VOLUNTARY PENSION PLANS FOR SELF EMPLOYED PERSONS

Explanation of H.R. 10 (by Mr. Keogh) same as H.R. 9 (by Mr. Jenkins) as ordered to be reported by the Ways & Means Committee.

A. Purpose.

Under present law certain tax advantages are extended to participants in qualified employee pension and profit sharing plans. These tax advantages include postponement of the tax which otherwise would be payable by the individual beneficiary on annual contributions to the plan until the pension benefits are paid out, a similar postponement of tax on the interest earned on funds held for the plan in trust, and capital gains treatment on certain lump sum distributions under the plan. The provisions dealing with employee pension and profit sharing plans were thought desirable as a means of encouraging private provision for the cost of old age, thereby relieving the Federal, State and local government of much of this responsibility.

This bill corrects what in the opinion of its proponents amounts to a serious inequity created by the fact that the large group of self employed persons are foreclosed under present law from establishing retirement savings programs which will permit them to enjoy the same tax advantages which are extended to employees under qualified plans established by their employer.
B. **Qualified Persons.**

The benefits of this bill are extended to all persons who are subject under the Social Security Act to the tax on self employment income; in addition several categories of persons who are exempted from the tax on self employment income and not now covered by the social security program will receive benefits from the bill. These additional categories include physicians, lawyers, dentists, osteopaths, veterinarians, chiropractors, naturopaths, optometrists, Christian Science practitioners, ministers of a church and members of a religious order. Most of these persons would be excluded under the Social Security Act under legislation which has passed the House and is now pending in the Senate. A person who is self employed and who also is an employee covered by a qualified employer plan or a government retirement plan may still be covered if more than 75 percent of his earned net income is derived from self employment.

C. **Eligible Pension Funds.**

The bill provides a limited deduction for contributions into certain specific types of retirement savings programs. These include restricted retirement funds established for the exclusive benefit of participants in which the contributions are held in a trust, custodian accounts, and restricted retirement life insurance or annuity contracts.

In the case of restricted retirement trust funds and custodian accounts the following conditions must be met:

1. Participant rights must be nonassignable except for permission to designate a beneficiary or to elect a joint and survivor annuity with
a dependent or spouse.

2. The trustee or custodian must be a bank and investments by the trustee or custodian must be controlled by trust indenture and local law except that the trustee or custodian may purchase a restricted annuity contract.

3. Except for the total and permanent disability of the beneficiary, there can be no distribution of interests to participants before age 65. Distribution thereafter can be in any form.

In the case of a restricted retirement life insurance or annuity contract the contract must be purchased from an insurance company and it must meet the conditions described in 1 and 3 above.

D. Limitations on the Amount of Income Tax Deductions for Payments to Eligible Pension Funds.

The annual contribution to a pension fund for which the self employed individual may take a tax deduction is limited to 10 percent of his earned income or $5,000 a year, whichever is less, but the aggregate deduction during the individual's lifetime cannot exceed $100,000.

The bill provides a carryover feature to take care of the situation where the individual does not invest up to the above limitation in a particular year. In this case a deduction may be taken in the current year for contributions in excess of 10 percentage of earned income up to a limit of $5,000. However, a carryover from a particular year must be used within one of the five succeeding years.

A special rule is provided for taxpayers who are beyond the age of 55 on the effective date of the bill. The limitation on their annual exclusion is raised by 1 percent of earned income, or $500, for each
year by which the taxpayer's age exceeds 55 on the effective date, except that the increase shall not be credited for more than 20 years. This rule works in the following way: a taxpayer who is age 65 when the bill becomes effective may increase his annual limitation by 10 percentage points or by 10 times $500, so that he can deduct for tax purposes in each year up to 20 percent of his earned income, or $10,000, whichever is less, if he makes that large a payment into an eligible pension fund. If the taxpayer is age 75, the limitations would be raised to 30 percent, or $15,000, whichever is the lesser. The limitation does not extend beyond this point even though the taxpayer is over 75.

The definition of earned income used in the application of these limitations corresponds to the definition of self employment income which is used in calculating the social security tax on self employment income except, of course, the income of the specially included categories, such as ministers and physicians, is included for this purpose.

In the case of contributions made by a self employed individual to a restricted retirement insurance contract providing both life insurance and annuity benefits, the portion of the contributions properly allocable to life insurance benefits as distinguished from the equity acquired is not allowed as a deduction.

E. Treatment of Distributions.

Amounts distributed from a restricted retirement fund, except in a lump sum, shall be taxable as an annuity with the investment in the contract limited to contributions which have not previously been deducted from gross income. Thus, any deduction from taxable incomes on account of a distribution is limited to contributions for which no tax
benefit was previously received. If the taxpayer has been able to *deduct* all his contributions, then the whole of each annuity payment must be included in gross income.

Amounts received by the estate or beneficiary of the taxpayer from an insurance contract qualifying as a fund will be includable in the decedent's gross estate for tax purposes but benefits, other than life insurance benefits, will be taxable as income to the estate or beneficiary.

If the entire amount in the restricted retirement fund is distributed in a lump sum it will be taxable as a long term capital gain but only if the fund has accumulated over a period greater than 5 years.

F. Miscellaneous Provisions.

Contributions made to an eligible fund within 60 days of the close of the year may be treated as payments made in the prior year. This is designed to deal with the problem faced by self employed persons who might not know their exact income at the end of the taxable year and thus would not know precisely how large a deduction would meet the 5 percent test.