

[COMMITTEE PRINT]

TAX TREATMENT OF PENSION PLANS  
PART TWO: INDIVIDUAL RETIREMENT ACCOUNTS,  
LIMITATIONS ON CONTRIBUTIONS,  
AND LUMP SUM DISTRIBUTIONS

---

PREPARED FOR THE USE OF  
THE COMMITTEE ON WAYS AND MEANS  
U.S. HOUSE OF REPRESENTATIVES

BY  
THE STAFF  
OF THE  
JOINT COMMITTEE ON INTERNAL  
REVENUE TAXATION



OCTOBER 23, 1973

U.S. GOVERNMENT PRINTING OFFICE  
WASHINGTON : 1973

22-662

JCS-32-73

## CONTENTS

|   | Page |
|---|------|
| I. Individual retirement accounts.....  | 1    |
| Present law.....  | 1    |
| Issue.....  | 2    |
| The Senate bill (H.R. 4200) and H.R. 10470.....                               | 2    |
| In general.....   | 2    |
| Requirements for an individual retirement account.....                        | 3    |
| Premature distributions.....  | 4    |
| Taxation of beneficiaries.....  | 4    |
| Other rules.....  | 5    |
| Qualified retirement bonds.....   | 5    |
| Salary reduction pension plans and cash or deferred profit-sharing plans..... | 6    |
| Section 403(b) annuity plans.....   | 6    |
| Effective date.....   | 6    |
| Alternative proposals.....  | 6    |
| H.R. 2.....   | 6    |
| H.R. 7157.....  | 6    |
| H.R. 10489.....   | 7    |
| Areas for committee consideration.....  | 7    |
| The salary reduction alternative.....   | 7    |
| The size of the limitation.....   | 8    |
| Government "pickup" plans.....  | 8    |
| Cash or deferred profit-sharing plans.....                                    | 9    |
| II. Limitations on contributions and benefits.....                            | 9    |
| Present law.....  | 10   |
| H.R. 10 plans.....  | 10   |
| "Regular" corporate plans.....  | 10   |
| Subchapter S plans.....   | 11   |
| Professional corporations.....  | 11   |
| Issue.....  | 12   |
| The Senate bill (H.R. 4200) and H.R. 10470.....                               | 12   |
| H.R. 10 plans.....  | 12   |
| Corporate plans.....  | 13   |
| Subchapter S corporations.....  | 14   |
| Money purchase plans.....   | 15   |
| Custodial accounts.....   | 15   |
| Effective date.....   | 15   |
| Alternative proposals.....  | 15   |
| H.R. 2.....   | 15   |
| H.R. 7157.....  | 15   |
| H.R. 10489.....   | 16   |
| Areas for committee consideration.....  | 16   |
| Factors to be considered in connection with the limitation.....               | 16   |
| (a) Profit-sharing plans and other defined contribution plans.....            | 18   |
| (b) Defined benefit plans.....  | 18   |
| (c) Cost of living adjustment.....  | 18   |
| (d) Combination plans.....  | 18   |
| (e) Sanctions.....  | 19   |
| (f) Antidiscrimination rules.....   | 19   |
| (g) Effective dates.....  | 19   |
| (h) Transitional rules.....   | 20   |
| Subchapter S corporations.....  | 20   |
| Integration.....  | 20   |
| Partnership pooling.....  | 21   |
| Other rules.....  | 21   |

IV

|   | Page |
|---|------|
| III. Lump sum distributions.....                | 22   |
| Present law.....                                | 22   |
| Issue.....                                      | 23   |
| The Senate bill (H.R. 4200) and H.R. 10470..... | 23   |
| Areas for committee consideration.....          | 25   |

## I. INDIVIDUAL RETIREMENT ACCOUNTS

(Secs. 701 and 706 of the Senate bill and secs. 72, 219, 408, 409, and 4960 of the Code)

This section concerns the extent to which an individual should receive a deduction for his own personal savings for retirement, outside the scope of a qualified plan, or for his own contributions to a qualified plan established by his employer.

### *Present law*

Generally, an employee is not allowed to deduct amounts which he contributes from his own funds to a retirement plan. There is no provision for an employee to establish his own retirement plan with tax-free dollars. Also, while an employer's qualified plan may allow employees to contribute their own funds to the plan;<sup>1</sup> no deduction is allowed for these contributions (except to the extent that tax excludable contributions made in connection with salary reduction plans, including cash or deferred profit-sharing plans, described below, may be viewed as employee contributions). However, the income earned on employee contributions to an employer's qualified plan is not taxed until it is distributed.<sup>2</sup>

In the case of a salary reduction plan or a cash or deferred profit-sharing plan, however, the Internal Revenue Service has permitted employees to exclude from income amounts contributed by their employers to the plan, even where the source of these amounts is the employees' agreement to take salary or bonus reductions or forego salary increases. In the case of a cash or deferred profit-sharing plan, the employee generally has the election to take a bonus currently in cash or deferred by payment into the plan. In the case of a salary reduction plan, the employee generally agrees with his employer to reduce his salary or forego a salary increase which is contributed into a pension plan for his benefit. In either case, if the plan met certain nondiscrimination requirements, the Internal Revenue Service in the past had taken the position that, under certain circumstances, the payment into the plan would be treated as an employer contribution, not taxable to the employee until benefits were received from the plan. The maximum amount that could be so treated generally was 6 percent of compensation.<sup>3</sup>

<sup>1</sup> Generally, if the plan allows it, employees may make voluntary contributions to a qualified retirement plan of up to 10 percent of compensation, I.R.S. Publication 773, p. 14 (Feb. 1972).

<sup>2</sup> At one time, Congress took the position that a contribution to an H.R. 10 plan on behalf of a self-employed person was made half by the employer and half by the self-employed person; no deduction was allowed for half of the contribution (the half regarded as "contributed by" the self-employed person). This limitation (sec. 404(a)(10)) was repealed for taxable years after December 31, 1967.

<sup>3</sup> In the case of employees of tax-exempt charitable, educational, religious, etc., organizations and employees of public educational institutions, a specific statutory provision provides for employer contributions of up to 20 percent of compensation, times years of service, reduced by amounts previously contributed by the employer for annuity contracts on a tax excluded basis to the employee (sec. 403(b)). The regulations under the statute allow the employer contributions to be made under these salary reduction plans. Anti-discrimination provisions that apply generally to qualified plans do not apply to those tax sheltered annuities. The Senate bill and H.R. 10470 do not affect the tax treatment of these contributions.

On December 6, 1972, the Service issued proposed regulations (37 Fed. Reg. 25938) which would change this result in the case of qualified pension plans by providing that amounts contributed by an employer to such a plan in return for a reduction in the employee's basic or regular compensation, or in lieu of an increase in such compensation, will be considered to have been contributed by the employee and consequently will be taxable income to the employee.<sup>4</sup> Public hearings have been held on these proposed regulations but regulations in final form have not yet been issued.

*Issue*

While in the case of many millions of employees provision is made for the accumulation of retirement funds out of tax-free dollars by their participation in qualified retirement plans, many other employees do not have the opportunity to participate in qualified plans. Often plans are not available because an employer is not willing to incur the cost of contributing to a retirement plan. This may be so even though the employees would be willing to contribute their own funds for this purpose. The employees not covered under a qualified plan who, as a result, are not able to set anything aside for their retirement out of before-tax dollars, are further disadvantaged by the fact that in their case earnings on their retirement savings are subject to tax, and grow more slowly than the tax sheltered earnings on contributions to a qualified plan.

*The Senate bill (H.R. 4200) and H.R. 10470*

*In general.*—Under the Senate bill and H.R. 10470, any individual who was not covered during a year as an active participant<sup>5</sup> in a qualified retirement plan, a government retirement plan (whether or not qualified), or a section 403(b) annuity plan, is to be permitted a deduction of \$1,000 a year from earned income, or (if greater) 15 percent of earned income up to \$1,500, for contributions to an individual retirement account. The bills provide that the deduction in this case is to be from gross income, and as a result can be taken even by those taxpayers who also take the standard deduction. Earnings on these contributions would also be tax free (until actually distributed to the employee as benefits from the account).

In the case of a married couple, each spouse may establish his or her separate retirement savings account and the \$1,000 (or 15 percent-\$1,500) limitation is to be applied separately to the earned income of each spouse. For this purpose, earned income is to be determined without regard to State community property laws.

Under the bills, the employee can establish his own retirement savings account, or the retirement savings can be made through the medium of contributions by an employer (either in the form of additional compensation provided by the employer or a salary reduction plan) if there is no qualified, government, or section 403(b) plan in which the employee in question is an active participant.

<sup>4</sup> The proposed regulations would not affect the tax treatment of contributions to certain qualified profit-sharing plans, where the contributed amounts are distributable only after a period of deferment; however it was indicated that there would be reconsideration of the rulings permitting exclusion of such profit sharing contributions. (Rev. Rul. 56-497, 1956-2 C.B. 284; Rev. Rul. 63-180, 1963-2 C.B. 139; Rev. Rul. 68-39, 1968-1 C.B. 402.)

<sup>5</sup> If contributions were made on behalf of an individual under a plan during the taxable year, he would generally be considered an active participant for that year.

Where individual retirement accounts are set up by the employer, the aggregate of the contributions excludable from the employee's income and the contributions deductible by the employee (which are to be accounted for separately in the records of the account) are not to exceed \$1,000 per year.<sup>6</sup> Of course, all benefits under the salary reduction plan are to be immediately vested, since the contributions, in effect, either represent compensation to the employee or come from his own funds.

*Requirements for an individual retirement account.*—If an individual wishes to establish an individual retirement account, the trustee (or other holder of the assets) of the account would have to maintain, under the provisions of a written governing instrument, a separate accounting of the individual's contributions, the earnings on them, and the distributions made either to the individual involved or to his beneficiaries. The balance in the account could, for example, be vested in insurance annuity contracts, in a common trust fund managed by a bank, in a savings account with a savings and loan institution or a credit union, or in stock of a mutual fund. However, in any case, the funds must be held by a bank or other person who establishes to the satisfaction of the Service that the manner in which it will hold the balance in the account is consistent with the intention of the new provision. The funds might be held in a trust, a custodial account, an annuity contract, or any similar arrangement approved by the Internal Revenue Service.

The bills also contain a number of other provisions designed to ensure that the accounts will be used for retirement savings, many of which are similar to requirements which are already in the law with respect to H.R. 10 plans.

For example, the written governing instrument is to provide that no contributions in excess of the deductible limit can be made to the plan, except for amounts transferred from qualified plans or other individual retirement accounts. Any excess contributions inadvertently made would have to be refunded to the individual with interest within 6 months after notice of the excess contribution was sent by the Internal Revenue Service. If the excess contributions were not repaid, the account would be disqualified for that year and all succeeding taxable years. In this case, the individual would also be reduced to take into income the assets of the account (valued as of the first day of the taxable year in which the account became disqualified), required by any contributions in the account for the current year for which deductions are denied.

In addition to the rules on excess contributions, the written instrument is also required to provide that no distributions can be made to the individual prior to age 59½, except in the event of death or disability. On the other hand, under the bills, the plan is required to begin distributions not later than the year during which the individual attains the age of 70½, and distributions then have to be made not

<sup>6</sup> Any amount deductible or excludable under these provisions is not to be considered to be part of the employee's investment in the contract for purposes of computing the taxable part of a distribution from the account, since all of the contributions would be made, in effect, with tax-free dollars. If contributions in excess of these limits are made, the employer is not to receive a deduction for the excess contribution, and all excess would have to be repaid to the employer.

less rapidly than ratably over the remaining lifetime (or period of life expectancy) of the individual, or of the individual and his spouse. After age 70½, an excise tax of 10 percent a year is imposed on the proportion of the individual's account that represents the amount that should have been (but was not) distributed.<sup>7</sup> Also, under the bills, no tax deductible contributions could be made to the account during or after the taxable year during which the individual attains the age of 70½.

If the individual establishing the account dies before his entire interest in the account has been distributed to him, the governing instrument is generally to require that the undistributed assets be distributed, or be applied to the purchase of an annuity for his beneficiaries, within 5 years after his death. However, this rule does not apply if distributions began prior to his death, and the account was to be completely distributed over a period not exceeding the life expectancy of the individual and his spouse (measured as of the time when distributions from the account began).

In addition, if the assets of the account are invested in an insurance contract, the governing instrument must provide that any refunds of premiums are to be held by the insurance company and applied toward the payment of future premiums or the purchase of additional benefits within the current taxable year or the next succeeding year.

*Premature distributions.*—Premature distributions frustrate the intention of saving for retirement, and the bills, to prevent this from happening, impose a penalty tax. If a premature distribution from the account is made before the individual attains the age of 59½, the distribution is subjected to a penalty tax of 30 percent of the amount of the taxable distribution.<sup>8</sup> This is in addition to any other income taxes payable on this distribution, and would not be offset by any tax credits. Also, this tax would not be treated as reducing the individual's tax liability under the minimum tax provisions (sec. 56).

The penalty tax is not to apply in the event of distribution due to death or disability.

To permit flexibility with respect to the investment of an individual retirement account, the bills provide that money or property may be distributed from an individual retirement account, without payment of tax, if the same amount is reinvested by the individual within 60 days in another qualifying individual retirement account.

*Taxation of beneficiaries.*—Generally, the proceeds of an individual retirement account are to be taxable to the individual when distributed. Since the contributions to the account will in most cases be made with tax free dollars, the employee's basis in the account generally will be zero.

The amounts distributed to the individual are not to be eligible for capital gains treatment, and the special averaging rules applicable to lump sum distributions (under sec. 72) are not to be available. However, the individual would be permitted to use the general averaging rules (sec. 1301).

<sup>7</sup> The language of the Senate bill is not completely clear on this point, but it is believed that this was the intended result.

<sup>8</sup> The distribution would not, however, be subject to the penalty provided under section 72(m)(5) for premature distributions to owner-employees.

If any individual borrows money, pledging his interest in the retirement account as security, the portion pledged as security is to be treated as a distribution from the retirement account to the individual. Any contribution to an individual retirement account, or any income of the account, applied to the purchase of current life insurance protection under any retirement income, endowment, or other life insurance contract also will constitute income to the individual.

For purposes of the estate and gift taxes the amounts in individual retirement accounts are not to be excluded from tax (secs. 2039(c) and 2517).

*Other rules.*—Under present law, if an asset of an individual is transferred pursuant to a divorce settlement, the individual is deemed to realize gain on the difference between his basis in the asset and its fair market value at the time of the transfer (if the asset has appreciated). Under the bills, if an individual retirement account is transferred to the individual's spouse pursuant to a divorce decree, or settlement agreement, this transfer is not to be taxable to the transferor.

*Qualified retirement bonds.*—In addition to the various types of investment described above in which an individual retirement account can be placed, the bills also provide that these amounts may be invested annually in retirement bonds to be issued by the Government. The bonds are to be issued under the Second Liberty Bond Act and provide for the tax-free accumulation of interest until the time of redemption. In conformity with the general provisions for individual retirement accounts, the bills provide that the bonds generally can be cashed only after the individual has reached the age of 59½ years, or if he becomes disabled or dies before that age.<sup>9</sup>

Consistent with the general rules for individual retirement accounts, the bills provide that the bonds are to cease to bear interest when the individual reaches age 70½. In addition, during that year the individual is also required to take any of these bonds he is still holding into income, even if he does not cash them in.

Also the bills provide that the bonds are to cease to bear interest not later than five years after the death of the individual in whose name the bonds have been issued.

The bonds are to be issued in the name of the individual who purchases them for his retirement and are not to be transferable, under any circumstances, except to his executor in the event of his death (or to a trustee for his benefit in the event he became incompetent to manage his own affairs). For example, the bonds could not be pledged for the payment of debts, and could not be assigned to a trustee in bankruptcy. Also, the bonds could not be awarded to the individual's spouse as the result of a divorce settlement.

When the bonds are redeemed, the full proceeds of the bonds, including any interest earned on them, are to be treated as ordinary income to the individual, whose basis in the bonds would be zero. However, if the individual chose to do so, he could treat this income

<sup>9</sup> Such a bond could be redeemed within 12 months after issuance, but no interest is payable if it is redeemed in that period.

under the general averaging provisions of the tax law (sec. 1301 et seq.).

*Salary reduction pension plans and cash or deferred profit-sharing plans.*—As discussed above, until recently, the Internal Revenue Service had taken the position that amounts contributed to a qualified retirement plan on a salary-reduction basis could, under certain conditions be considered as tax excludable employer contributions to the plan. Under the bill, this treatment is continued with respect to contributions to a qualified pension or profit-sharing plan made prior to January 1, 1974. Thereafter, as the Senate Finance Committee Reports states is already true under present law in the case of employee contributions under the Federal Civil Service Retirement Plan, contributions which are really employee contributions (whether required to be made or made at the individual option of the employee in return for a reduction in his compensation, or in lieu of an increase in such compensation) are to be treated as such and will no longer be excludable from income by the employee.<sup>10</sup> This is so with respect to both salary reduction pension plans and cash or deferred profit-sharing plans. The only modification in this rule is that where an individual is not covered by a qualified plan, a government plan, or a sec. 403(b) annuity plan, employer contributions of up to \$1,000 per annum can be made to an individual retirement account under a salary reduction arrangement. Income earned on amounts contributed under a qualified salary reduction pension plan or profit-sharing plan prior to 1974 would for the future remain tax exempt, as would the earnings on these amounts.

*Section 403(b) annuity plans.*—Under present law, the proceeds of a section 403(b) annuity plan, for the benefit of teachers or employees of tax-exempt charitable, etc., organizations, may be invested only in insurance contracts. The Senate bill and H.R. 10470 provide that the assets of these accounts may also be invested in mutual funds, under appropriate custodial restrictions.

*Effective date.*—These provisions are to apply with respect to taxable years beginning after December 31, 1973.

#### *Alternative proposals*

*H.R. 2.*—The bill would not change the rules in the Internal Revenue Code on the treatment of personal savings retirement plans.

*H.R. 7157.*—A deduction would be allowed for contributions made by an employee to an employer retirement plan, or to his own qualified retirement account; generally, the deduction could not exceed the lesser of 20 percent of earned income, or \$1,500. The maximum deductible amount for an employee would be reduced by any payments made on his behalf by an employer to a qualified plan (which contributions could, at the employee's option, be deemed to be 7 percent of his earned income). In the case of an employee who had earned income which was not subject to social security or the railroad retirement system, the maximum deductible amount would also be reduced by the tax which would have been imposed on such income had it been subject to

<sup>10</sup> At the fiscal year 1973 level of contributions the tax impact of the exclusion from income, for tax purposes, of employee contributions under the Federal Civil Service Retirement Plan is estimated at \$10 million; in the long run this tax impact would be offset in part by the tax treatment accorded pension benefits.

about \$500

this tax. In the case of a married couple, each spouse would be entitled to claim the deduction and the limit would be applied separately to each spouse.

In general, contributions to such a retirement account would not be permitted to exceed the 20-percent-\$1,500 limit noted above, and then could be made only by the employee. A qualified retirement account would be treated as a qualified owner-employee plan, for purposes of the Code's provisions on exempt organizations (such as the prohibited transactions and unrelated business income provisions) and procedure and administration (such as the requirement for fiduciary returns).

Penalties would be imposed on premature distributions (generally, distributions before the employee or spouse reaches age 59½) and distributions would be required to begin from a personal retirement savings account by the time the individual attains the age of 70½. An annual 10-percent excise tax on amounts retained in the individual retirement account in excess of those amounts necessary so that the account may be distributed ratably over the life expectancy of the employee or the employee and spouse, after they reach the age of 70½ (sec. 3 of the bill).

*H.R. 10489.*—In most respects, the provisions of H.R. 10489 with respect to personal retirement savings plans are the same as those in H.R. 7157. However, in the case of employee contributions to an employer plan, the maximum deductible contribution by the employee would be reduced on account of employer contributions by the lesser of (1) 7 percent of his earned income or (2) that percentage of his earned income equal to the ratio of the employer's aggregate contributions that year under the plan to the aggregate compensation paid to employees covered under the plan (sec. 502 of the bill).

*Areas for committee consideration*

*The salary reduction alternative.*—Under the Senate bill and H.R. 10470, as outlined above, a deduction for contributions to individual retirement accounts would be permitted. One method of doing this would be through accounts which the employer could establish and contribute to for his employees. On the other hand, under another provision of the bills, contributions to a qualified plan in exchange for a reduction in the employee's compensation would be treated as employee contributions which were not tax excludable to the employee for years beginning after December 31, 1973.

One alternative to the action taken under the Senate bill and H.R. 10470 would be to strike out the provisions with respect to individual retirement accounts, but to continue to allow contributions to a qualified plan based on a salary reduction to be tax excludable to the employee.<sup>11</sup>

To some extent at least, the availability of individual retirement accounts to the self-employed and shareholder-employees of corporations, would tend to take away the incentive which such individuals otherwise might have to establish qualified pension plans which would benefit their employees, as well as the individuals themselves. Also,

<sup>11</sup> As discussed above, the Treasury Department is now considering, through the medium of proposed regulations, the extent to which such contributions are tax excludable under present law.

it might be noted that there is a revenue loss of \$355 million per year which it is estimated would be incurred in connection with the provisions of the Senate bill and H.R. 10470 relating to individual retirement accounts. The Treasury has estimated that H.R. 7157's provisions on this point would result in revenue losses rising to a level of \$900 million per year by the fourth year after the effective date.

Further, some are concerned that the individual retirement account would establish a precedent for allowing a deduction for personal savings. There are few deductions under the tax law today for personal expenses, and such deductions as do exist in the tax law, such as the deduction for medical expenses (sec. 212), or the deduction for theft and casualty losses (sec. 165) are generally intended to cover emergency situations. It is argued that once the precedent of allowing a deduction for personal savings for retirement (and tax-deferred buildup of earnings) has been established there will be pressure on the Congress to increase the deduction or to allow deductions for other forms of savings.

A related problem is that it may not be possible to prevent an employee from withdrawing sums from his or her own individual retirement account to meet an emergency, an apparent economic crisis, an economic opportunity, or a temporary drop in taxable income.

As a possible substitute for individual retirement accounts the committee might wish to consider allowing (within limits) salary reduction plans or cash and deferred profit-sharing plans, and taking other steps to encourage employers to establish qualified retirement plans for their employees.

If the committee decides to preserve the basic concept of the individual retirement account, it may wish to provide that the deduction for individual retirement accounts would be permitted only where the account was established by the employer. For example, the committee may wish to provide that up to \$1,000 or \$1,500 per year could be contributed by the employer to an account on a tax excluded basis for the employee.

*The size of the limitation.*—Under the Senate bill as reported by the Finance Committee, the limitation on deductible contributions to individual retirement accounts was a flat \$1,000 per year (but not in excess of earned income). Under the Senate bill, as amended on the floor, this limit was changed to \$1,000, or 15 percent of earned income up to a maximum deductible contribution of \$1,500.

It was estimated that the revenue loss under the flat \$1,000 limitation would ultimately rise to \$270 million per year. Under the Senate bill as amended, this loss would be increased to an estimated \$355 million per year.

Under the Senate bill as amended, the 15 percent or \$1,500 alternative is available only in the case of employer contributions to an individual retirement account. If the employer establishes an account for his employee, the maximum permissible deduction is limited to \$1,000. If the 15 percent or \$1,500 alternative should be chosen, consideration might be given to also making this available in the case of an employer-established account. Likewise, consideration might be given to removing the 15 percent limitation, since, as a practical matter, this affects only individuals whose earned income is less than \$10,000 per year.

*Government "pick-up" plans.*—Some State and local government plans designate certain amounts as being employee contributions. Nevertheless, in a number of instances, statutes authorize or require the relevant government units or agencies to "pick up" some or all of what would otherwise be the employee's contribution requirements. The committee may wish to consider making it clear that, where the State or local governmental unit or agency picks up such required employee contributions, then those contributions are employer contributions for tax purposes, even though the State or local government involved continues to refer to them as employee contributions for purposes of the rules relating to that State or local government retirement plan.

*Cash or deferred profit-sharing plans.*—As indicated above, proposed Treasury regulations provide that contributions under salary reduction plans involving basic salaries are to be treated as employee contributions, not excludable from the employees' income. Although the proposed regulations would not apply where the reduction is in the amount of a bonus or profit-sharing amount which the employee might elect to take part in cash or entirely by way of contribution to a retirement plan, the Treasury has indicated that it does not object to treating such bonus or profit-sharing plans in the same manner as salary reduction plans involving basic compensation. The Senate bill treats both types of plans the same—i.e., the discretionary portion of the contribution to the plan is treated as an employee contribution, includable in the employee's income. It has been maintained that such bonus or profit-sharing plans should be treated differently from plans involving the basic compensation or that, at least, there be a delayed effective date with regard to any rule affecting bonus or profit-sharing plans.

The committee may want to deal with this problem in either of two possible ways. First, the staff and the Treasury Department staff, believed that the committee might want to consider a provision to the effect that these cash or deferred profit-sharing plans will be treated in the same manner as regular profit-sharing plans in those cases where the plan is of such a nature that in fact a large proportion of those who have this opportunity to make an election between cash and deferred profit-sharing in fact take the latter alternative. Thus, it has been suggested, for example, that this treatment could be provided where at least 80 percent of the employees eligible to participate in the plan (which itself, is a nondiscriminatory plan) in fact elect the deferred profit-sharing alternative.

As an alternative (or perhaps in addition to the first possibility) the committee might want to provide a transitional rule for those who already have significant cash or deferred profit-sharing plans in existence. Any such companies might be allowed to gradually convert their cash or deferred profit-sharing plan into a true profit-sharing plan over possibly a period of 10 years. In this case, for example, it could be provided that the plan in the first transition year would have to require that 10 percent of the employee's bonus with respect to any individual was set aside in the deferred profit-sharing plan. In the next year, this would be increased to 20 percent and increased thereafter in each year by an additional 10 percent until the entire amount was so included at the end of the 10-year period.

Another question that has been raised in this area is whether any limitations on salary reduction pension plans and on cash or deferred profit-sharing plans should also apply where an employee has a choice between cash and other fringe benefits, some of which may be normally nontaxable (e.g., health insurance, life insurance within the permissible limits).

## II. LIMITATIONS ON CONTRIBUTIONS AND BENEFITS

(Secs. 702, 704, and 706 of the Senate bill and secs. 72, 401, 404, 412, 414, and 1379 of the Code)

This section concerns the amount of the contributions which can be made to a qualified pension plan on behalf of employees and self-employed persons and the amount of the deductions allowable for such contributions, or the amount of the benefits that can be paid from such a plan. The ceilings on the size of the contributions have the effect of limiting the size of the pension which can build up for an individual out of tax-sheltered contributions and tax-sheltered earnings on contributions.

### *Present law*

Under present law, different rules are provided for employer and employee contributions in the case of plans for self-employed individuals (H.R. 10 plans), plans of "regular" corporations, and plans of electing small business corporations (subchapter S).<sup>1</sup> These are described below.

*H.R. 10 plans.*—The amount of deductible contributions to an H.R. 10 plan on behalf of a self-employed person cannot exceed the lesser of 10 percent of his earned income<sup>2</sup> or \$2,500 (sec. 404(e)). In addition, nondeductible contributions may be made in certain cases, but these contributions on behalf of owner-employees may not exceed the lesser of 10 percent of earned income or \$2,500. Allowable voluntary contributions of employees of owner-employees must be at least proportionate to allowable voluntary contributions for owner-employees (sec. 401(e)(1)(B)(ii)).

*"Regular" corporate plans.*—In the case of a "regular" corporate plan there are no limitations on how much may be contributed by the employer. There are, however, limitations on the amount of the contribution that is deductible. Different limitations apply to profit-sharing and stock bonus plans and to pension plans. All those limitations are based on the aggregate covered payroll rather than being on an employee-by-employee basis.

In the case of profit-sharing or stock bonus plans, the amount of the contribution that is allowable as a deduction is not to exceed in the aggregate 15 percent of compensation to employees covered under the

<sup>1</sup> All the types of plans must, in addition to the rules described below, meet the general reasonable compensation tests (sec. 162). The statute does not specify limitations on the benefits which may be paid under a qualified pension plan. However, in Rev. Rul. 72-3, 1972-1 CB. 105 the Internal Revenue Service ruled that pension benefits from a qualified pension plan are intended as a substitute for compensation, and that in general a plan which provides benefits in excess of an employee's compensation is therefore not qualified.

<sup>2</sup> "Earned income" is generally defined as being equivalent to "net earnings from self-employment"—the kind of income that may be subject to self-employment taxes in lieu of FICA taxes (sec. 401(c)(2)).

plan. Contributions in excess of the 15-percent limitation may be carried over to future years. In addition, within certain limits, to the extent that an employer does not make the full 15-percent contribution in one year he may increase the amount of his deductible contribution in a future year.

In the case of pension plans, the amount of the contribution that is deductible is not to exceed 5 percent of the compensation to employees covered under the plan, plus the amount of the contribution in excess of 5 percent of compensation to the extent necessary to fund normal pension costs and remaining past service costs of all employees under the plan as a level amount or as a level percent of compensation over the average remaining future service of plan participants. In the alternative, the taxpayer may compute the limit on his deductible contributions by limiting his deduction to his normal cost for the plan plus 10 percent of the past service cost of the plan (sec. 404(a)). In practice, these limitations have very little effect in limiting the size of contributions to regular corporate pension plans.

Where an employer contributes to two or more retirement plans which are governed by different limits on deductions (pension or employee's annuities on the one hand, and profit-sharing or stock bonus, on the other hand), the total amount annually deductible under the plans cannot be more than 25 percent of compensation otherwise earned by the plan beneficiaries. If any excess is contributed, it may be deducted in the following year; the maximum deduction in the following year (for carryover and current contributions together) is 30 percent of compensation. A carryover is available for additional excess contributions which are deductible in the succeeding taxable years in order of time.

*Subchapter S plans.*—The limitations on the deductibility of contributions to a subchapter S corporation plan are the same as those in "regular" corporate plans. However, a shareholder-employee (an employee who owns more than 5 percent of the outstanding stock of the corporation) must include in his gross income the amount by which the deductible contributions paid on his behalf exceed the lesser of 10 percent of his compensation or \$2,500 (sec. 1379(b)).

*Professional corporations.*—Generally, lawyers, doctors, accountants and certain other professional groups in the past have been unable to carry on their professions through the form of corporations because of the personal nature of their responsibility or liability for the work performed for a client or patient. Consequently, their contributions to retirement plans were limited by the rules governing self-employed persons. In recent years, however, all States have adopted special incorporation laws which provide for what are generally known as "professional corporations." These have been used increasingly by groups of professional persons, primarily to obtain the more favorable tax treatment for pensions generally available to corporate employees. The Treasury Department, in the so-called Kintner regulations, held that professional corporations were not taxable as corporations. A number of court cases, however, have overturned the regulations and the Service has now acquiesced and generally recognizes these professional corporations as corporations for income tax purposes.

*Issue*

Many self-employed people, especially professionals, feel that they are discriminated against as compared with corporate executives and proprietary employees of corporations in regard to the tax treatment of retirement savings. This is because, at present, there is no comprehensive limit on the amounts the corporate employer can contribute on behalf of its executives and proprietary employees. Self-employed persons, on the other hand, are subject to the contribution limits described above.

In addition, many of the self-employed argue that, as a result of these contribution limits, it is difficult for them to provide adequately for their retirement, particularly as many professionals have a limited number of years of peak earnings in which it is comparatively easy to set something aside. It is also argued that the \$2,500 limit is no longer appropriate, since in the approximately 10 years since H.R. 10 was first enacted, there has been a substantial inflation factor in the economy. Furthermore, it is contended that the present law in the retirement plan area creates an artificial incentive for the incorporation of businesses which more traditionally, and perhaps more appropriately, have been conducted in unincorporated form.

At the same time that some individuals have been questioning the relatively low level of tax deductible contributions for H.R. 10 plans, others have questioned the wisdom of permitting virtually unlimited pension benefits in corporate plans to be funded out of tax-free dollars. The lack of any limitation on benefits for regular corporate plans has been cited repeatedly by those who advocate raising the limitations for H.R. 10 plans.

*The Senate bill (H.R. 4200) and H.R. 10470*

*H.R. 10 plans.*—The Senate bill and H.R. 10470 increase the maximum deductible contribution on behalf of self-employed persons to the lesser of \$7,500 or 15 percent of earned income.<sup>3</sup> (A similar, although not identical, rule is applied in the case of defined benefit pension plans.) No more than the first \$100,000 of earned income may be taken into account in testing for discrimination under the plan. The \$100,000 ceiling on the earned income rate base means that a self-employed person with more than \$100,000 income will have to contribute at a rate of at least 7½ percent on behalf of his employees if he wishes to take the full \$7,500 deduction on his own behalf (in order to comply with the antidiscrimination requirements.) The bills also permit self-employed individuals to set aside each year as a deductible contribution to a pension plan a minimum amount (\$750 out of earned income) even though it exceeds the otherwise applicable percentage limitation (15 percent of earned income).

Also, the bills contain a formula which would allow the self-employed, in effect, to translate the 15 percent—\$7,500 limitation on contributions, to which they would otherwise be subject, into a limitation on benefits which they could receive under a defined benefit plan.

<sup>3</sup> The limitations on nondeductible contributions on behalf of owner-employees in a self-employed plan is not increased, however.

Under the formula, the basic benefit for the employee (in terms of a straight life annuity commencing at the later of age 65 or 5 years from the time the participant's current period of participation began, with no ancillary benefits), attributable to employer contributions, is not to exceed the amount of the employee's compensation which is covered under the plan (up to a maximum of \$50,000)<sup>4</sup> times the percentage shown on the following table.

| Age at start of current period of participation : | Percentage |
|---|------------|
| 30 or less.....                                   | 6.5        |
| 35 .....  | 5.4        |
| 40 .....  | 4.4        |
| 45 .....  | 3.6        |
| 50 .....  | 3.0        |
| 55 .....  | 2.5        |
| 60 or over.....                                   | 2.0        |

The percentages in early years are higher to reflect the fact that contributions made during these time periods earn interest for a longer period prior to retirement than contributions made in later years.

In addition, the bills contain a provision generally limiting the annual benefits which can be paid out under defined benefit plans to 100 percent of the participant's average compensation from the employer during his highest 3 consecutive years of earnings adjusted for changes in the cost of living.

Another provision of the bills would allow self-employed individuals, in effect, to pool their contribution limitations. In effect, a plan could provide that the older partners in a law firm could accrue more than their share of retirement benefits, if the younger partners accrue less than their share, the benefits do not result in prohibited discrimination, and the overall contribution limits are met. The purpose of the provision is to allow an older partner to exceed the above-described H.R. 10 limits on tax-sheltered contributions so that the firm can fund a more generous pension for him than would be permitted if he had to adhere to those limits. It is expected that this provision would increase the likelihood that a firm's decision-makers, who generally are older than the other partners, would decide to institute a plan. In such a case, the 75-percent—\$100,000 limit on corporate plan benefits (described below) would also apply.

Contributions by self-employed persons (and other cash basis taxpayers) would be deductible, under the bills, if they were made at any time up to the point when the Federal income tax return for the year in question is due (whereas, under present law, the contributions must be made by the end of the taxable year). Also, the bills would permit owner-employees to withdraw their voluntary contribution to a self-employed plan prior to retirement, without penalty, whereas, under present law, this may not be done by owner-employees (although it may be done by other participants).

*Corporate plans.*—The bills impose limitations on the contributions which may be made or the benefits which may be paid under qualified corporate plans for all employees.<sup>5</sup>

<sup>4</sup> For purposes of the antidiscrimination rules, the maximum amount of compensation which is to be taken into account is \$100,000.

<sup>5</sup> The bill as reported by the Senate Finance Committee would, in general, have made certain corporations, those having "proprietary employees," subject to essentially the same rules and limitations on contributions which are imposed under the tax law on H.R. 10

Under the provisions, in the case of a defined benefit plan, no deduction is allowable for any contribution which exceeds the amount necessary to fund (from employer contributions and the earnings therefrom), a basic benefit in the form of a straight-life annuity commencing at age 65 (with no ancillary benefits), in excess of 75 percent of the participant's average high-three year compensation from the employer, not in excess of the first \$100,000 per year. In other words, the basic pension benefit from employer contributions cannot exceed \$75,000 per year. (To the extent that employee contributions are made, the \$75,000 limit could be exceeded.) This benefit would have to be funded over at least a 10-year period and in the case of employees who participated in the plan for less than 10 years, the maximum permissible benefit would be scaled down proportionately.

In the case of a defined contribution plan (a money purchase pension, profit-sharing, or stock bonus plan), the corporation would be permitted to make deductible contributions sufficient to fund for the employee a pension on this same 75 percent of average high-three year pay basis. For example, if an employee had an average high three years salary of \$50,000, this figure would be multiplied by 75 percent (\$37,500) to determine the maximum amount of pension the employee would be entitled to receive. The amount of contributions needed to fund this size pension would then be computed. First, the amount of the pension would be multiplied by a conversion factor of 10 (in the case of a basic benefit commencing at age 65) to determine the total funding which will be needed to provide the pension at age 65 (\$375,000). Second, from this amount (\$375,000) would be subtracted any amounts already contributed by the employer on behalf of the employee (together with the past earnings on these contributions and the assumed interest which will be earned in future years on these contributions before the employee's retirement). The difference between these two amounts is called the "unfunded limitation balance" and (subject to certain other limitations imposed under present law) the employer may deduct contributions which, together with 6-percent earnings on these contributions, would be sufficient to build up to a \$375,000 balance by the time the employee reaches normal retirement age.

If the corporation has both a defined benefit plan and a defined contribution plan, the maximum benefit payable under the defined benefit plan would have to be reduced in proportion to the amount of the benefit which was funded through the defined contribution plan.

*Subchapter S corporations.*—Under present law (sec. 1379 of the Code), as described above, shareholder employees of subchapter S corporations are subject to contribution limitations which are very

plans. In general, a "proprietary employee" would be any individual owning at least 2 percent of the voting stock or total stock in the corporation, where all proprietary employees who are active participants, as a class, had at least 25 percent of the value of the accrued benefits under the plan. The philosophy of this provision was that corporate plans which came within this description resembled self-employed plans more closely in essential respects than other types of corporate plans, thus justifying a distinction in the type of tax treatment to be afforded. On the Senate floor, however, these distinctions between different types of corporate plans were eliminated, and instead, a provision was adopted imposing certain limitations on all corporate plans.

similar to the limitations imposed on self-employed individuals. Under the bills, these provisions would be repealed, and subchapter S corporations would be subject to the same limitations as other corporations.

*Money purchase plans.*—The bills contain a provision that tax excludable contributions to a money purchase plan cannot exceed 20 percent of the employee's compensation. Any additional contributions on behalf of the employee must be included in income by him.

Any amount included in gross income under this provision would be considered as part of the employee's investment in the contract for purposes of computing the taxable amount of a distribution from the plan to the employee. However, these contributions would be considered to be made by the employer for purposes of qualification of the plan. If the employee's rights under the plan should terminate before tax excludable payments under the plan equaled the amounts included in gross income under this provision, a tax deduction would be allowed equal to the unrecovered contributions.

*Custodial accounts.*—Under present law, a custodial account may be treated as a qualified trust, but only if the custodian is a bank, and the investments are made solely in the stock of open-end mutual funds, or solely in annuity, endowment, or life insurance contracts (and certain other conditions are met) (sec. 401 (f)). The bills would allow the custodian of the account to be someone other than a bank; however, the custodian would have to establish, to the satisfaction of the Internal Revenue Service, that it would manage the assets of the account in a manner consistent with the intention of the tax law. As under present law, the bills provide that someone other than the trustee or custodian, including the employer, can have authority to control the investments of the plan account, either by directing the investment policy of the plan, or by exercising a veto power.

*Effective date.*—Generally, these provisions will take effect in years beginning after December 31, 1973.

#### *Alternative proposals*

*H.R. 2.*—This bill would not change the rules in the Internal Revenue Code on the limitations on contributions and benefits.

*H.R. 7157.*—The bill would increase the limitation on deductible contributions on behalf of a self-employed individual (H.R. 10 plans) and the excludable contributions made on behalf of a shareholder-employee (subchapter S plans) to the lesser of \$7,500 or 15 percent of his earned income (sec. 4 of the bill). Limitations on nondeductible contributions on behalf of owner-employees would be correspondingly increased.

The bill also in effect provides a limitation on the amount which can be contributed on an employee's behalf under a money purchase pension plan. Under the bill, contributions in excess of 20 percent of the employee's compensation are included in his gross income and treated as a part of his investment in the contract for purposes of determining the tax-free portion of the pension when distributions are ultimately made.

The 20-percent limitation in the case of pension plans applies across

the board to all money purchase pension plans. This limitation would not apply, however, in the case of any other types of pension plan contributions made on behalf of any corporate employees.

*H.R. 10489.*—The bill would increase the limitation on deductible contributions on behalf of a self-employed individual (H.R. 10 plans) and the excludable contributions made on behalf of a shareholder-employee (subchapter S plans) to the lesser of \$7,500 or 15 percent of his earned income. Limitations on nondeductible contributions on behalf of owner-employees would be increased to the lesser of \$7,500 or 10 percent of earned income.

The bill also in effect provides a limitation on the amount which can be contributed on an employee's behalf under a money purchase pension plan. Under the bill, contributions in excess of 25 percent of the employee's compensation are included in his gross income and treated as a part of his investment in the contract for purposes of determining the tax-free portion of the pension when distributions are ultimately made.

The 25 percent limitation in the case of pension plans applies across the board to all money purchase pension plans. This limitation would not apply, however, in the case of any other types of pension plan contributions made on behalf of any corporate employees.

In addition, the bill contains a provision to allow the establishment of profit-sharing plans by tax-exempt organizations.

*Areas for committee consideration*

*Factors to be considered in connection with the limitation.*—If the committee concludes that there should be no distinction between various types of corporate plans, but that there should be an overall ceiling on the contributions made to, or benefits paid from, a qualified plan for all employees (corporate and self-employed), there are a number of issues which need to be considered. The suggestions in this category were developed in cooperation with the staff of the Treasury Department.

(a) *Profit-sharing plans and other defined contribution plans.*—Under the Senate bill, a pension of up to \$75,000 per year could be provided by employer contributions for upper income employees. However, the 75 percent of high-three-years limitation would also operate as a ceiling on the pensions of rank-and-file employees. This creates a particular problem in the case of a profit-sharing plan, such as the Sears Plan, which provides a generous retirement income for its rank and file employees, which could often exceed the 75 percent limitation.<sup>6</sup> This problem could be avoided by providing a floor on the amount of the pension.

Since it is the 75 percent limitation which has an impact on many rank-and-file employees, one way of dealing with the problem would be to remove the percentage limitation (as the committee has tentatively decided to do). However, in this case a ceiling could be retained providing that when an employee's account balance in any profit-

<sup>6</sup> The Sears Plan has a \$15,000 ceiling on the contribution base.

sharing or other defined contribution plan<sup>7</sup> reaches an amount which (together with assumed earnings on the account would be sufficient to provide a pension of \$75,000 per year beginning at age 65, or the actuarial equivalent of such a pension, subsequent employer contributions and forfeitures would be treated as taxable amounts. This would permit a tax-deferred accumulation in an employee's account of approximately \$750,000 funded by employer contributions, earnings on employer and employee contributions, and (in the case of certain profit-sharing plans) forfeitures.<sup>8</sup>

As a further limitation, to insure that the employee's benefit under a defined contribution plan is funded over a reasonable period of time, it could be provided that the maximum amount which could be added to the employee's account balance in the plan in any one year as a result of employer contributions, forfeitures, and employee contributions could not exceed 25 percent of the employee's compensation (based on no more than \$100,000 of compensation, subject to increase as the cost of living rises). The employee would be permitted to contribute up to 8 percent of his compensation in any one year to the plan. (This would be included in the 25-percent limit.) Any amounts contributed in excess of the 25-percent limitation or in excess of the account balance limit would not go into a qualified trust but instead would be treated as taxable amounts (as would the earnings on those amounts). If any amount in excess of these limitations is contributed, the employer would not receive a deduction for the contributions until the employee's rights become nonforfeitable (at which point the employee would have to take the amounts into income). At this point, of course, the employee could be given the right to withdraw the amounts if he so elected. Also, if the excess contributions result from forfeitures of amounts which had previously been deducted by the employer, the employer would have to include these amounts in income (unless the employee had a nonforfeitable right to the amount).

As previously indicated, under present law the contributions allowable as a deduction in a combination profit-sharing and pension plan may not exceed 25 percent of the aggregate compensation to employees covered under the plan. However, where excess contributions are made, these may be carried forward and deducted in succeeding years, and the deduction limitation for those years is increased from 25 to 30 percent. The committee may wish to consider a modification of this result by continuing to allow the carryover, but providing that the ceiling on deductible contributions remains at 25 percent.

In addition, under present law, in the case of a profit-sharing plan alone, the limitation on deductible contributions is 15 percent of the aggregate compensation paid to employees covered under the plan. In cases where the employer fails to utilize his full 15 percent allowance, the unused portion may be carried forward and used in succeeding years, up to 30 percent of aggregate compensation limit in any 1 taxable year. The committee may also wish to provide that the

<sup>7</sup> Besides profit-sharing plans, the other major type of defined contribution plan is the money purchase pension plan.

<sup>8</sup> To determine the funding necessary to provide a pension at age 65, the annual basic benefit allowable at that age (\$75,000) is multiplied by 10.

carryover of unused contribution limits in this case may not result in a situation where the employer could deduct more than 25 percent of aggregate covered employee compensation in any one year.

(b) *Defined benefit plans.*—In addition to the \$75,000 limitation on benefits which may be paid under one or more defined benefit plans of one employer or employer-group, the Senate bill contains a provision, which applies in the case of defined benefit plans, limiting the annual benefits which can be paid out under these plans (at age 65) to 100 percent of the participant's average compensation from the employer during the highest 3 consecutive years of earnings (including a cost of living adjustment).<sup>9</sup> The theory of this provision is that a pension is essentially a substitute for earning power during the retirement years and therefore no qualified pension plan should pay defined benefits which are higher than an employee's average earnings during his highest 3 years. This provision was intended to clarify and make more explicit present law (Rev. Rul. 72-3, 1972-1 C.B. 105).

Benefits purchased with employee contributions (but not the tax-deferred earnings on such contributions) would not be subject to the \$75,000 or 100 percent of compensation limitation. In addition, the maximum permissible benefit would also have to be adjusted in cases where the plan provided ancillary benefits (such as death benefits) or the annuity was payable at a retirement age of other than 65. Also, the maximum benefits could only be paid if the employee was a participant in the plan for at least 10 years and would have to be reduced pro rata where the participation was for a lesser period.

As is the case with respect to defined contribution plans, employee contributions to a qualified defined benefit pension plan would not exceed 8 percent of compensation per year.

(c) *Cost of living adjustment.*—The Senate bill, which provides for a flat dollar limitation on the maximum retirement benefit which can be provided under a plan, contained no provisions for a cost of living adjustment. In other words, a \$75,000 pension would gradually be reduced in terms of actual purchasing power during a period of inflation. One method of adjusting for inflation would be to adjust the limitation annually in accordance with the consumer price index. This adjustment (which the committee has tentatively decided upon) would permit a larger accumulated balance to allow for the extra cost of the adjustment, in the case of a defined contribution plan.

(d) *Combination plans.*—Where a corporation has 2 or more plans, or 2 or more different types of plans, the limitations, of course, must operate as an overall ceiling on the maximum benefit the employee can obtain under all the plans. Otherwise, it would be possible to escape the limitations by the simple device of establishing as many plans as were needed to provide the benefits desired. Additionally, rules need to be provided where an employee is employed by two or more related corporations of the same employer, some of whom have separate pension plans. In such a case all the plans are to be subject to the overall ceiling. The overall ceiling would be computed, in general, by aggregating similar plans (defined contribution or defined benefit) and reducing the limitation on one type by the benefits or contributions of the other.

<sup>9</sup> As indicated above, the committee has tentatively decided to eliminate the 75-percent limitation of the Senate bill.

(e) *Sanctions.*—Under the Senate bill, the sanction for making contributions in excess of those necessary to fund the maximum limitation on employee benefits is denial of the deduction. In the case of defined benefit plans, separate funding accounts are not maintained for the covered employees and thus it would be difficult to determine for any given year whether the contributions by the employer with respect to pension benefits of an employee are in excess of the limitations in the Senate passed bill. On the other hand, it is relatively easy in a defined benefit plan to determine the benefits that an employee will receive upon his retirement. Thus, a more appropriate sanction in the case of defined benefit plans might be to impose a sanction based on the amount by which the benefit under the plan exceeds the maximum permitted benefit. Alternatively, the committee may wish to require loss of qualified status for the plan if the plan provides for benefits in excess of those permitted under the law.

Since in the case of defined contribution plans, excess funding will result in the excess being taxable to the employee as income (if the employer receives a deduction) no special sanction is necessary if the plan provides that the excess funding may not be placed in a tax exempt trust and is immediately taxable to the employee or not deductible by the employer. On the other hand, failure of the plan to provide that the excess contribution is to be transferred out of the qualified plan could result in loss of qualification for the plan.

(f) *Antidiscrimination rules.*—As described above, the bill reported by the Senate Finance Committee would have imposed certain limitations on corporate plans where there were proprietary employees. One of these rules provided that for purposes of the antidiscrimination rules, not more than \$100,000 of compensation of any such employee could be taken into account. In other words, if the plan provided a corporate executive with a pension of \$2,000 per year of service, lower echelon employees covered under the plan would have to receive a benefit under the plan equal to at least 2 percent of compensation per year of service, even if the executive actually earned \$200,000 per year and his accrued benefit under the plan was thus equal to only 1 percent of his actual compensation.

The bill which passed the Senate eliminated distinctions between proprietary employee plans and other corporate plans. Thus (although the language of the bill may not be completely clear on this point), it appears that under the Senate bill this \$100,000 limitation, for purposes of the antidiscrimination rules, would be applied to all corporate plans. As a practical consequence, in the context of large corporate plans where a few executives may receive compensation well in excess of the \$100,000 limitation, this rule might have the effect of severely curtailing pension benefits for all of the employees covered under the plan by causing the executives to deemphasize retirement plan benefits. Thus, it is suggested that this provision not be adopted by the committee with respect to corporate plans.

(g) *Effective dates.*—Under the Senate bill, the limitations on contributions would apply to plan years beginning after December 31, 1973. However, even if the pension legislation is enacted this year, it is anticipated that a number of technical problems will remain to be

dealt with by regulations. Thus, the committee might want to consider the possibility of applying the contribution limits on corporate plans to plan years beginning after December 31, 1975, for plan provisions in effect on the date the committee reached its first tentative decisions on this subject (October 2, 1973), in order to allow adequate time to fully implement the new rules through regulations. The effective date with respect to the remaining provisions (for example, those provisions increasing the contributions limitations for H.R. 10 plans) would remain plan years beginning after December 31, 1973.

(h) *Transitional rules.*—Under the Senate bill, a deduction would be disallowed for any contribution if the amounts of the contribution or the defined benefit provided under the plan is in excess of the permitted amount. This rule would not operate to bar deductions for contributions made in plan years beginning before January 1, 1976. However, in the case of a defined benefit plan, an additional rule is needed to permit the plan to pay benefits which have accrued before that date (whether or not contributions were made before that date with respect to those benefits).

*Subchapter S corporations.*—The Senate bill repeals the provisions of present law (sec. 1379) which treat shareholder employees in Subchapter S corporations in the same general way as self-employed persons for the purposes of the tax law with respect to deductible contributions. At the time the Senate Finance Committee reported out the provision implementing this repeal, the bill also contained provisions imposing limitations on corporations where there were proprietary employees. Thus, it was concluded that no special rules were needed for shareholder employees.

The bill which passed the Senate, however, continued the distinction of present law between plans for the self-employed and corporate plans, but eliminated distinctions between different types of corporate plans as contained in the Finance Committee bill. Since Subchapter S corporations are not subject to normal corporate tax, and the stockholders of the corporation are taxed generally like self-employed partners, it may be appropriate to retain section 1379 in the Code, while raising the limitations on deductible contributions for Subchapter S stockholders to the same substantially increased deductible amounts which are allowed under the Senate bill for self-employed individuals, and also adopting the bill's H.R. 10 rules as to defined benefit plans.

*Integration.*—Under present law (sec. 401), a qualified plan is not treated as being discriminatory merely because the benefits or contributions under the plan are "integrated" with social security. In other words, in very general terms, the contributions or benefits attributable to employer contributions under social security are treated as though they were part of the plan.

As the level of social security benefits has increased substantially in recent years, integration has had an ever-increasing effect of reducing the amount of the pension which an integrated qualified plan will provide for rank and file employees. The impact of integration is most severely felt at the lower income levels, since the pension which would otherwise be provided under the plan to low income employees may be entirely, or substantially, eliminated through integration for employees whose income is at or slightly above the average social secur-

ity wage base (currently about \$6,000 per year). The committee may wish to consider the possibility of minimizing further decreases of pension benefits through integration with respect to the future.

*Partnership pooling.*—Under the Senate bill, partners in a firm would be permitted, in effect, to pool their contribution or benefit limitations so that the more senior partners could accrue more than their share of retirement benefits if the more junior partners accrued less than their share. (For example, if a senior partner was entitled to a \$7,500 deduction, and a junior partner was entitled to a \$3,000 deduction, then under this rule, the senior partner might be able to receive benefits from \$10,000 of the \$10,500 contributed to the plan, if the junior partner's benefits were limited to those produced by the remaining \$500.)

This rule would allow older partners, who establish a pension plan at a late stage in their careers, to build up a relatively sizeable pension in a short period of time. On the other hand, it obviously makes it more difficult for the younger self-employed partners to fund an adequate pension for themselves on a gradual basis.

Since the ceiling on deductible contributions which may be made on behalf of the self-employed has been increased substantially under the Senate bill (from 10 percent of earned income or \$2,500 per year to 15 percent of earned income of \$7,500 per year), it may be questioned whether a further increase for the older self-employed (with a corresponding decrease for the younger self-employed) in the form of the pooling provision is really needed. In addition, the rule of the Senate bill may diminish to some extent the incentive for the self-employed to establish pension plans at an early stage in their career, which generally would mean that employees under the plan would be covered for a longer period of time.

*Other rules.*—Under present law, there are a number of limitations which currently apply only in the case of H.R. 10 plans. It might be desirable, in certain cases, to consider extending these rules across the board, to apply to corporate employees as well as to the self-employed. For example, payments under a qualified pension plan to a corporate employee would have to begin by the time he attained age 70½, and the employee's account would have to be paid out not less rapidly than ratably over the life of the employee or the lives of the employee and his spouse or their expected lifetimes (sec. 401(a)(9)).

In addition, if a corporate employee borrows money, pledging his interest in the pension plan as security, the portion pledged as security might be treated as a distribution under the pension plan to the employee (perhaps with a de minimus exception) (sec. 72(m)(4)). The purpose of this rule is to prevent the employee from engaging in an arbitrage type of transaction, in which he makes a tax deductible contribution to the pension, which also earns tax-free interest, then gets the money out of the plan, in effect, by means of a loan secured by his portion of the plan assets, and also receives a tax deduction for the amount of interest paid on the loan (subject to certain limitations on excess investment interest (sec. 163(d))).

Also, under an H.R. 10 plan, no benefits may be paid to any owner-employee, except in the event of his becoming disabled, until he attains the age of 59½ (sec. 401(d)(4)(B) of the Code). The purpose of this rule against pre-retirement distributions is to insure that benefits accumulated tax-free in a pension plan are, in fact, used for retirement purposes. The committee may wish to consider the possibility of ex-

tending this rule to cover all employees under all types of plans (corporate as well as self-employed), except perhaps where the benefits clearly are contemplated as retirement benefits (e.g., 30-and-out plans or age 55 retirement plans) and are as available—both in theory and in practice—to rank and file employees as they are to shareholders, officers, and the highly compensated.

If this approach were adopted, the possibility might also be considered of providing a *de minimis* rule which would allow the distribution of a lump-sum payment of \$1,000 or less under a pension plan, prior to age 59½, to discharge obligations of the plan with respect to the employee upon his separation from service. This would enable the plan to clear its records of employees who had vested rights to very small pensions. The possibility also might be considered of lowering the age from 59½ to 54½, or to the age when the employee has 30 years of service, to take into account that some plans have early or normal retirement ages of 55 or have early retirement provisions after 30 years of service.

In the case of profit-sharing plans, to assure that deferred amounts were used for retirement purposes, it could be required that no distributions could be made from the profit-sharing plan until the employee's retirement (or death or disability).

### III. LUMP-SUM DISTRIBUTIONS

(Sec. 703 of the Senate bill and secs. 72, 402, and 403 of the Code)

This section concerns the tax treatment of lump-sum distributions from retirement plans.

#### *Present law*

Retirement benefits generally are taxed under the annuity rules (sec. 72) as ordinary income when the amounts are distributed, to the extent they do not represent a recovery of the amounts contributed by the employee. However, an exception to this general rule under the law in effect before the Tax Reform Act of 1969 provided that if an employee's total accrued benefits were distributed or paid in a lump-sum distribution from a qualified plan within one taxable year on account of death or other separation from service (or death after separation from service), the taxable portion of the payment was treated as a long-term capital gain, rather than as ordinary income.

The capital gains treatment accorded these lump sum distributions allowed employees to receive substantial amounts of deferred compensation at more favorable tax rates than compensation received currently. The more significant benefits under this treatment apparently accrued to taxpayers with adjusted gross incomes in excess of \$50,000, particularly in view of the fact that a number of lump-sum distributions of over \$800,000 have been made.

To correct this problem, the Tax Reform Act of 1969 provided that part of a lump sum distribution received from a qualified employee's trust within one taxable year on account of death or other separation from service (or death after separation from service) is to be given ordinary income treatment, instead of the capital gains treatment it had been given under prior law. The ordinary income treatment applies to the taxable portion of the distribution (i.e., the

total distribution less the employee's contribution) which exceeds the sum of the benefits accrued during plan years beginning before 1970, and the portion of the benefits accrued thereafter which does not consist of employer contributions (secs. 402(a)(5) and 403(a)(2)(c)).

The 1969 Act provided a special limitation in the form of a seven-year "forward" averaging formula which applies to the portion of the lump sum distribution treated as ordinary income. An employee (or beneficiary) is eligible for the special 7-year forward averaging provision if the distribution is made on account of death or other separation from service (or death after separation from service)<sup>1</sup> and if he has been a participant in the plan for 5 or more taxable years before the taxable year in which the distribution is made.

#### *Issue*

The Treasury has had great difficulty in formulating regulations to carry out the 1969 Act provisions for determining the precise breakdown between ordinary income and capital gain in a lump-sum distribution. It has also had great difficulty in formulating regulations to carry out the 1969 Act provisions for determining the amount of tax imposed on account of the "ordinary income" element of post-1969 lump-sum distributions. Recently, the Treasury withdrew its earlier proposed regulations on the second point and substituted new ones which, in general, would produce lower tax liabilities than those determined under the earlier set of proposed regulations. The new regulations would produce lower tax liabilities than under current long-term capital gain rates in some cases, and this could mean that they would result in revenue losses, rather than revenue gains, in comparison to the law which would have applied in the absence of any special action with respect to this provision in the Tax Reform Act of 1969.

More important, the new proposed regulations appear to share with the old proposed regulations the problem of excessive complexity. It is frequently maintained that lump-sum distributees are unable to compute their taxes, and that accountants and tax lawyers have been refusing to attempt the computations.

#### *The Senate bill (H.R. 4200) and H.R. 10470*

The Senate bill and H.R. 10470 substitute for the computational procedure provided under the 1969 Act a new procedure designed to simplify the calculations required to determine the tax while preserving revenues at at least as high a level as they would be under the latest proposed regulations.

Under the bills the portion of the distribution attributable to post-1973 value, in excess of the employee's own contributions, is to be taxed as ordinary income, but the tax is to be determined separately from any other income or losses which he may have and is to be eligible for 15-year averaging. The portion of the distribution attributable to pre-1974 value is to receive capital gains treatment and is to be included with the taxpayer's other income in determining his tax liability for the year of the distribution.

<sup>1</sup> Self-employed taxpayers, on the other hand, continue to be eligible for their special 5-year forward averaging only on lump-sum distributions received on account of death, disability as defined in sec. 72(m)(7) of the Code, or if received after age 59½ and, in the case of receipt by an employee, after at least 3 years of participation.

In computing the ordinary income element on the post-1973 value, a special minimum distribution allowance is to be provided to give assurance that the tax on relatively small lump-sum distributions will not be appreciably more than under present law. This allowance is half of the distribution up to \$20,000. Above that level, it is phased out on a \$1.00 for \$5.00 basis with the result that it is entirely eliminated for distributions of \$70,000 or more.

In determining the proportion of a distribution attributable to pre-1974 value (and, therefore, eligible for capital gains treatment) and the portion attributable to post-1973 treatment (and therefore treated as ordinary income but with 15-year averaging), the bills provide that the allocation is to be made on the basis of the amount of time in which the employee was covered by the plan before 1974 and after 1973.

In order to treat all distributees the same, all computations of tax on the 15-year averaging ordinary income portion are to be made on the basis of the tax schedule for single individuals.<sup>2</sup> For this purpose, community property laws are to be ignored, and as a result, a distributee in a community property State is to compute his tax on the basis of the entire amount of the distribution.

The bills provide that where the distributee accrued part of the value of his lump-sum distribution as a regular corporate employee and part as a self-employed individual, the 5-year averaging available for self-employed individuals is to be used for the entire distribution if the number of years while he was covered as a self-employed individual exceeds 50 percent of the total time he was a participant in the plan. Otherwise, the 15-year averaging rule is to apply to the entire amount.

To protect against tax avoidance possibilities the bills provide that distributions made during the previous five years are to be included in the 15-year averaging computation for purposes of determining the tax on the last distribution. When the total tax is determined, however, the amount of tax liability on any earlier distributions is to be subtracted and the tax on the final distribution is to be the remainder. All distributions made within the prior five years to the same distributee are to be subject to this 5-year lookback rule.<sup>3</sup>

The computation of the ordinary income element in the lump-sum distribution is to take into account any annuity purchased for the distributee in the year of distribution (or in the prior five years where the lookback provision applies). The value included for purposes of the annuity is its cash surrender value. Although the value of the annuity is included for purposes of determining the rate of tax on the remainder, its value is not taxed as a part of the lump-sum distribution.

No changes are made with respect to the basic tax treatment of distributions of employer securities.

<sup>2</sup> Distributees in computing the tax on their other income (including the capital gain element of the distribution) may use any appropriate tax schedule. They may also use, when appropriate, the regular 5-year averaging method for the tax on this other income.

<sup>3</sup> For this purpose, in the case of a distribution that is required to be reported to the insurance corporation for purposes of the plan termination insurance provisions described above, the 5-year period is not to end sooner than 5 years after the distribution has been so reported.

*Areas for committee consideration*

To eliminate the present distinction between the averaging computation for employees of corporations and the 5-year forward averaging given under present law to self-employed persons who receive lump-sum distributions, the committee might want to consider providing 10-year forward averaging for both classes of distributees. As under the 15-year averaging provision of the Senate bill and H.R. 10470, the tax on the ordinary income element, to which the 10-year forward averaging would be applied, would be computed separately from the other income of the distributee.

Also, in determining the value of annuities for purposes of this provision, instead of using the cash surrender value of the annuity as its value, it would appear more appropriate to use its purchase price.

Another possible treatment is to include with ordinary income some specified percentage—perhaps 60 percent—of the lump-sum distribution.

○