental authority.

(2) *Vesting.*—Paragraph (2)(A) of the new subsection (d) provides that, in the case of a plan which provides contributions or benefits for employees some or all of whom are owner-employees, each employee's rights to or derived from the contributions under the plan must be nonforfeitable at the time such contributions are paid to or under the plan. The requirement of vesting shall not apply to contributions which, under provisions of the plan adopted pursuant to regulations prescribed by the Secretary or his delegate to preclude the discrimination prohibited by section 401(a)(4), may not be used to provide benefits for designated employees in the event of early termination of the plan.

(3) *Profit-sharing plans.*—Paragraph (2)(B) of the new subsection (d) also provides that in the case of a profit-sharing plan which provides contributions or benefits for employees some or all of whom are owner-employees, there must be a definite formula for determining contributions to be made to the trust by the employer on behalf of employees other than owner-employees.

(4) *Required coverage.*—Paragraph (3) of the new subsection (d) provides that, in the case of a plan which provides contributions or benefits for an owner-employee who owns more than 10 percent of the business, the trust forming a part of such plan shall constitute a qualified trust under section 401 only if such plan benefits each employee having a period of employment of 3 years or more. For the purpose of determining whether an individual is an employee for whom a covered owner-employee is required to provide benefits, the new paragraph (3) provides that the term "employee" does not include any employee whose customary employment is for not more than 20 hours in any one week or is for not more than 5 months in any calendar year.

(5) *Consent to being included.*—Paragraph (4)(A) of the new subsection (d) provides that, under the plan, contributions or benefits must not be provided for any owner-employee unless such owner-employee has consented to being included under the plan.

(6) *Time of distribution.*—Paragraph (4)(B) of the new subsection (d) provides that, under the plan, no benefits may be paid to any owner-employee, except in the case of his disability (within the meaning of sec. 213(g)(3)), prior to his attaining age 59½.

(7) *Contributions for owner-employees.*—Paragraph (5) of the new subsection (d) provides that the plan must not permit—

(A) contributions to be made by an employer for any owner-employee in excess of the amounts which may be deducted under section 404 (determined without regard to sec. 404(a)(10)) for the taxable year;

(B) in the case of a plan which covers only owner-employees, contributions to be made on behalf of any owner-employee in excess of those which are deductible under section 404 (without regard to sec. 404(a)(10)) for the taxable year (i.e., contributions by an owner-employee in his capacity as an employee may not be made); and

(C) if a distribution under the plan is made to any owner-employee before such owner-employee attains the age of 59½ or becomes disabled, contributions to be made on behalf of such owner-employee for the 5 taxable years succeeding the taxable year in which such distribution is made.

Such paragraph (5) also provides that subparagraphs (A) and (B) shall not apply to any contribution which is excepted from the definition of excess contribution contained in section 401(e)(1) by reason of the application of section 401(e)(3).

(8) *Coordination with social security.*—Paragraph (6) of the new subsection (d) provides that a plan providing contributions or benefits for any owner-employee must, except as otherwise provided in such paragraph (6), satisfy the requirements of section 401(a)(4) without taking into account, for any purpose, contributions or benefits under chapter 2 (relating to the tax on self-employment income), chapter 21 (relating to Federal Insurance Contributions Act), title II of the Social Security Act, as amended, or any other Federal or State law. Such paragraph (6) further provides that, if—

(A) of the contributions deductible under section 404 (determined without regard to sec. 404(a)(10)) for the taxable year, not more than one-third is deductible by reason of contributions by the employer for owner-employees; and

(B) taxes paid by the owner-employees under chapter 2 (relating to tax on self-employment income), and the taxes which would be payable under such chapter 2 by the owner-employees but for paragraphs (4) and (5) of section 1402(c), are taken into account as contributions by the employer on behalf of such owner-employees,

then taxes paid under section 3111 (relating to tax on employers) with respect to an employee may, for purposes of section 401(a)(4) be taken into account as contributions by the employer for such employee under the plan.

(9) *Distribution after death.*—Under paragraph (7) of the new subsection (d), the plan must provide that, after the death of an owner-employee, his remaining interest in the plan must be either distributed to his beneficiary within 5 years, or used within that period to purchase an immediate annuity for his beneficiary which will be distributed immediately to such beneficiary or beneficiaries. A similar rule is provided if distribution of the interest of an owner-employee has been commenced to his surviving spouse, and the surviving spouse dies before the entire interest is distributed. However, such paragraph (6) shall not apply if distribution of the interest of an owner-employee has commenced and such distribution is for a term certain over a period permitted under section 401(a)(9)(B)(ii).

(10) *Repayment of excess contributions.*—Paragraph (8) of the new subsection (d) provides that, under the plan—

(A) any excess contribution, together with the income attributable thereto, is (except in the case of a willfully made excess contribution) to be repaid to the owner-employee on whose behalf such excess contribution was made;

(B) if for any taxable year the plan does not, by reason of section 401(e)(2)(A), meet (for purposes of sec. 404) the requirements of section 401(d) with respect to an owner-employee, the income for the taxable year attributable to the interest of such owner-employee under the plan is to be paid to such owner-employee; and

(C) the entire interest of an owner-employee is to be repaid to him, when required by section 401(e)(2)(E) (relating to willful excess contributions).

(11) *Control of more than one trade or business.*—Paragraph (9)(A) of the new subsection (d) provides that, if the plan provides contributions or benefits for an owner-employee who controls, or two or more owner-employees who together control, the trade or business with respect to which the plan is established, and who also control as an owner-employee or as owner-employees one or more other trades or businesses, such plan and the plans established by such other trades or businesses must constitute one overall plan which meets the requirements of section 401 (a) (including the new paragraph (10) of section 401(a) and section 401(d)), with respect to the employees of all such trades or businesses.

Paragraph (9)(B) of the new subsection (d) provides that an owner-employee, or two or more owner-employees, shall be considered to control a trade or business if such owner-employee, or such two or more owner-employees together—

(i) own the entire interest in an unincorporated trade or business, or

(ii) in the case of a partnership, own more than 50 percent of either the capital interest or the profits interest in such partnership.

For purposes of determining his ownership interest, an owner-employee, or two or more owner-employees, shall be treated as owning any interest in a partnership which is owned, directly or indirectly, by a partnership which such owner-employee, or such two or more owner-employees, are considered to control within the meaning of paragraph (9)(B).

(12) *Owner-employee benefited under more than one plan.*—Paragraph (10) of the new subsection (d) provides that a plan must not provide contributions or benefits for any owner-employee who controls (within the meaning of sec. 401(d)(9)(B)), or for two or more owner-employees who together control, as an owner-employee or as owner-employees, any other trade or business, unless the employees of each trade or business which such owner-employee or such owner-employees control are included under a plan which satisfies the requirements of section 401(a) (including sec. 401(a)(10)) and section 401(d), and provides contributions and benefits for employees which are not less favorable than contributions and benefits provided for owner-employees under the plan.

The application of such paragraph (10) may be illustrated by the following example:

Example.—X, a self-employed individual, is a 15 percent partner in the XYZ partnership and is the owner of the P company, a sole proprietorship. The pension plan of the XYZ partnership must not provide contributions or benefits for X unless the employees of the P company are included under a pension plan of that company which satisfies the requirements of section 401(a) (including sec. 401(a)(10)) and section 401(d), and which provides contributions and benefits for employees which are not less favorable than contributions and benefits provided for X under the plan of the XYZ partnership. This requirement must be met whether or not X is included under the plan of the P company.

(13) *Contributions limited to the earned income from the trade or business.*—Paragraph (1) of the new subsection (d) provides that, under the plan, contributions on behalf of any owner-employee may

be made only with respect to the earned income of such owner-employee derived from the trade or business with respect to which the plan is established.

Section 401(e)

Paragraph (3) of section 2\ of the bill adds a new subsection (e) to section 401, which contains a definition of "excess contribution" and which sets forth the consequences of making such an excess contribution. For the purpose of determining whether an excess contribution has been made on behalf of any owner-employee in a taxable year, there must be taken into account all other contributions made on behalf of such owner-employee for such taxable year.

(1) *Definition of "excess contribution"*.—Paragraph (1) of the new subsection (e) defines the term "excess contribution" for purposes of section 401. Except as otherwise provided in section 401(e)(3), the term "excess contribution" means—

(A) if, in the taxable year, contributions are made under the plan only on behalf of owner-employees, so much of any contribution made on behalf of any owner-employee as is not deductible under section 404 (determined without regard to sec. 404(a)(10)) for the taxable year; or

(B) if, in the taxable year, contributions are made under the plan on behalf of both owner-employees and other employees—

(i) so much of any contribution made by an employer on behalf of any owner-employee as is not deductible under section 404 (determined without regard to sec. 404(a)(10)) for the taxable year;

(ii) so much of any contribution as is made by an owner-employee (as an employee) at a rate which exceeds the rate of contributions permitted to be made by employees other than owner-employees;

(iii) so much of any contributions made by an owner-employee (as an employee) as exceeds the lesser of $2,500 or 10 percent of the earned income for such taxable year derived by such owner-employee from the trade or business with respect to which the plan is established;

(iv) in the case of any individual on whose behalf contributions are made under more than one plan as an owner-employee, the amount of any contribution made by such owner-employee (as an employee) under all such plans which exceeds $2,500; and

(C) any contribution made on behalf of an owner-employee in any taxable year for which, under section 401(e)(2)(A) or (E), the plan does not (for purposes of sec. 404) meet the requirements of section 401(d) with respect to such owner-employee.

Such paragraph (1) provides, however, that the amount of any contribution which is allocable (determined in accordance with regulations prescribed by the Secretary or his delegate) to the purchase of life, accident, health, or other insurance shall not be taken into account in determining the amount of any contribution for purposes of determining whether such contribution is an excess contribution.

(2) *Effect of excess contribution.*—Paragraph (2)(A) of the new subsection (e) provides that, if an excess contribution (other than a willful excess contribution to which sec. 401 (e)(2)(E) applies) is made

on behalf of an owner-employee in any taxable year, the plan with respect to which such excess contribution is made shall, except as provided in section 401(e) (2) (C) and (D), be considered, for purposes of section 404, as not meeting the requirements of section 401(d) with respect to such owner-employee for the taxable year and for all succeeding taxable years. In any year when an otherwise exempt trust forming part of a plan is (pursuant to par. (2)(A)) considered, for purposes of section 404, as not meeting the requirements of section 401(d) with respect to an owner-employee, the earnings of such trust (including those attributable to the interest of the owner-employee with respect to whom the excess contribution was made) shall remain exempt from tax in the hands of the trust. However, the trust shall not be considered exempt for purposes of deducting any contributions made on behalf of the owner-employee with respect to whom the excess contribution was made.

Paragraph (2)(B) of the new subsection (e) provides that, for any taxable year for which a plan does not meet the requirements of section 401(d) with respect to an owner-employee by reason of paragraph (2)(A), such owner-employee shall currently include in his gross income the income for such year attributable to his interest in the plan.

Paragraph (2)(C) of the new subsection (e) provides that paragraph (2)(A) (and, consequently, par. (2)(B)) shall not apply to an excess contribution with respect to any taxable year if (on or before the close of the 6-month period beginning on the day on which the Secretary or his delegate sends by certified or registered mail, to the trust, insurance company, or other person to whom such excess contribution was paid, notice of the amount of such excess contribution) the amount of such excess contribution, and the income attributable thereto, is repaid to the owner-employee on whose behalf such excess contribution was made. Such paragraph (2)(C) further provides that, if the contribution is an excess contribution by reason of exceeding the deduction limitations under section 404, the notice required to be sent by the Secretary or his delegate shall not be mailed prior to the time that the amount of the tax under chapter 1 of the Internal Revenue Code of the owner-employee to whom the excess contribution is to be repaid has been finally determined for the taxable year in which such excess contribution was made.

Paragraph (2)(D) of the new subsection (e) provides that, if an excess contribution, together with the income attributable thereto, is not repaid within the 6-month period, paragraph (2)(A) shall not apply to any taxable year beginning with the taxable year in which the trust, insurance company, or other person to whom such excess contribution was paid repays the amount of such excess contribution to the owner-employee on whose behalf such excess contribution, and also pays to the owner-employee with respect to whom the excess contribution was made the amount of income attributable to the interest of such owner-employee which, under paragraph (2)(B), is required to be included in such owner-employee's gross income for any prior taxable year.

(3) *Special rule if excess contribution was willfully made.*—Paragraph (2)(E) of the new subsection (e) provides that, if an excess contribution made on behalf of an owner-employee is determined to have been willfully made, then, instead of applying the provisions of section 401(e)(2) (A), (B), (C), and (D)—

(i) there shall be distributed to the owner-employee on whose behalf such excess contribution was willfully made his entire interest in all plans in which he is a participant as an owner-employee; and

(ii) contributions may not be made on behalf of such owner-employee to any plan in which he is a participant as an owner-employee for the taxable year in which it is determined that such excess contribution was willfully made and for the 5 taxable years following such taxable year.

Thus, when it has been determined that an excess contribution has been willfully made to a plan on behalf of an owner-employee, such owner-employee's entire interest in all plans in which he is a participant as an owner-employee must be distributed to him and he may not participate in any plan with respect to which he is an owner-employee for the taxable year of the determination and for the 5 succeeding taxable years.

(4) *Statute of limitations.*—Paragraph (2)(F) of the new subsection (e) provides that, in any case in which a plan does not meet the requirements of section 401(d) with respect to an owner-employee by reason of paragraph (2)(A), the period for assessing any deficiency arising by reason of—

(i) the disallowance of any deduction under section 404 because such plan does not meet the requirements of section 401(d) with respect to an owner-employee on whose behalf an excess contribution was made, or

(ii) the inclusion, under paragraph (2)(B), in gross income of such owner-employee of the income attributable to his interest under a plan,

for the taxable year in which such excess contribution was made or for any succeeding taxable year shall not expire prior to 1 year after the close of the 6-month period referred to in pargraph (2)(C).

(3) *Contributions for premiums on annuity, etc., contracts.*—Paragraph (3) of the new subsection (e) provides for certain exceptions to the definition of an "excess contribution" in section 401(e)(1). Such paragraph (3) provides that a contribution by an employer on behalf of an owner-employee shall not be considered to be an excess contribution within the meaning of section 401(e)(1), if—

(A) under the plan such contribution is required to be applied (directly or through a trustee) to pay premiums or other consideration for one or more annuity, endowment, or life insurance contracts issued under the plan on the life of such owner-employee, and

(B) the amount of such contribution exceeds the amount deductible under section 404 with respect to contributions made by the employer on behalf of such owner-employee; and

(C) the amount of such contribution does not exceed the average of the amounts which were deductible under section 404 (determined without regard to sec. 404(a)(10)) with respect to contributions made by the employer on behalf of such owner-employee (or which would have been deductible if section 404 had been in effect for prior years) for the first 3 taxable years (i) preceding the year in which the last such annuity, endowment, or life insurance contract was issued under the plan, and (ii) in which such owner-employee derived earned income from the trade

or business with respect to which the plan is established, or for so many of such taxable years as such owner-employee was engaged in such trade or business and derived earned income therefrom.

The new paragraph (3) also provides that, in the case of any individual on whose behalf contributions described in the new paragraph (3)(A) are made under more than one plan as an owner-employee during any taxable year, the amount of contributions to which the new paragraph (3) applies for such taxable year must not exceed $2,500. Thus, if the premiums or other consideration for annuity contracts paid on behalf of an owner-employee under more than one plan from contributions made by employees exceed $2,500, the excess contributions rules of sections 401(e) (1) and (2) apply to all such contributions on behalf of such owner-employee for such taxable year. Furthermore, any contribution which is not considered to be an excess contribution by reason of the application of the provisions of section 401(e)(3) shall, for purposes of section 401(e)(1)(B) (ii), (iii), and (iv), be taken into account as a contribution made on behalf of such owner-employee as an employee to the extent that the amount of such contribution is not deductible under section 404 (without regard to section 404(a)(10)) for the taxable year, but only for the purpose of applying such sections to other contributions made on behalf of such owner-employee as an employee.

Section 401(f)

Under the present law, section 401(a) of the code relates only to trusts which form part of pension, profit-sharing, and stock-bonus plans. Paragraph (3) of section 2 of the bill also adds a new subsection (f) to section 401(a), which permits certain custodial accounts to qualify under section 401(a) if they form a part of qualified plans. Under the new subsection (f), a custodial account shall be treated as a qualified trust, if—

(1) such custodial account satisfies all the requirements which must be satisfied by a qualified trust;

(2) the custodian is a bank (as defined in section 401(d)(1));

(3) the investment of the funds in such account (including all earnings) is to be made either solely in regulated investment company stock with respect to which an employee is the beneficial owner (treating as subject to this requirement all capital gain dividends and any refund to the custodian under section 852(b)(3)(D)(ii) of the code), or solely in annuity, endowment, or life insurance contracts issued by an insurance company;

(4) in the case of investments in regulated investment company stock, the custodian or its nominee is the shareholder of record of all stock held in the account; and

(5) in the case of annuity, endowments, or life insurance contracts, the contracts are held by the custodian until distributed under the plan.

For purposes of the code, in the case of a custodial account treated as a qualified trust under section 401 by reason of the new section 401(f), the custodian of such account is to be treated as the trustee thereof.

Paragraph (2) of the new subsection (f) defines "regulated investment company" to mean a domestic corporation (A) which is a regulated investment company within the meaning of section 851(a), and (B) which issues only redeemable stock.

Section 401(g)

Paragraph (3) of section 2 of the bill also adds a new subsection (g) to section 401 which provides that, for purposes of sections 401, 402, 403, and 404, the term "annuity" includes a face-amount certificate as defined in section 2(a)(15) of the Investment Company Act of 1940 (15 U.S.C. 80a-2); but does not include any contract or certificate issued after December 31, 1961, which is transferable, if any person other than the trustee of a qualified trust is the owner of such contract or certificate.

SECTION 3. DEDUCTIBILITY OF CONTRIBUTIONS TO PLANS

Section 3 of the bill amends section 404 of the Internal Revenue Code of 1954 to allow the deductions for certain amounts of contributions made on behalf of self-employed individuals who are covered under qualified pension, annuity, and profit-sharing plans. In addition, section 404 is amended to provide additional limitations on the amount that may be deducted with respect to contributions on behalf of self-employed individuals.

Section 404(a)

(1) *Annuity plans.*—Section 404(a)(2) allows, within the applicable limitations, the deduction of employer contributions paid toward the purchase of retirement annuities if such purchase is a part of a plan which meets the requirements of section 401(a) (3), (4), (5), and (6), and if certain other conditions are met. Subsection (a)(1) of section 3 of the bill amends section 404(a)(2) to provide that the annuity plan must, in addition to meeting the present requirements, also meet the requirements in the new paragraphs (7), (8), and (9) of section 401(a) and, if the plan benefits owner-employees, the requirements of the new sections 401(a)(10) and 401(d) (other than section 401(d)(1). Thus, a qualified annuity plan is, in general, subject to the same requirements as is a qualified pension, profit-sharing, or stock-bonus trust.

(2) *Inclusion of self-employed.*—Subsection (a)(2) of section 3 of the bill adds a new paragraph (8) to section 404(a), which allows the deduction under section 404(a) of contributions to a qualified, plan covering self-employed individuals. To accomplish this purpose the new paragraph (8) provides that, for purposes of applying section 404 to a qualified pension, annuity, or profit-sharing plan covering self-employed individuals—

(A) the term "employee" is defined to include a self-employed individual who is an employee within the meaning of section 401(c)(1), and the employer of such a self-employed individual is defined to mean the person treated as his employer under section 401(c)(4);

(B) the term "earned income" has the meaning assigned to it by section 401(c)(2);

(C) the contributions to such a plan on behalf of a self-employed individual shall be considered to satisfy the conditions of section 162 or section 212 to the extent that such contributions do not exceed the earned income (as defined in sec. 401(c)(2) of such individual derived from the trade or business with respect to which such plan is established. However, contributions on

behalf of self-employed indivuduals which are allocable (determined in accordance with regulations prescribed by the Secretary or his delegate) to the purchase of life, accident, health, or other insurance are not considered to satisfy the conditions of section 162 or section 212 and, therefore, are not deductible under section 404; and

(D) all references in section 404 to the term "compensation" shall, in the case of a self-employed individual, be considered a reference to the earned income (as defined in sec. 401(c)(2)) of such individual derived from the trade or business with respect to which the plan is established.

(3) *Plans benefiting owner-employees.*—Subsection (a)(2) of section (3) of the bill adds a new paragraph (9) to section 404(a), which provides special rules for computing the limitations on the amounts deductible for contributions under a qualified pension, annuity, or profit-sharing plan covering owner-employees.

Subparagraph (A) of the new paragraph (9) provides that the limitations in paragraphs (1), (2), (3), and (7) of section 404(a) shall be computed, with respect to employees (other than owner-employees), as if such employees were the only employees for whom contributions or benefits are provided under the plan. For example, if a qualified profit-sharing plan covers both owner-employees and other employees, the amount deductible under section 404(a)(3) with respect to contributions on behalf of such other employees is 15 percent of the compensation paid to such other employees if there are no carryovers for such year.

Subparagraph (B) of the new paragraph (9) provides that the limitations in paragraphs (1), (2), (3), and (7) of section 404(a) with respect to contributions under a qualified plan on behalf of owner-employees, shall be computed—

(i) as if such owner-employees are the only employees for whom contributions or benefits are provided under the plan; and

(ii) without regard to the carryover provisions contained in section 404(a)(1)(D), the second and third sentences of section 404(a)(3), and the second sentence of section 404(a)(7).

Subparagraph (C) of the new paragraph (9) provides that the amounts which are otherwise deductible under section 404(a) with respect to contributions on behalf of an owner-employee shall not exceed the additional limitations provided in section 404(e).

The new paragraph (9) further provides that, for purposes of section 404, the term "owner-employee" has the meaning assigned to it by section 401(c)(3) (determined with the application of the rules of constructive ownership contained in sec. 401(c)(5)).

(4) *Special limitation on amount allowed as a deduction for self-employed individuals.*—Subsection (a)(2) of section 3 of the bill adds a new paragraph (10) to section 404(a), which provides a special limitation on the amount allowable as a deduction under sections 404(a)(1), (2), (3), and (7) in any taxable year with respect to contributions made on behalf of any individual who is an employee within the meaning of section 401(c)(1).

The new paragraph (10) provides that, notwithstanding any other provision of section 404, in the case of any individual who is an employee within the meaning of section 401(c)(1), the amount allowable as a deduction is equal to—

(1) so much of the contributions made on behalf of such individual which are deductible under sections 404(a) (1), (2), (3), and (7) (determined without regard to the new paragraph (10)) as does not exceed $1,000, plus

(2) one-half of so much of the contributions made on behalf of such individual which are deductible under such sections as exceeds $1,000.

The new paragraph (10) further provides that, for purposes of section 401, the amount which may be deducted, or the amount deductible, under section 404, with respect to contributions made on behalf of a self-employed individual, shall be determined without regard to the new section 404(a)(10).

(5) *Interrelation of provisions of section 404(a).*—Section 404(a)(10) provides that any self-employed individual will be limited to a deduction of one-half of the amount in excess of $1,000 that would otherwise be deductible under section 404(a). The Provisions limiting the amount of otherwise deductible contributions are distinct from the provisions integrating the retirement plans of self-employed individuals into the structure of the present provisions of the code relating to qualified plans. Consequently, the special limitation in section 404(a)(10) is applied solely for the purpose of determining the amount which will be allowed as a deduction under section 404 for income tax purposes.

(6) *Determination of amount allowed as a deduction from gross income.*—In the case of self-employed individuals who are not owner-employees, the amount of the contributions made on their behalf which is deductible is determined by first applying to the applicable provisions of sections 404(a) (1), (2), and (3), and (7). Although there is no fixed maximum limitation the amount deductible under section 404(a), the new section 404(a)(8) provides that certain amounts contributed on behalf of self-employed individuals do not satisfy the requirements of sections 162 or 212 and are, therefore, not deductible under sections 404(a) (1), (2), or (3). The amounts to which the new section 404(a)(8) applies are contributions on behalf of self-employed individuals which exceed their earned income derived from the trade or business with respect to which the plan is established, and contributions which, under regulations prescribed by the Secretary or his delegate, are allocable to the purchase of life, accident, health, or other insurance. Finally, for the purpose of determining the amount which will be allowed as a deduction for income tax purposes, section 404(a)(10) is then applied.

In the case of owner-employees, the limitation in new section 404(e) is pertinent to the determination of the amount allowed as a deduction. Therefore, the discussion of the method of computing such amount is included with the discussion of the provisions of section 404(e).

Section 404(e)

Subsection (b) of section 3 of the bill adds to section 404 a new subsection (e), which provides additional limitations on amounts which may be deducted with respect to contributions on behalf of owner-employees.

(1) *Special limitations for owner-employees.*—Paragraph (1) of the new subsection (e) provides the additional limitations which are applicable in determining the amount that may be deducted with

respect to contributions under a qualified plan on behalf of owner-employees. Under paragraph (1), the amounts deductible under section 404(a) in any taxable year with respect to contributions on behalf of such owner-employees shall not exceed $2,500, or 10 percent of the earned income derived by such owner-employee from the trade or business with respect to which the plan is established, whichever is the lesser.

(2) *Overall limitation.*—Paragraph (2) of the new subsection (e) provides that in any taxable year in which amounts are deductible under two or more plans on behalf of an individual who is an owner-employee with respect to such plans, the aggregate amount deductible for such taxable year under all such plans with respect to contributions on behalf of such owner-employee shall not exceed $2,500. The overall limitation in paragraph (2) has no application with respect to contributions made under a plan on behalf of an employee who is not an owner-employee of the trade or business with respect to which the plan is established, even though such employee may be covered as an owner-employee under a plan or plans established by other trades or businesses.

Paragraph (2)(B) of the new subsection (e) provides that, in any case when paragraph (2)(A) reduces the amounts which are otherwise deductible under section 404 with respect to contributions made on behalf of an owner-employee under two or more plans, the portion of such reduced amount which is deductible under each plan shall be determined in accordance with regulations prescribed by the Secretary or his delegate.

(3) *Contributions allocable to insurance protection.*—Paragraph (3) of the new subsection (e) provides that the special limitations in section 404(e) are not applicable with respect to contributions which are allocable (determined under regulations prescribed by the Secretary or his delegate) to the purchase of life, accident, health, or other insurance.

(4) *Computation of amount allowed as a deduction from gross income in the case of owner-employees.*—If contributions are made on behalf of an owner-employee under a qualified plan, the provisions of the new section 404(a)(8) are applicable, and the computation of the amount deductible under sections 404(a)(1), (2), (3), and (7) is made in the manner prescribed in new section 404(a)(9). Furthermore, section 404(a)(9)(C) requires that the amount deductible, as so determined, must not exceed the applicable limitation in section 404(e). Section 404(e) places a ceiling on the amount deductible. That limit is 10 percent of the earned income of the owner-employee, or $2,500, whichever is the lesser. Finally, if the amount deductible as so determined exceeds $1,000, the special limitation of section 404(a)(10) provides that only one-half of such excess may be deducted.

Section 404(f)

Subsection (b) of section 3 of the bill adds to section 404 a new subsection (f), which provides that, for purposes of section 404, any amount paid, directly or indirectly, by an owner-employee in repayment of any loan on an insurance policy which, under section 72(m)(4)(B), was treated as an amount received under a contract shall be treated as a contribution to which section 404 (including the limitations therein) applies on behalf of such owner-employee.

SECTION 4. TAXABILITY OF DISTRIBUTIONS

Section 4 of the bill amends section 72 of the Internal Revenue Code of 1954 to provide rules for the taxation of amounts distributed under qualified plans for self-employed individuals or the beneficiaries of such individuals. In addition, section 4(b) adds a new subsection (m)(3) to section 72 of the code which applies to all qualified plans.

Section 72(d)

Existing section 72(d) of the code provides a special rule for the taxation of an annuity receivable by an employee when the aggregate amount receivable by the employee under the terms of the contract during the 3-year period beginning on the date on which the amount is first received under the contract as an annuity is equal to or greater than the consideration for the contract contributed by the employee. Subsection (a) of section 4 of the bill amends section 72(d)(2) to provide that, for purposes of section 72(d), any contribution which is made with respect to the contract while the employee is a self-employed individual but which is not allowed as a deduction under section 404 shall be treated as consideration for the contract contributed by the employee. This amendment merely makes clear that, as in the case of qualified plans established by corporations, a self-employed individual may not treat as consideration for the contract contributed by the employee any contributions under the plan for which deductions were allowed and which, consequently, are considered employer contributions. Moreover, under the new section 72(m)(2), described below, contributions on behalf of an owner-employee which are used to purchase life, accident, health, or other insurance are not, for purposes of section 72(d), included in the employee's basis for the contract.

Section 72(m)

Subsection (b) of section 4 of the bill adds to section 72 a new subsection (m), which provides special rules applicable to the taxation of employee annuities and distributions under employee plans.

(1) *Amounts received before annuity starting date.*—Paragraph (1) of the new subsection (m) provides that any amounts which are received under an annuity, endowment, or life insurance contract before the annuity starting date and which are not received as an annuity (within the meaning of sec. 72(e)(2)) shall be included in the recipient's gross income for the taxable year in which received to the extent that—

> (A) such amounts, plus amounts theretofore received under the contract and includible in gross income under such paragraph (1), do not exceed
>
> (B) the aggregate premiums or other consideration paid for the contract on behalf of an employee while such employee was an owner-employee (as defined in sec. 401(c)(3)) which were allowed as deductions under section 404 for the taxable year and all prior taxable years.

Such paragraph (1) further provides that any amounts received under an annuity, endowment, or life insurance contract before the annuity starting date which are not received as an annuity and which are not includible in gross income under such paragraph (1) shall be subject to the provisions of section 72(e).

The provisions of paragraph (1) may be illustrated by the example of a self-employed individual who receives $8,000 as a distribution under a qualified pension plan before the annuity starting date. At the time of such distribution, $10,000 had been contributed (the whole amount being allowed as a deduction) under the plan on behalf of such individual before he became an owner-employee and $5,000 had been contributed under the plan on his behalf while he was an owner-employee, of which $4,000 was allowed as a deduction. In addition, such individual had contributed $1,000 on his own behalf as an employee under the plan. Of the $8,000, $4,000 (the amount allowed as a deduction with respect to contributions on behalf of the individual while he was an owner-employee) is includible in gross income under paragraph (1). Of the remaining $4,000, $2,000 (the amount in excess of the sum of the portion of the contributions not allowed as a deduction by the employer and the amount contributed by the individual on his own behalf) is includible in gross income under section 72(e).

(2) *Computation of consideration paid by a self-employed individual.*—Paragraph (2) of the new subsection (m) provides that in computing—

(A) the aggregate amount of premiums or other consideration paid for the contract for purposes of section 72(c)(1)(A),

(B) the consideration for the contract contributed by the employee for purposes of section 72(d)(1), and

(C) the aggregate premiums or other consideration paid for purposes of section 72(e)(1)(B),

any amount allowed as a deduction with respect to the contract under section 404 while the employee was a self-employed individual shall be treated as consideration contributed by the employer. Such paragraph (2) further provides that the amounts described in paragraph (2) (A), (B), and (C) shall not include any portion of the premiums or other consideration for the contract paid while the employee was an owner-employee which is allocable (as determined under regulations prescribed by the Secretary of the Treasury or his delegate) to the cost of life, accident, health, or other insurance.

Paragraph (2) merely makes it clear that there shall not be included in an employee's, or in his beneficiary's, basis for a contract any amount which was contributed by such employee under a qualified plan and which was allowed as a deduction under section 404. In addition, under paragraph (2), there shall not be included in the basis of any contract the amount of any premiums or other consideration paid to purchase for an employee while he was an owner-employee any life, accident, health, or other insurance. Present law is to be applied in determining whether an amount to which paragraph (2) does not apply should be included in the basis of a contract.

(3) *Life insurance contracts.*—Paragraph (3) of the new subsection (m) is applicable to any life insurance contract—

(i) which is purchased as part of a qualified annuity plan described in section 403(a), or

(ii) which is purchased by a qualified trust, if the proceeds of such life insurance contract are payable directly or indirectly to a participant in such trust or to a beneficiary of such participant.

Paragraph (3)(B) provides that any contributions to such a qualified annuity plan or such a qualified trust allowed as a deduction under section 404, and any income of such a qualified trust, which are

determined (in accordance with regulations prescribed by the Secretary or his delegate) to have been applied to purchase the life insurance protection under a life insurance contract to which paragraph (3) applies are includible in the gross income of the employee for whom such protection is purchased for the taxable year when such contributions, or such income, are so applied. In the case of the death of an employee insured under a life insurance contract to which paragraph (3) applies, an amount equal to the cash surrender value of such contract immediately before the death of the employee shall be treated as a payment under the qualified plan or trust, and the excess of the amount payable by reason of the death of the insured over such cash surrender value shall not be includible in gross income under section 72 and shall be treated as provided in section 101. The provisions of paragraph (3) are rules presently contained in the regulations under the Internal Revenue Code of 1954.

(4) *Amounts constructively received.*—Paragraph (4)(A) of the new subsection (m) provides that, if during any taxable year an owner-employee assigns (or agrees to assign) or pledges (or agrees to pledge) any portion of his interest in a qualified trust or any portion of the value of a contract purchased as part of a qualified annuity plan, such portion shall be treated as having been received in such taxable year by such owner-employee as a distribution from such trust or as an amount received under such contract. Paragraph (4)(B) provides that, if during any taxable year an owner-employee receives, directly or indirectly, any amount from an insurance company as a loan under a contract purchased by a qualified trust or purchased as a part of a qualified annuity plan and issued by such insurance company, the amount of such loan is to be treated as an amount received under the insurance contract in such taxable year.

(5) *Penalties applicable to certain amounts received by owner-employees.*—Paragraph (5) of the new subsection (m) provides a penalty tax on certain amounts received by an owner-employee under a qualified trust or annuity plan. Paragraph (5)(A) provides that the penalty tax is applicable—

(i) to amounts (other than any amount received by an individual in his capacity as a policyholder of an annuity, endowment, or life insurance contract which is in the nature of a dividend or similar distribution) which are received under a qualified pension, annuity, or profit-sharing plan by an individual, who is, or has been, an owner-employee, before such individual attains the age of 59½, for any reason other than the individual's becoming disabled (within the meaning of sec. 213(g)(3) of the code), but only to the extent that such amounts are attributable to the contributions paid on behalf of such individual (whether or not paid by him) while he was an owner-employee;

(ii) to amounts which are received under such a qualified plan at any time by an individual who is, or has been, an owner-employee, or by the successor of such individual, but only to the extent that such amounts are determined, under regulations prescribed by the Secretary or his delegate, to exceed the benefits provided for such individual under the plan formula; and

(iii) to amounts which are received, by reason of the distribution under the provisions of section 401(e)(2)(E) (relating to willfully made excess contributions), by an individual who is, or

has been, an owner-employee of his entire interest in all such qualified plans.

The penalty tax is applicable to such amounts even though, at the time they are received, the recipient is not an owner-employee. In the case of an early distribution described in paragraph (5)(A)(i), the penalty tax is applicable to only so much of the distribution as is attributable to contributions paid on behalf of the recipient while he was an owner-employee. However, the penalty tax is applicable to the entire amount, to the extent it exceeds the benefits under the plan formula, received by an employee (or by the successor of an employee) who is, or has been, an owner-employee, even though a portion of such amount may be attributable to contributions made on behalf of such employee while he was not an owner-employee.

The penalty tax will, of course, apply only to amounts which would be includible in the recipient's gross income.

Paragraph (5)(B) provides that, if the aggregate of the amounts to which the penalty tax is applicable received by any person in his taxable year equals or exceeds $2,500, the increase in his tax for that taxable year attributable to the receipt of such amounts shall not be less than 110 percent of the aggregate increase in taxes, for that taxable year and the four immediately preceding taxable years, which would have resulted if such amounts had been included in such person's gross income ratably over such taxable years. If deductions had been allowed under section 404 for contributions paid on behalf of such person while he is an owner-employee for a number of prior taxable years less than 4, paragraph (5)(B)(i) shall be applied by taking into account the number of taxable years immediately preceding the taxable year in which the amount was so received equal to such lesser number.

Under paragraph (5)(C), if the aggregate of the amounts to which the penalty tax is applicable received by a person in his taxable year is less than $2,500, the increase in tax attributable to the receipt of such amounts shall be 110 percent of the increase computed without regard to this penalty tax.

paragraph (5)(D) provides that the penalty tax shall not apply to any amount (those amounts received with respect to contribut'ons made on his behalf when he was not a self-employed individual) which is taxed, under section 402(a)(2) or section 403(a)(2), as capital gains. On the other hand, since a distribution required as a result of a determination that a willful excess contribution has been made on behalf of an owner-employee is not a distribution on account of separation from service or death, the penalty tax will, in all cases, be applicable to such a distribution.

Paragraph (5)(E) indicates that section 72(n)(3) is to be applied for purposes of computing the taxable income for taxable years to which paragraph (5) applies.

Paragraph (6) of the new subsection (m) provides that, for purposes of section 72, the term "owner-employee" has the meaning assigned to it by section 401(c)(3) (determined with the application of the attribution rules of section 401(c)(5)).

Section 72(n)

Subsection (b) of section 4 of the bill also adds to section 72 a new subsection (n), which provides special tax treatment with respect to

certain total distributions received under qualified plans which are attributable to contributions on behalf of self-employed individuals.

(1) Paragraph (1) of the new subsection (n) sets forth the distributions to which the special tax treatment in section 72(n) applies. In the case of a qualified pension or profit-sharing trust, the special tax treatment is applicable to amounts distributed to a distributee, if such amounts represent the total distributions payable to the distributee with respect to an employee and if such amounts are paid to the distributee within 1 taxable year of the distributee—

(i) on account of the employee's death,

(ii) after the employee has attained the age of 59½ years, or

(iii) after the employee has become disabled (within the meaning of section 213(g)(3) of the code).

In the case of a qualified annuity plan, the special tax treatment is applicable to amounts paid to a payee, if such amounts represent the total amounts payable to the payee with respect to an employee and if such amounts are paid to the payee within 1 taxable year of the payee—

(i) on account of the employee's death,

(ii) after the employee has attained the age of 59½ years, or

(iii) after the employee has become disabled (within the meaning of section 213(g)(3)).

For the special tax treatment to be applicable to a distributee or payee with respect to a distribution of an employee's interest in a qualified plan, it is not necessary that there also be distributed within the 1-year period any portion of the employee's interest which is payable to another payee or distributee.

The special tax treatment provided by the new section 72(n) is, under paragraph (1)(C), applicable only with respect to so much of any distribution or payment as is attributable to contributions made under a qualified plan on behalf of an employee within the meaning of section 401(c)(1). If an employee receives a distribution or payment of his own interest in a qualified plan or trust, the special tax treatment is applicable to such distribution or payment only if contributions which were allowed as a deduction under section 404 have been made on behalf of such employee while he was a self-employed individual for five or more taxable years prior to the taxable year in which such distribution is paid. In addition, the special tax treatment is not applicable to amounts to which the penalty tax in section 72(m)(5) is applicable.

(2) Paragraph (2) of the new subsection (n) provides that, in any case when the special tax treatment applies, the tax attributable to the amounts to which the new subsection (n) applies for the taxable year for which such amounts are received is not to exceed whichever of the following is the greater:

(A) five times the increase in tax which would result from the inclusion in gross income of the recipient of 20 percent of so much of the amount so received as is includible in gross income; or

(B) five time the increase in tax which would result if the taxable income of the recipient for such taxable year equaled 20 percent of the amount of the taxable income of the recipient for such taxable year determined under section 72(n)(3)(A).

(3) Paragraph (3) of the new subsection (n) provides that (notwithstanding sec. 63) for purposes only of computing the tax under chapter 1 of the Internal Revenue Code of 1954 attributable to

amounts to which the new subsection (n) or section 72(m)(5) (relating to the penalty tax in the case of certain distributions) applies and which are includible in gross income—

(A) the taxable income of the recipient for the taxable year of receipt is to be treated as being not less than the amount by which (i) the aggregate of such amounts so includible in gross income exceeds (ii) the amount of the deductions allowed for such taxable year under section 151 (relating to deductions for personal exemptions); and

(B) in making ratable inclusion computations under paragraph (5)(B) of section 72(m), the taxable income of the recipient for any taxable year involved in such ratable inclusion is to be treated as being not less than the amount required by such paragraph (5)(B) to be treated as includible in gross income for such taxable year.

In any case in which section 72(n)(3) results in an increase in taxable income for any taxable year, the resulting increase in the taxes imposed by section 1 or section 3 for such taxable year shall not be reduced by any credit under part IV of subchapter A of chapter 1 (other than sec. 31) of the Internal Revenue Code of 1954 which, but for this provision, would be allowable.

In no case is there subjected to tax under the penalty tax in section 72(m)(5) or the special tax treatment in section 72(n) amounts which represent a recipient's basis in the distribution.

The application of the rules in paragraph (3) of the new subsection (n) in the case of a total distribution to which the special tax treatment in the new section 72(n) applies may be illustrated by the following example: A, a sole proprietor, established a qualified pension trust to which he made annual contributions for 10 years of 10 percent of his earned income. A withdrew his entire interest in the trust during a taxable year for which, without regard to the distribution, he had a net operating loss and for which he is allowed under section 151 a deduction for one personal exemption. At the time of the withdrawal, A was 64 years old. The amount of the distribution that is includible in his gross income is $25,600. For purposes of determining the tax attributable to the $25,600, A's taxable income for the taxable year in which he received such amount is treated, under paragraph (3) of the new subsection (n), as being $25,000 ($25,600 minus $600 (the deduction allowed for his personal exemption)). Thus, under paragraph (2) of the new subsection (n), the tax attributable to the $25,600 would be five times the increase in tax which would result if the taxable income of A for the taxable year he received such amount equaled $5,000 (20 percent of his taxable income determined under paragraph (3) of the new subsection (n)).

The application of the rules in paragraph (3) of the new subsection (n) in the case of a distribution to which section 72(m)(5) applies may be illustrated by the following example: Assume the same facts as in the example in the preceding paragraph except that A was 55 years old (and not disabled) at the time of the withdrawal. In addition, A had a net operating loss for the taxable year immediately preceding the taxable year in which he received the $25,600. The other 3 taxable years involved in the computations under section 72(m)(5)(B) were years of substantial income. For purposes of determining A's increase in tax attributable to the receipt of the $25,600

(before the application of the spreading provisions in section 72(m)(5)(B)), A's taxable income for the year he received the $25,600 is treated, under paragraph (3)(A) of the new subsection (n), as being $25,000 ($25,600 minus $600). For purposes of determining whether 110 percent of the aggregate increase in taxes which would have resulted if 20 percent of the amount of the withdrawal had been included in A's gross income for the year of receipt and for each of the 4 preceding taxable years is greater (and thus is the amount of his increase in tax attributable to the receipt of the $25,600), A's taxable income for the taxable year of receipt, and for the immediately preceding taxable year, is treated, under paragraph (3)(B) of the new subsection (n), as being $5,120 ($25,600 divided by 5).

Section 402(a)

Existing section 402(a)(2) provides that certain total distributions from qualified trusts are taxable as capital gains. Subsection (c) of section 4 of the bill amends section 402(a)(2) to provide that the capital gains treatment is not applicable to distributions paid to any distributee to the extent such distributions are attributable to contributions made on behalf of the employee while he was an employee within the meaning of section 401(c)(1). In other words, in the case of an individual who was covered under a qualified plan both while he was an employee within the meaning of common law and while he was a self-employed individual, the capital gains treatment could only apply to that part of a distribution that is attributable to contributions made on his behalf while he was an employee within the meaning of common law.

Section 403(a)

Existing section 403(a) provides the tax treatment for distributions under qualified nontrusteed annuity plans. Subsection (d)(1) of section 4 of the bill amends section 403(a)(2)(A)(i) to provide that a qualified annuity plan must meet the new qualification requirements included by this bill in sections 401 (a) and (d).

Existing section 403(a)(2) provides capital gains treatment for certain total distributions under qualified annuity plans. Subsection (d)(2) of section 4 of the bill amends section 403(a)(2)(A) to provide that the capital gains treatment shall not apply to amounts paid to any payee to the extent such amounts are attributable to contributions made on behalf of an employee while he was an employee within the meaning of section 401(c)(1). This amendment applies similar treatment to distributions under qualified annuity plans as the amendment made by subsection (c) of section 4 of the bill applies to distributions from qualified trusts.

Subsection (d)(3) of section 4 of the bill adds to section 403(a) a new paragraph (3) providing that, for purposes of section 403(a), the term "employee" includes a self-employed individual within the meaning of section 401(c)(1), and the employer of such individual is the person treated as his employer under section 401(c)(4). This amendment merely makes it clear that a self-employed individual can participate in a qualified annuity plan.

SECTION 5. PLANS FOR PURCHASE OF U.S. BONDS

Section 5 of the bill adds a new section 405 to the Internal Revenue Code of 1954 to provide for the establishment of qualified bond purchase plans. In general, participants in such a qualified bond purchase plan will be granted tax treatment similar to that granted to participants in qualified pension and profit-sharing plans.

Section 405(a)

Subsection (a) of the new section 405 provides that a plan of an employer for the purchase for and distribution to his employees or their beneficiaries of U.S. bonds described in section 405(b) shall constitute a qualified bond purchase plan if—

(1) the plan meets the requirements of section 401(a) (3), (4), (5), (6), (7), and (8) and, if applicable, the requirements of section 401(a) (9) and (10) and of section 401(d) (other than subparagraphs (1), (5)(B) and (8)); and

(2) contributions under the plan are used solely to purchase for employees or their beneficiaries the U.S. bonds described in section 405(b).

A qualified bond purchase plan can be established by an employer for his employees without the creation of a trust but, if such a plan is established, only the special bonds can be purchased under the plan. A qualified trusteed plan can also purchase the special bonds together with other assets but, if a trusteed plan is established, the plan must qualify under section 401 as a pension or profit-sharing plan.

In general, a qualified bond purchase plan must meet the same qualification requirements as a qualified annuity plan. However, sections 401(d) (5)(B) and (8) are not applicable to a qualified bond purchase plan and, consequently, there is no limit on the amount of contributions in excess of those which are deductible that may be made under the plan.

Section 405(b)

Subsection (b)(1) of the new section 405 describes the special bond which can be purchased under a qualified bond purchase plan. Such paragraph provides that such a bond is a bond issued under the Second Liberty Bond Act, as amended, which by its terms, or by regulations prescribed by the Secretary under the Second Liberty Bond Act—

(A) provides for payment of interest or investment yield only upon redemption;

(B) may be purchased only in the name of an individual;

(C) ceases to bear interest, or provide investment yield, not later than 5 years after the death of the individual in whose name it is purchased;

(D) may be redeemed before the death of the individual in whose name it is purchased only if such individual—

(i) has attained the age of 59½ years, or

(ii) has become disabled (within the meaning of sec. 213(g)(3)); and

(E) is not transferable.

Subsection (b)(2) of the new section 405 provides that bonds purchased under a qualified bond purchase plan must be purchased in the name of the employee for whom it is purchased.

Section 405(c)

Subsection (c) of the new section 405 provides that contributions paid by an employer to or under a qualified bond purchase plan shall be allowed as deductions in an amount determined under section 404 in the same manner and to the same extent as if such contributions were made to a qualified trust described in section 401(a) which is exempt from tax under section 501. Thus, for contributions to a qualified bond purchase plan to be deductible under section 405(c), all of the requirements of section 404 must be met. For example, the contributions must meet the requirements of section 162 or 212, and must be made (or deemed to have been made under section 404(a)(6)) in a taxable year of an employer which ends with or within a year of the bond purchase plan for which it qualifies under section 405.

If the amount of the contributions to the qualified bond purchase plan are determined by reference to the profits of the employer, as in the case of a qualified profit-sharing plan, the amount deductible with respect to such contributions is determined under section 404(a)(3), relating to qualified profit-sharing plans. Moreover, such a bond purchase plan shall be considered a profit-sharing plan for purposes of the provisions in section 404(a)(3) relating to a situation when contributions are made to two or more profit-sharing trusts. In other cases, the amount deductible with respect to contributions to a qualified bond purchase plan will be determined under section 404(a)(1). If the qualified bond purchase plan covers self-employed individuals, the amount deductible with respect to contributions to the plan is subject to the further limitations of section 404(a)(10). Similarly, in the case of a qualified bond purchase plan covering owner-employees, the special rules in section 404(a)(9) for computing the limitations with respect to deductions for contribution under the plan shall be applicable. Thus, the carryover provisions of section 404(a) are not applicable with respect to contributions made under a qualified bond purchase plan on behalf of owner-employees, Moreover, the additional limitations in section 404(e) and 404(a)(10) shall apply in the case of a qualified bond purchase plan covering an owner-employee.

Section 405(d)

Subsection (d)(1) of the new section 405 provides that no amount is includible in the gross income of a distributee at the time a bond described in section 405(b) is distributed to him under a qualified bond purchase plan or from a qualified trust. Upon the redemption of such a bond, however, the proceeds are subject to taxation under chapter 1 of the Internal Revenue Code of 1954. In applying chapter 1, for purposes of determining the amount of tax due, the provisions of sections 72 and 1232 shall not be applied. In other words, the bonds described in section 405(b) received under a qualified bond purchase plan or from a qualified trust are not subject to tax until they are redeemed. In addition, upon redemption, no part of the proceeds will be treated as an amount received from the sale or exchange of a capital asset by reason of section 1232.

Subsection (d)(e) of the new section 405 provides rules for determining the basis of any bond received by a distributee under a qualified bond purchase plan. If the bond was purchased for an employee within the meaning of common law, the basis of such bond shall be

an amount equal to the amount of the contributions made under the plan by the employee himself which were used to purchase the bond. If the bond was purchased for an employee at a time when he was a self-employed individual, the basis of such bond is an amount equal to the amount of the contributions used to purchase the bond which were made on behalf of such employee and which were not allowed as a deduction under section 405(c). Such subsection (d)(2) further provides that the basis of a bond described in section 405(b) which is received by a distributee from a qualified trust shall be determined under regulations prescribed by the Secretary or his delegate.

Section 405(e)

Subsection (e) of the new section 405 provides that the capital gains treatment of section 402(a)(2) shall not apply to any of the bonds described in section 405(b) and that, for purposes of applying section 402(a)(2) to amounts distributed by a qualified trust, any such bonds distributed to any distributee and any such bonds to the credit of any employee shall not be taken into account. In other words, for purposes of applying section 402(a)(2), a distribution under a qualified trust may be considered a total distribution of an employee's interest in such trust even though the trust retains bonds described in section 405(b). In the case of a distribution from a qualified trust which qualifies for the capital gains treatment of section 402(a)(2) and which includes both bonds of the type described in section 405(b) and other property, the capital gains treatment will be applicable to such other property. In no case, however, will the capital gains treatment be applicable to the proceeds received as a result of the redemption of any of the bonds described in section 405.

Section 405(f)

Subsection (f) of the new section 405 provides that, for purposes of section 405, the term "employee" includes an individual who is an employee within the meaning of section 401(c)(1), and the employer of such individual shall be the person treated as his employer under section 401(c)(4). Such subsection (f) has the effect of enabling the self-employed individual to participate in a qualified bond purchase plan to the same extent that he may participate in qualified pension, annuity and profit-sharing plans.

Section 405(g)

Subsection (g) of the new section 405 provides that, at the time of the purchase of any of the bonds described in section 405, proof of such purchase shall be furnished in such form as will enable the purchaser, and the employee in whose name such bond is purchased, to comply with the provisions of section 405.

Section 405(h)

Subsection (h) of the new section 405 provides that the Secretary or his delegate shall prescribe such regulations as may be necessary to carry out the provisions of section 405.

SECTION 6. PROHIBITED TRANSACTIONS

Section 6 of the bill amends section 503 of the Internal Revenue Code of 1954 to provide a special definition of the term "prohibited transaction" in the case of certain qualified employees' trust covering

owner-employees. This special definition is only applicable when the owner-employees covered by the qualified employees' trust, control the trade or business with respect to which the trust is established.

Section 6 of the bill adds to section 503 a new subsection (j) which provides that, in the case of a trust described in section 401(a) which is part of a plan covering owner-employees (as defined in sec. 401(c)(3)) who control the trade or business with respect to which the plan is established, the term "prohibited transaction" means, in addition to the transactions described in section 503(c), any transaction in which such trust, directly or indirectly—

(A) lends any part of the corpus or income of the trust to;

(B) pays any compensation for personal services rendered to the trust to;

(C) makes any part of its services available on a preferential basis to; or

(D) acquires for the trust any property from, or sells any property to;

any person described in section 503(c) or to any such owner-employee, a member of the family (as defined in sec. 267(c)(4)) of any such owner-employee, or a corporation controlled by such owner-employee through the ownership, directly or indirectly, of 50 percent or more of the total combined voting power of all classes of stock entitled to vote or 50 percent or more of the total value of shares of all classes of stock of the corporation.

For purposes of determining whether owner-employees covered under a qualified employees' trust control the trade or business with respect to which such trust is established, the rules in section 401(d)(9)(B), determined with the application of the rules of constructive ownership in section 401(c)(5), are to be applied.

Paragraph (2) of the new subsection (j) provides that, for purposes of the new definition of "prohibited transaction" in paragraph (1), the following rules shall apply with respect to a loan made before the date of the enactment of the bill which would be a prohibited transaction if made in a taxable year beginning after December 31, 1961:

(A) If any part of the loan is repayable prior to December 31, 1964, the renewal of such part of the loan for a period not extending beyond December 31, 1964, on the same terms, shall not be considered a prohibited transaction.

(B) If the loan is repayable on demand, the continuation of the loan beyond December 31, 1964, shall be considered a prohibited transaction.

SECTION 7. OTHER SPECIAL RULES, TECHNICAL CHANGES, AND ADMINISTRATIVE PROVISIONS

Section 7 of the bill provides certain technical amendments and administrative provisions.

Section 7(a) of the bill amends section 37 of the Internal Revenue Code of 1954, relating to the retirement income credit, to make clear that any distribution to a self-employed individual under a qualified pension, annuity, or profit-sharing plan, and that any income derived by any person from the bonds described in section 405(b) received under a qualified bond purchase plan or from a qualified trust, may qualify as retirement income for purposes of such credit.

Section 7(b) of the bill amends section 62 of the Internal Revenue Code of 1954, relating to the definition of "adjusted gross income," to provide that, in computing adjusted gross income, there shall be allowed, in the case of a self-employed individual, the deductions allowed under sections 404 and 405 for contributions on behalf of such an individual to a qualified pension, annuity, profit-sharing, or bond-purchase plan.

Section 7(c) of the bill amends section 101(b) of the Internal Revenue Code of 1954, relating to employees' death benefit. Paragraph (1) of section 7(c) amends section 101(b) so that the rule applicable to distributions under a qualified annuity plan will only apply if the annuity plan meets the new qualification requirements of section 401 (a) and (d) applicable to annuity plans.

Paragraph (2) of section 7(c) amends section 101(b) by adding a new paragraph (3), which provides that, for purposes of section 101(b), the term "employee" does not include an individual who is an employee within the meaning of section 401(c)(1) (relating to self-employed individuals). Thus, if at the time of his death, a self-employed individual is a participant in a qualified pension, annuity, or profit-sharing plan and after his death a distribution is made to his beneficiary, the exclusion of section 101(b) is not applicable to any portion of such distribution even though such individual was at one time an employee (under common law) of the trade or business and a portion of the distribution is attributable to contributions which were made while he was such an employee. Similarly, the exclusion of section 101(b) is not applicable to any portion of a distribution from such a qualified plan on behalf of an individual who was retired at the time of his death and who at the time of his retirement participated in the plan as a self-employed individual.

Section 7(d) of the bill amends section 104(a) of the Internal Revenue Code of 1954, relating to compensation for injuries or sickness, to make clear that the exclusion of such section is not applicable to any benefits which are attributable to contributions to a qualified pension, annuity, or profit-sharing plan on behalf of an individual while he was a self-employed individual to the extent that such contributions were allowed as deductions under section 404.

Section 7(e) of the bill amends section 105 of the Internal Revenue Code of 1954, relating to amounts received under accident and health plans, by adding a new subsection (g) which provides that, for purposes of section 105, the term "employee" does not include an individual who is an employee within the meaning of section 401(c)(1) (relating to self-employed individuals). For example, if at the time an individual commences to receive benefits described in section 105 from a qualified pension plan, he is covered under such plan as a self-employed individual, such benefits do not qualify for the exclusion of section 105.

Section 7(f) of the bill amends section 172 (d)(4) of the Internal Revenue Code of 1954, relating to net operating loss deductions, to make clear that any deduction under section 404 or 405 attributable to contributions on behalf of a self-employed individual under a qualified employees' plan shall not be treated as attributable to the trade or business of such individual for purposes of section 172.

Section 7(g) of the bill makes conforming amendments to section 805 of the Internal Revenue Code of 1954, relating to pension plan reserves of life insurance companies.

Section 7(h) of the bill amends section 1361 of the Internal Revenue Code of 1954, relating to unincorporated business enterprises electing to be taxed as domestic corporations, to permit a partner or proprietor of such an unincorporated business to participate in a qualified pension, annuity, profit-sharing, or bond-purchase plan. However, for purposes of applying all the provisions relating to such qualified plans, such a partner or proprietor shall be considered a self-employed individual and will be considered an employee only to the extent he is so considered under section 401(c)(1).

Section 7(i) of the bill amends section 2039 of the Internal Revenue Code of 1954, relating to exemption from gross estate of annuities under certain trusts and plans. Paragraph (1) of section 7(i) amends section 2039(c)(2) to provide that the exclusion of the value of an annuity under a qualified annuity plan will be applicable only if the annuity plan meets the additional qualification requirements of sections 401 (a) and (d). Paragraph (2) of section 7(i) amends section 2039(c) by adding at the end thereof a new sentence which provides that, for purposes of section 2039(c), contributions or payments on behalf of the decedent while he was an employee within the meaning of section 401(c)(1) made under a qualified pension, annuity, or profit-sharing plan shall be considered to be contributions or payments made by the decedent. Accordingly, the estate tax exclusion of section 2039(c) is not applicable to the portion of a decedent's interest in a qualified plan which is attributable to contributions on behalf of an individual while he was a self-employed individual.

Section 7(j) of the bill amends section 2517 of the Internal Revenue Code of 1954, relating to exclusion from gift tax in case of certain annuities under qualified plans, in the same manner as section 7(i) of the bill amends the estate tax exclusion with respect to qualified plans.

Sections 7 (k) and (l) of the bill amend section 3306(b)(5) of the Internal Revenue Code of 1954 (relating to the Federal Unemployment Tax Act) and section 3401(a)(12) of such code (relating to the withholding of income tax). These amendments make conforming changes and exclude from the definition of "wages" under such sections any payment made to, or on behalf of, an employee or his beneficiary, under or to a bond-purchase plan which, at the time of such payment, is a qualified bond-purchase plan described in section 405.

Section 7(m) of the bill amends the Internal Revenue Code of 1954 to add a new section 6047, giving the Secretary or his delegate authority to require the furnishing of additional information which is necessary to administer the new provisions in this bill. Section 7(m) of the bill also amends section 7207 of the 1954 code to provide penalties for willfully furnishing false or fraudulent information.

SECTION 8. EFFECTIVE DATE

Section 8 of the bill provides that the amendments made by this bill will be applicable to taxable years beginning after December 31, 1961.

X. Changes in Existing Law

In the opinion of the committee, it is necessary, in order to expedite the business of the Senate, to dispense with the requirements of subsection 4 of rule XXIX of the Standing Rules of the Senate (relating to the showing of changes in existing law made by the bill, as reported).

MINORITY VIEWS ON H.R. 10

In our opinion, H.R. 10 should not be enacted into law. This measure violates every rule of equity and fair play in that it sets up a program in which only a few of the already fortunately situated can participate. Furthermore, it sets a dangerous precedent by allowing a tax deduction to be taken by a taxpayer for actions which that taxpayer voluntarily takes for his own peculiar benefit.

On very practical grounds there are also serious objections. The bill singles out for assistance a class of people, the self-employed, who as a group are, generally speaking, least in need or deserving of assistance. The doctor, lawyer, or small businessman is not forced to retire at a specified age. He typically builds up a practice or business, takes in younger associates, and continues to benefit from such practice or business well beyond the earning years of the average employee. Then too, the bill badly erodes the tax base at a time when the crying need is for tax reform through broadening that base. If we can afford the revenue loss which this bill represents, we can certainly suffer such loss in order to gain more worthy objectives.

The bill fails even to accomplish its major ostensible objective of equating retirement privileges of the self-employed with those of the executive of closely held corporations. To achieve parity in this regard, limitations of considerable stringency would need to be placed on corporate executives. The committee refused to acknowledge this fact and summarily voted down all attempts in that direction.

The entire pension and profit sharing area is in dire need of a thorough cleanup. The enactment of this legislation does nothing to improve existing law. It merely rather loosely bastes another patch on this crazy quilt.

Some of these points require elaboration.

THE TAX BENEFITS OF THE BILL

This bill would extend to the so-called self-employed individuals certain tax benefits in connection with funds which such individuals set aside for their retirement. A part of the funds so set aside would be deductible from current income for income tax purposes, and the earnings on such funds would be entirely exempt from current taxation. Although the funds and earnings would be taxable when withdrawn, the opportunity to postpone taxation of the funds and earnings represents a very significant tax advantage, especially to those people receiving very large incomes when the funds are set aside. (1) When the funds and earnings are withdrawn, the taxpayer almost invariably will be receiving less income and, consequently, the funds and earnings will be taxable at a lower rate. (2) Furthermore, the interest received on his savings during the period of accumulation, although really a part of his income, will not be taxable although if the savings were invested in stocks, bonds, mortgages, or bank deposits, the interest would be taxable. (3) In addition, the taxpayer may, when he withdraws the funds and earnings, be entitled to the retirement income

credit and the additional exemptions allowed individuals over age age 65, and these benefits would further reduce the tax ultimately paid on the funds set aside for retirement.

ILLUSTRATION OF TAX BENEFITS

The very attractive tax benefits which would result from the enactment of the bill may be illustrated by the following example. If a self-employed individual, whose earned income is $20,000 a year, contributes $2,000 a year to a retirement plan qualifying under the bill, each $2,000 contribution would entitle him to a $1,500 deduction. If this self-employed individual has no other income subject to tax, is married, has two dependents in addition to his wife, and is entitled to itemized deductions equal to 10 percent of his income for each year, each $1,500 deduction would reduce his taxes by $450. Thus, each year's contribution of $2,000 would bring an immediate after-tax return of $450, or 22½ percent of the contribution. If a contribution of this amount is made each year for 30 years, the aggregate tax savings attributable to these deductions would be $13,500. In addition, the total sum accumulated under the retirement plan at the end of 30 years would be $105,000, assuming an interest rate of 3½ percent. This total sum would include $45,000 of accumulated interest, but if the interest were currently taxable to the self-employed individual, there would have been approximately $14,900 less of accumulated interest in the fund. Thus, almost $15,000 of the fund is due to exemption of the interest income from current taxation. This is a tax saving of $15,000 in addition to the $13,500 tax savings attributable to the deductions or a total of $28,500.

INSIGNIFICANCE OF EMPLOYEE REQUIREMENT

A self-employed individual who is an employer and who desires to take advantage of the bill would be required to set up a retirement plan covering his permanent full-time employees with more than 3 years of service. However, this requirement may not have as much significance as would first appear. In the first place, the privilege of excluding employees with less than 3 years of service would permit many of the employers for whom the bill would be enacted to exclude a large number of employees from participation in any retirement plan established by the employer. Moreover, any contributions which an employer makes on behalf of his employees will also be deductible in computing the employer's tax.

AN UNWARRANTED SUBSIDY

In these times, we of the Congress are confronted with many very grave problems. Our Nation is engaged in a frightening contest with communism, and our interests are being threatened throughout the world. Our rights to access to Berlin are being challenged, and to meet this thrust and the other advances of communism and to demonstrate to the Russians that we will not compromise principle, we must increase our Armed Forces. To provide this increase in our military strength, we have recently approved increased appropriations of more than $3 billion.

The Russians are also challenging us by attempting to influence and control the underdeveloped nations of the world. To meet this challenge and to assist the deserving people of the world, we have just authorized the spending of more than $4.2 billion this year and have authorized the President to commit $11.9 billion during the next 5 years.

In addition to meeting these threats by the Russians, we must maintain a healthy and growing society in the United States. We must not sacrifice our own sources of strength, such as the education of our young people. In fact, we must appropriate substantially more money to the improvement of our educational system.

The enactment of this bill would result in an annual loss of revenue which is estimated to be almost $200 million. The enactment of such legislation is in effect the granting of a subsidy of almost $200 million to the people who would be benefited by the legislation. Let us see who is requesting this large subsidy.

SMALL GROUP WOULD BENEFIT

The self-employed individuals who would be granted a tax reduction by this bill include those people who own and operate businesses. The most active proponents of the legislation include organized groups of doctors, lawyers, and accountants. It is said that there are more than 6 million self-employed individuals in this country who might benefit by the legislation. However, in fact, according to the estimates of the Treasury Department, about 80 percent of the tax reductions which would be allowed by the bill would be received by self-employed people with an annual income in excess of $10,000, and about 50 percent of such tax reductions would be received by self-employed people with an annual income in excess of $20,000. Now, there are about 379,000 self-employed people in the United States with an annual income in excess of $20,000. These people constitute only about 6 percent of the self-employed people subject to tax, but this 6 percent would receive about 50 percent of the tax benefits which would be provided by the bill. Thus, although it is argued that the bill would benefit many people, it is apparent that the primary benefit will be derived by a very small group. Furthermore, the group which would derive the primary benefit consists of individuals who are receiving very substantial incomes and who do not need any preferential tax treatment to enable them to provide for their retirement.

The professions which are represented by these groups are among the most honorable, and deservedly well rewarded in our country. In 1955, for example, the average annual income of all doctors was $18,122, and of family physicians was $15,000. The average annual income in 1958 of dentists was $13,956.

In 1954 the average annual income of lawyers was $10,258. The average annual income of senior public accountants in 1958 ranged from $8,000 to $10,000. The present average income of both doctors and lawyers is obviously substantially higher than these figures.

These incomes compare with an average annual income in 1960 of all wage and salary workers of only $4,705, and of wage and salary workers in manufacturing of $5,342.

TAX EVASION AND AVOIDANCE GREATEST FOR SELF-EMPLOYED

In testimony before a subcommittee of the Appropriations Committee of the Senate, Secretary Dillon reported on some estimates made by the Internal Revenue Service concerning unreported taxable income. According to these estimates, $24.4 billion of taxable income was not reported for the year 1959. Of this amount, $12 billion was income received by individuals engaged in business or farming. Thus, the very class of people who are requesting the tax concessions which would be provided by this bill were responsible for almost one-half of the unreported taxable income in 1959. The amount of unreported taxable income received by this group exceeded the amount of such income received by any other group in our society. Moreover, the amount of unreported taxable income received by this group constituted between 25 and 27 percent of the total amount of taxable income received by that group. Percentagewise, their record is worse than any other group of taxpayers. Many people engaged in businesses faithfully perform their obligations to report their income and assume their proper share of the tax burden, and these people should not be condemned for the failures of others in their class. However, in view of this very poor record of tax compliance, it seems to us that this group as a class does not seriously merit consideration for receiving tax concessions.

WHY TAX REDUCTION FOR THE SELF-EMPLOYED

This Congress may in the near future be asked by the President to increase taxes. If the people who are urging us to adopt this bill came before us and requested us to appropriate them a subsidy of almost $200 million, we believe that this Congress would not seriously consider such a request. In view of the demands upon the public Treasury for appropriations of huge sums for national defense and other very worthwhile and necessary public objectives, the request of these people for a subsidy must rank very low in priority. Yet, by asking for the tax concessions which would be provided by this bill, these people are asking for just such a subsidy, and their request for these tax concessions should be considered no more favorably than their request for a similar subsidy.

EROSION OF THE TAX BASE

In his tax message to the Congress, the President recognized and pointed out to the Congress the need for a fundamental revision of our tax system. He announced that he had directed the Secretary of the Treasury to study the tax system with the view of submitting a proposed revision of the tax law. Even before this statement of the President, this need for a fundamental revision of our tax system was considered by the Joint Economic Committee and the House Ways and Means Committee, and many of those who appeared before those committees also recognized the urgent need for a redistribution of the tax burden.

The present law contains many provisions which extend preferred tax treatment to selected groups of taxpayers. The result of the preferred tax treatment received by these groups is that the rates of

tax imposed upon other taxpayers generally are higher than they otherwise would be. In other words, many people feel that the present tax rates are too high; yet, if these rates are to be reduced, the resulting loss of revenue must be offset by removing the preferred tax treatment now received by selected groups of taxpayers. By redistributing the tax burden in this manner, all taxpayers would be treated more equitably. In fact, although any discussion of the tax law becomes technical and therefore is of little interest to most people, it is our observation that more and more people are recognizing the fundamental facts that some groups of taxpayers are receiving more favorable tax treatment and that if these special tax provisions were eliminated, the rates for all taxpayers could be reduced.

This bill is inconsistent with the recognized need for redistributing the tax burden. By extending to the self-employed favorable tax treatment for their retirement savings, the bill would further erode the tax base. What is more, the granting of these tax benefits to the self-employed is likely to lead to further erosion of the tax base. If self-employed people are to receive preferred tax treatment for their retirement savings, equity would seem to require that similar treatment should be provided for other taxpayers. The employers of many employees have not established retirement plans for their employees, and if this bill is adopted, it would seem that these employees should also receive comparable tax treatment for their retirement savings. Furthermore, many employees who are nominally covered by present retirement plans do not, in fact, have any substantial rights under these plans. Thus, it would seem, if this bill is adopted, that these employees who are inadequately covered by present retirement plans should also receive comparable tax treatment for their retirement savings. To extend similar tax treatment to the employees who are not covered by employer-sponsored retirement plans or whose coverage under such plans is inadequate would cause a loss of revenue of about $1.7 billion.

If the self-employed are permitted to deduct the funds which they set aside for their retirement, employees who are required to make contributions to the social security system, to the railroad retirement system, to other Government plans, or to plans established by their employers will claim that they too should be permitted to deduct the contributions for their retirement. To allow employees to deduct their contributions to the social security system would cost about $1.1 billion of revenue. Fifty-five million dollars of revenue would be lost if employees were permitted to deduct their contributions to the railroad retirement system; $370 million would be lost if employees were permitted to deduct their contributions to Federal, State, and local government plans; and $165 million of revenue would be lost if employees were permitted to deduct their contributions to private retirement plans. If this bill is adopted, the Congress will receive requests to allow these additional deductions and if these deductions are allowed, the aggregate loss of revenue would be staggering. That loss of revenue would have to be met either by deficit financing or by increasing the taxes imposed upon taxpayers generally.

Although we are opposed to further erosion of the tax base and to any action which would result in such a large loss of revenue, we offered for the consideration of the committee an amendment which would have extended comparable tax benefits to employees who are

not covered or who are inadequately covered by employer-sponsored retirement plans, but the committee rejected our amendment. Although by rejecting this amendment, the committee has refused to recognize at this time the compelling equity of the case of these employees for receiving comparable tax benefits, the enactment of this bill will inevitably lead to more and more requests by such employees for similar tax concessions.

DEDUCTIONS FOR OTHER FORMS OF SAVINGS

This bill deals with retirement savings, but the question will be asked why should retirement savings be treated more favorably than other personal expenses? If we are to allow tax incentives for retirement savings, why should we not also allow tax deductions for the expenses of sending children to school or the costs of purchasing a family residence? It is socially desirable to encourage people to provide for their own retirement, but it would seem equally desirable to encourage the further education of our children and to encourage the purchase of family residences. We see no adequate basis for extending tax concessions to retirement savings without extending similar tax concessions to many other socially desirable causes. The Congress must come to recognize that if we submit to the importuning of every group which asks for some special tax concession for funds set aside for some laudatory purpose, the base of the income tax will be destroyed, and we will be left with a tax on consumption—not income.

Since the percentages devoted to consumption decrease and the proportions set aside for savings increase as total income increases,[1] this means that a smaller and smaller percentage of total income would be subject to income taxation. State and local taxation, based primarily upon sales taxes and real property, is already quite heavily regressive. A great reduction in the progressive features of the Federal income tax would probably make the total tax structure regressive and one which would weigh more heavily upon those with low and moderate means than upon those with larger annual incomes. There would also be a greater concentration of economic power. These are social consequences which we do not like and regard as detrimental to the ideals of our democratic society. As we preach tax reform to the Latin Americans, let us not violate these principles ourselves. Social justice is for internal use and not merely for export.

It is true that the present law provides tax benefits for retirement plans established by an employer for his employees. However, in view of the pending reconsideration of the proper base for imposing an income tax, we believe that no preferred tax treatment should be extended to any additional selected group of taxpayers. In time, we can consider the basic question of whether retirement savings should be treated differently than other personal expenses, and when that decision is made, we can then adopt laws which treat all people in a comparable and equitable manner.

When this basic question is fully considered, should it be decided to give a tax concession to encourage savings for retirement, there are several groups which must be treated differently. The ordinary employee, the highly compensated corporate executive, the owner-

[1] The technical description for this is that the income elasticity of consumption is less than unity and that for savings is greater than unity. This is borne out by a large number of budgetary studies.

manager of a closely held corporation, the self-employed professional man, and the owner of a nonincorporated business all require somewhat different treatment in order to arrive at comparable and equitable solution.

TAX REFORM NEGLECTED

In the past 2 years, this committee has spent many days considering the plea of the self-employed for tax relief in connection with their retirement savings. Instead of spending our time on this subject the committee should have devoted this time to a study of the abuses which are prevalent in our present tax system and a study of the means of reforming this system. In his tax message to the Congress, the President submitted a modest program of tax reform for the consideration of the Congress this year. However, this committee has given no serious consideration to those Presidential recommendations.

To provide the committee with an opportunity to consider these recommendations, we offered amendments to H.R. 10 which would have closed the door on some of the most conspicuous means of tax avoidance or evasion. These amendments included a proposal to withhold upon dividends and interest at the source, to correct the widespread practice of claiming excessive tax deductions for entertainment and travel expenses, to reduce the extraordinary and unjustified depletion allowances, to remove the wholly undesirable dividends received credit, and to prevent corporate executives from converting their compensation into capital gains by receiving stock options. All these amendments were rejected by the committee. It is because of the abuses which would have been corrected by these amendments and because of other tax concessions to favored groups that our people generally are required to pay the present high rates of tax, and this committee cannot much longer continue to refuse to face this deplorable situation.

The continued refusal of the Senate Finance Committee to deal with well known and greatly abused methods and systems of tax avoidance, while at the same time repeatedly recommending tax reductions, favors, and concessions to special groups, cannot help but bring our entire tax system into disrepute and disrespect. We insist that the public interest would be served by removal and repeal of tax loopholes. Conversely, we insist that creating one more favoritism after another adversely affects the public interest.

THE FAILURES OF THE BILL

The proponents of the bill argue on its behalf that the self-employed people are the victims of discrimination. If an employer establishes a retirement plan for his employees which meets certain requirements of the present law, the employees are not currently taxable on the funds which are set aside for their retirement, and the earnings on such funds are also exempt from current taxation. If a business is incorporated, and the owners work in the business, they can participate in such a retirement plan and derive these tax advantages. It is argued that since some businesses cannot be incorporated, the owners of such businesses should receive comparable tax treatment. In many States, statutes have recently have been enacted which permit professional people to incorporate or to form professional associa-

tions which would be treated like corporations for Federal tax purposes. It is argued that this bill should be adopted to provide the self-employed who are not incorporated with comparable tax treatment and to eliminate the pressures for the adoption of the State statutes permitting the formation of professional corporations or associations. However, this bill would not accomplish these objectives.

If this bill is adopted, there would still remain very substantial differences in the tax treatment of incorporated and unincorporated businesses. The bill would place limits on the deductions which would be allowable with respect to contributions on behalf of the owners of unincorporated businesses, but no comparable limits would be placed on deductions for contributions on behalf of owners who are technically employees of incorporated businesses. Owners of incorporated businesses would continue to receive the privilege of having certain total distributions from plans covering them treated as long-term capital gains, although this privilege would not be extended to the owners of unincorporated businesses.

For example, the committee has been informed by the Treasury that there are instances in which lump-sum distributions in excess of $800,000 have been made to a corporation executive from sums set aside for his benefit. Under existing law, distribution of these large sums is accorded the 25-percent capital gains tax rate. In reality, such "income" bears no relationship whatever to capital gains in the ordinary meaning of that term. Rather, such a distribution reflects an accumulation of ordinary income, the distribution of which has been deferred.

Similarly, the interest of an owner under a corporate plan would continue to be exempt from the gift tax and the estate tax, but the interest of an owner under an unincorporated plan would not receive these tax advantages. The bill would place other restrictions on the qualifying plans of the self-employed, but comparable restrictions would not be placed upon corporate plans.

BILL MORE UNDESIRABLE THAN 1960 VERSION

When this committee considered this matter last year, it recognized the need to treat substantial owners in a similar manner, regardless of whether the business was incorporated or unincorporated. Although there were some unfortunate differences between the treatment of corporate owners and the self-employed, the bill which this committee acted upon favorably last year was materially better than this bill because it did contain some limits on the abuses which occur under the present corporate plans. We thought it inadvisable to act favorably upon last year's bill, but we consider this bill infinitely more undesirable.

Any legislation dealing with retirement savings must recognize the need to treat all people in a comparable manner. Theoretically, all people could be treated alike by permitting them to participate in retirement plans subject only to the rules of the present law, but this possibility seems to be unacceptable. The alternative is to place similar restrictions upon all participants in retirement plans which receive preferred tax treatment. As a minimum, any legislation relating to retirement savings must include restrictions upon the benefits

with respect to which the favored tax treatment is to be extended. Such legislation should, like last year's bill, place limits on the participation of corporate owners, but unlike last year's bill, those limits should not be more favorable than the limits which are imposed upon self-employed people. Last year's bill was also defective in that it failed to include limits on the participation of corporate executives. Accordingly, that bill in effect discriminated against closely held corporations and in favor of the larger widely held corporations. This discrimination is unfortunate and unjustifiable, and to avoid it, comparable limits should be placed upon the participation of corporate executives.

IMPROVING AMENDMENTS DEFEATED

Despite our view that we should not consider at this time the extension of preferred tax treatment to any other group, we thought that if the Congress is going to consider this bill at this time, we should make every effort to improve the bill. To this end, we offered amendments which would have made the bill more equitable by placing similar restrictions upon corporate plans, but the committee rejected all of these attempts to reform the abuses which are now occurring under corporate plans.

Since corporate plans would continue to receive more favorable tax treatment, we may be assured that if this bill is enacted, its advocates will come before this committee in future years to complain about the discrimination against the self-employed and to argue that the self-employed should be allowed to participate in retirement plans to the same extent as corporate owners. Thus, even if the Congress granted the present requests of the advocates of the self-employed, it will not be long until they are here again asking for liberalization of the rules established by this bill. Furthermore, as long as the law allows them substantially greater tax advantages under corporate plans, we may be certain that the professional people will take advantage of the opportunities to incorporate which some States have provided for then and that they will continue to seek new State statutes permitting them to form professional corporations or associations. After all, they can point to the vastly different tax treatment which applies to corporate plans and argue that to eliminate this discrimination, they should be permitted to incorporate. Thus, the enactment of the bill would not satisfy the self-employed but would merely permit them to take the first step in securing further tax concessions for their retirement savings.

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