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# The Right of a Professional Man to Establish a Tax-Deferred Pension Plan

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## CONCLUSION

Since 1935, and especially in the last ten years, the courts have re-examined the relationship of an employer to his employees in situations where the employer contemplates or undertakes a major change in its structure or operations. They have also demonstrated an increased willingness to go behind the facts in such cases and root out instances of bad faith and sham changes. The courts have imposed new restrictions on management's freedom to act in such situations and have gone further than ever before to require collective bargaining as to their efforts. It is doubtful that Congress intended the courts, in their interpretation of the NLRA, to give the unions a voice in basically management decisions. Yet, public policy considerations tend toward some greater participation by labor in these decisions. In the absence of legislative clarification of the NLRA, it is up to management and labor to resolve these situations. It is possible, through preventive bargaining, to arrive at peaceful solutions to such problems before they arise, and this seems the best means of serving the public interest.

*Eliot Landau*

THE RIGHT OF A PROFESSIONAL MAN TO ESTABLISH  
A TAX-DEFERRED PENSION PLAN

A pension plan is a formal or informal arrangement, whereby a portion of a person's compensation for his labor is deferred and set aside for payment to him upon his retirement. The plan may involve the compensation of one worker or many workers. The compensation involved may be the product of hourly factory or office work as an employee, and thus be paid by an employer,<sup>1</sup> or may be the product of even the most sophisticated and prestigious work by a person who is self-employed, in which case the compensation consists of net earnings from the work in which the person is engaged. In both cases, a certain portion of one's compensation is not paid directly, but is reserved for future payment upon the worker's retirement, and we thus have a pension plan. Any person who is entitled under the plan to receive compensation upon retirement is deemed to be "covered" by the plan.

For one who is covered by such a plan, the primary advantage, of course, is the assurance that at least a part of one's lifetime earnings will be accumulated and saved for one's retirement, when such savings may

<sup>1</sup> Some pension plans also allow the employee to make contributions to the pension fund in addition to the employer's contributions. The latter is considered to be deferred and indirect compensation to the employee.

be essential to the maintenance of a happy existence. Further, because the compensation set aside is generally not considered to have been received by the covered person in the year of contribution, that amount is not then taxable and becomes taxable only when received in later life, when the taxpayer-retiree may have the advantage of a lower tax bracket, the retirement income credit, and the trend toward lower federal income tax rates.<sup>2</sup>

Pension plans have enjoyed an extreme increase in popularity. From the establishment of the first private pension plan in the United States in 1875 by the American Express Company,<sup>3</sup> the idea grew to 400 plans in 1925 covering four million people,<sup>4</sup> and to 50,000 plans covering twenty million in 1961.<sup>5</sup> The growth has been especially pronounced in the fifteen years since 1950, when there were only 13,000 plans in existence.<sup>6</sup>

The reasons for this growth are numerous and no one factor can be considered to be the primary one. However, the following are undoubtedly among the foremost: the increase in the life expectancy of an American from 47.3 years in 1900<sup>7</sup> to 70.0 years in 1962;<sup>8</sup> the realization, brought about by the Industrial Revolution, and especially by the Great Depression of the thirties, of the inadequacy of the individual in providing financial security for and by himself, and of the continuing need for that security to be provided for times of need; the increase in "security consciousness" (i.e. the psychological setting) provided by the establishment, operation, and continual revision of the Social Security system; the growth, since World War II, of the desire by the average American for

<sup>2</sup> This trend is demonstrated by the following statistics showing the income tax assessed on a single individual having \$20,000 of taxable income, as taken from the applicable tax rate schedules:

1942 (World War II high) .....	\$7,910.00
1951 .....	7,396.00
1952 (all-time high) .....	8,116.00
1953 through 1963 .....	7,260.00
1964 .....	6,450.00
1965 .....	6,070.00

As can be seen, since 1942 the trend of the rates (except for 1952, due to the Korean Conflict) has been steadily downward, with decreases enacted in the two past years successively.

<sup>3</sup> TILOVE, PENSION FUNDS AND ECONOMIC FREEDOM 9 (1959). The first reported judicial proceeding involving pension funds was *Pennie v. Reis*, 132 U.S. 464 (1889).

<sup>4</sup> HARBRECHT, PENSION FUNDS AND ECONOMIC POWER 6 (1959).

<sup>5</sup> H. R. REP. No. 378, 87th Cong., 1st Sess., part 3, at 5 (1961).

<sup>6</sup> STRONG, EMPLOYEE BENEFIT PLANS IN OPERATION 1 (1951).

<sup>7</sup> U.S. DEPARTMENT OF COMMERCE, BUREAU OF THE CENSUS, HISTORICAL STATISTICS OF THE UNITED STATES 25 (1960).

<sup>8</sup> U.S. DEPARTMENT OF COMMERCE, BUREAU OF THE CENSUS, STATISTICAL ABSTRACT OF THE UNITED STATES, Table 61 at 55 (1964).

a higher standard of life, which cannot be terminated automatically upon one's reaching retirement; the generous tax benefits<sup>9</sup> alluded to above, which will be explained in greater detail below; the high corporate tax rates which permit the financing of pension funds at a low net cost (inasmuch as the monies which would otherwise not be expended as contributions to the pension funds would be "taxed away" at a high rate anyway);<sup>10</sup> and the government wage stabilization programs during World War II and the Korean Conflict, which effectively froze wages, but permitted employees to earn more through the increase of "fringe benefits," a primary example of such "benefit" being the pension plan.<sup>11</sup>

For the most part, the above reasons apply with equal validity to pension plans provided for employees and to those provided for the self-employed. Undoubtedly, therefore, the spectacular growth of pension plans in general has occurred in both types of plans. However, the respective tax advantages of those plans are by no means the same for both types. A self-employed person is in a significantly less favorable tax position when he has a pension plan than are the employer and employee who have a pension plan for the employee. In actuality, prior to very recent years,<sup>12</sup> the self-employed professional man had no tax advantages in establishing a pension plan for himself. The pension plan benefits of the Internal Revenue Code of 1954 extended only to plans provided exclusively for employees and in most states professionals could not incorporate (thereby becoming employees of their own corporation). Thus, though a professional could set up a pension plan, as far as the Internal Revenue Service was concerned, such a plan was only a savings fund and contributions to such a fund were non-deductible personal expenses. Further, any income earned by the fund was fully taxable. This was considerably different from the tax advantages connected with a pension plan for employees, where the employer's contributions to the fund were tax-deductible expenses, the amount of the contributions were not taxable income to the employees until received upon retirement, and the income produced by the fund's assets was tax exempt.

In recent years, two methods have been devised to right the apparent inequality of treatment afforded to the employee and the self-employed professional. The first has been the enactment in various state legislatures<sup>13</sup>

<sup>9</sup> Tax benefits have been a factor in pension planning since the Revenue Act of 1921, § 219(f), 42 Stat. 227, 247.

<sup>10</sup> This reason was advanced in S. REP. NO. 1734, 84th Cong., 2d Sess. 12 (1956).

<sup>11</sup> *Ibid.*

<sup>12</sup> The last five years have seen the majority of this increase.

<sup>13</sup> The following 32 states have enacted some form of such a statute: Alabama, Arizona, Arkansas, Connecticut, Florida, Georgia, Idaho, Illinois, Indiana (medical doc-

of a statute allowing professionals to form a "professional corporation" or "professional association." With such a "corporation"<sup>14</sup> in existence, it could hire each of its stockholders and founders as employees, receive all professional fees, out of which it would pay general expenses and salaries to its employees and establish and contribute to a pension fund for its employees, and distribute part or all of the balance of revenues to its stock-holders as dividends.

The second method used to equalize the tax treatment given to the two types of pension plans has been the amending of the Internal Revenue Code of 1954. After prolonged and considerable urging by various professional associations, Congress amended the Code in 1962, effective for tax years beginning after December 31, 1962.<sup>15</sup> Because of the prolonged efforts to pass this bill, this amendment is known even today by its bill number, H.R. 10.

#### THE PROFESSIONAL CORPORATION

Upon formation of the professional corporation, the professionals involved become employees,<sup>16</sup> for whom there might be provided a pen-

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ors only), Kentucky, Louisiana (lawyers only), Massachusetts, Michigan, Minnesota (physicians and lawyers only) Missouri, Montana, Nevada, New Jersey, New Mexico, North Dakota, Ohio, Oklahoma, Pennsylvania, Rhode Island, South Carolina, South Dakota (medical doctors and dentists only), Tennessee, Texas, Utah, Vermont, Virginia, Wisconsin. 6 CCH 1965 STAND. FED. TAX REP. ¶ 5943.0973.

<sup>14</sup> Generally, the business form labeled a "professional corporation" or "professional association" does not bear all of the attributes of an ordinary corporation. Instead, it is really a unique form of business organization which is designed specifically and solely for the purpose of enabling the "corporation" to rehire its stockholders as employees. Generally, the differing restrictions placed on the professional corporation (from those placed on the ordinary corporation) are of the type that will preserve and maintain the professional responsibility and integrity of the professional, which may be referred to as the "attorney-client relationship" or the "doctor-patient relationship." For example, the Illinois statute, ILL. REV. STAT. ch. 106½, §§ 101-110 (1963), provides that each professional association may engage in only one type of professional service. Another provision provides that the act in no way alters the existing legal relationship between the professional and his client or patient, thereby maintaining the full personal liability commonly imposed on the professional. For the federal tax effect of these "qualifications" of the corporate characteristics, see *infra* note 16.

<sup>15</sup> INT. REV. CODE OF 1954, §§ 72, 401, 404, 503, as amended by 76 Stat. 809 (1962).

<sup>16</sup> It is most important to note that the very fact that a professional corporation is labeled such under state law does not automatically guarantee that the Internal Revenue Service will recognize it as a "corporation" for tax purposes, so as to enable it to get tax benefits for pension plans available to corporations. Under the regulations, Treas. Reg. §§ 301.7701-1 (1960) and 301.7701-2 (1960), as amended February 2, 1965, T.D. 6797, 1965 INT. REV. BULL. No. 9, at 39, a business organization seeking to be classed as a corporation for tax purposes must actually have the following federal corporate characteristics under its local law: (a) continuity of life, (b) centralization of management, (c) liability for corporate debts limited to corporate property (i.e. no shareholder

sion plan even according to the pre-1962 Code. As such, those involved become entitled to all of the resulting tax advantages, the primary ones being deferred inclusion of the contributions in the employee's gross income until retirement, allowance of the amount of the contribution as a deduction from gross income of the employee, and tax exempt status for the fund for federal income tax purposes. In addition, section 402(a)(2) of the Code provides that if the benefits paid under the plan, whether paid by virtue of the employee's retirement, disability, or death, are paid within one taxable year of the distributee, those benefits shall be treated not as ordinary gross income to the distributee, but as long-term capital gains. Further, in cases where the benefits are to be received as an annuity after the retiree's death (e.g. by his surviving spouse for life or for a term certain), the value of that annuity is excluded from the retiree's gross estate for federal estate tax purposes.<sup>17</sup> Finally, the employer-corporation also benefits, since the amounts which would otherwise be subject to the accumulated-earnings tax<sup>18</sup> might be contributed to the pension plan. Hence, the corporation avoids the accumulated earnings tax altogether for the corporation and defers for the stockholders the tax on those amounts which would otherwise be taxable dividend distributions. Instead of subjecting those accumulations to the accumulated-earnings tax, they represent a current deduction<sup>19</sup> from gross income for the corporation.

These benefits, it is most important to note, do not apply to all pension plans established exclusively for the benefit of the corporation's employees. To receive these tax benefits, a pension plan must be deemed "qualified," which means that certain requirements must be met. The requirements, culled from the Code, the Regulations, and Revenue Rulings, may be classified into five categories. First, the plan must be written, definite, and communicated to the employees.<sup>20</sup> Second, the written in-

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has personal liability), and (d) free transferability of interests. In doubtful cases, the type of business organization which an entity "more nearly resembles" will be the deciding factor. Treas. Reg. § 301.7701-2(a) (1960). See *Morrissey v. Comm'r.*, 296 U.S. 344 (1935).

<sup>17</sup> INT. REV. CODE OF 1954, § 2039(c).

<sup>18</sup> The general purpose of this tax is to prevent (by the imposition of a tax thereon) the avoidance of the payment of income taxes on amounts, which taxes would become payable by the stockholders of a corporation if these amounts would be distributed as dividends, instead of being "accumulated" by the corporation. This tax is imposed, of course, only on those corporate accumulations in excess of the "reasonable needs of the business." See INT. REV. CODE OF 1954, §§ 531-537.

<sup>19</sup> Provided that these amounts do not exceed the statutory limitation on this type of deduction. See *infra* pages 138-39.

<sup>20</sup> Rev. Rul. 61-157, 1961-2 CUM. BULL. 67, 73-4, parts 2(j) and (k).

strument establishing the plan must definitely and expressly provide for the impossibility of diversion of any funds accumulated thereunder for any purpose other than employee pension benefits prior to the satisfaction of all accrued liabilities to the employees or their beneficiaries.<sup>21</sup> Third, the plan must be funded through a private trust,<sup>22</sup> through a "custodial account,"<sup>23</sup> or through the direct purchase of non-transferable annuity contracts<sup>24</sup> or a special type of United States bond.<sup>25</sup>

Fourth, the plan must not discriminate in its coverage in favor of highly compensated employees, officers, directors, or stockholders. To this end, the Code not only proscribes this type of discrimination<sup>26</sup> in a general statement,<sup>27</sup> but also specifically provides who must be benefited by such a plan. Section 401(a)(3) of the Code provides that the plan must benefit at least 70% of all employees or 80% of all eligible employees, so long as a minimum of 70% of all employees are eligible, or any other classification of employees found by the Internal Revenue Service not to be discriminatory. In considering the percentages of "employees," the Code permits the exclusion of all employees of the firm who have not been employees for some minimum period stated in the plan, not to exceed five years, and also those who do not work an average of twenty hours per week and/or

<sup>21</sup> INT. REV. CODE OF 1954, § 401(a)(2); Treas. Reg. § 1.401-2 (1964).

<sup>22</sup> The trust is not limited (except by § 511 of the Code as to the taxability of unrelated business income) with respect to the investments which it must make. Treas. Reg. § 1.401-1(b)(5) (1964).

<sup>23</sup> This is an account in a bank or a domestic building and loan association in which the financial institution is merely a custodian of the funds and does not have the duties and responsibilities of a trustee. The funds in this account may be invested solely in mutual fund stock or solely in annuity, endowment, or life insurance contracts issued by an insurance company. INT. REV. CODE OF 1954, § 401(f).

<sup>24</sup> Annuity contracts also include "face-amount certificates" as defined in the Investment Company Act of 1940, 15 U.S.C. § 80a-2(15) (1964). INT. REV. CODE OF 1954, § 401(g). Both these certificates and ordinary annuities must be non-transferable.

<sup>25</sup> These special types of bonds are described in detail in INT. REV. CODE OF 1954, § 405(b)(1), as explained in S. REP. No. 992, 87th Cong., 2d Sess., part 6, at 18 (1962). The purpose of allowing the plan to be funded by a means other than the private trust (the only means prior to 1962, Pub. L. 87-792, 76 Stat. 809) is the lesser costs involved for the other means, thereby encouraging the establishment of pension plans by smaller employers and the self-employed.

<sup>26</sup> Undoubtedly the purpose of Congress is proscribing this type of discrimination was to discourage the use of such plans by management personnel simply for the purpose of deferring the assessment of income tax on the amounts contributed to the plan, which amounts would otherwise be paid to them as salaries, taxable at their high tax rate. By requiring the plan to benefit a large part of an employer's employees, it is reasonably assured that an employer will receive the tax advantages only because he also establishes a bona fide plan to create a pension plan, not only for himself, but for his employees as well.

<sup>27</sup> INT. REV. CODE OF 1954, § 401(a)(4).

do not work an average of at least five months per year. Thus, newly hired, part-time, or seasonal workers need not be covered in such a plan.<sup>28</sup> A further provision allows the plan to be integrated with the Social Security system. Thus, in testing for "discrimination," a plan that is not discriminatory when its benefits and Social Security benefits are measured together is not considered discriminatory for pension plan purposes. Further, a plan is not discriminatory when it benefits only salaried or clerical employees and excludes wage-earners, or when its benefits per employee bear a uniform rate to each employee's average compensation.<sup>29</sup>

Finally, the benefits of a plan must vest, or become non-forfeitable, at a specific time provided for in the plan, but no later than retirement. Thus, the plan could provide that termination of one's employment prior to retirement age will cause that person's retirement benefits to be forfeited. However, this provision must not operate in practice so as to actually discriminate, as would be the case, for example, where the vast majority of employees are migratory workers and the only employees who would thus benefit practically from the plan would be the permanent executives and managers.<sup>30</sup>

In addition to the requirement that a pension plan be "qualified" to receive the aforementioned tax benefits, there are two other limitations on the benefits accruing from an employees' pension plan, both amounting to restrictions on the tax deduction allowed to the employer for the contributions he makes to the plan. First, since the contributions made by the employer will ultimately be compensation to the employees, the general rule of section 162(a) of the Code, relating to the limitation on deductions for compensation to employees in general, applies. Therefore, the combined deduction taken for an employee's direct compensation, plus the amount contributed for his pension, may not exceed "reasonable compensation" and must be an "ordinary and necessary business expense" when the deduction for total compensation is considered.<sup>31</sup>

Second, there is an absolute limitation on the deduction for the contributions. The limitation for a pension plan funded by a trust or a custodial account may be computed in one of two ways. It may be an amount which is 5% of the direct compensation paid during the tax year plus an amount necessary to fund any remaining cost of expected liabilities under the plan, whether for past or current service; or an amount necessary to actuarially fund the cost of expected liabilities currently accruing, plus

<sup>28</sup> INT. REV. CODE OF 1954, § 401(a)(3)(A).

<sup>29</sup> INT. REV. CODE OF 1954, § 401(a)(5).

<sup>30</sup> INT. REV. CODE OF 1954, § 401(a)(4); Rev. Rul. 61-157, part 5(c), 1961-2 CUM. BULL. 67, 87.

<sup>31</sup> Rev. Rul. 62-139, 1962-2 CUM. BULL. 123.

10% of any expected liabilities outstanding for unfunded past service by employees.<sup>32</sup> The limitation for a pension plan funded by direct purchase of annuity contracts or the special United States bonds is computed in a similar manner.<sup>33</sup>

#### THE SELF-EMPLOYED PENSION PLAN

The 1962 amendments of the Code<sup>34</sup> allow self-employed individuals to establish a tax-favored pension plan for themselves without necessitating their incorporation into a professional corporation.

Less tax advantages and stricter requirements characterize the qualified pension plan for the self-employed. At the outset, it should be pointed out that if a plan benefits both self-employed persons and employees of those self-employed persons, the plan, for the purpose of meeting requirements, would be considered in its two parts separately; i.e., the part benefiting the employees would have to meet only the requirements for an employees' plan, and the part benefiting the self-employed would be required to meet the requirements of a self-employed's pension plan.

The requirements for the self-employed's plan take the form of two parts. The first part is simply a repetition of the same five requirements that apply to the employees' plan, namely a definite and written plan, express proscription of diversion of funds, funding only through the prescribed means, non-discrimination in favor of particular beneficiaries, and ultimate vesting.<sup>35</sup> The second part of the requirements consists of nine additional provisions, each of which in some way modifies or qualifies the above-enumerated requirements.<sup>36</sup> In general, the additional provisions are designed to insure that the pension plan allowed by the Code is used by the self-employed for that primary purpose and not for the primary purpose of receiving tax-free or tax-deferred income. Undoubtedly, Congress felt the need for additional requirements because of the absence in the self-employed plan of the inherent conflict of interest and reciprocal checks between the employer and employee, thus presenting

<sup>32</sup> INT. REV. CODE OF 1954, 404(a)(1); Treas. Reg. § 1.404(a)-3-6 (1961).

<sup>33</sup> INT. REV. CODE OF 1954, § 404(a)(2); Treas. Reg. § 1.404(a)-8 (1964).

<sup>34</sup> INT. REV. CODE OF 1954, §§ 72, 401, 404, 503, as amended by 76 Stat. 809 (1962).

<sup>35</sup> The counterpart provisions to those provisions for employees' plan relating to the limitation on the employer's tax deductions are found in the "part two" requirements for self-employed's plans.

<sup>36</sup> As explained above, the additional requirements apply only to that portion of the plan attributable to benefits for the self-employed. Thus, whether a plan benefiting the self-employed is set up to benefit the self-employed's employees or not is immaterial. Only that portion of a pension plan which benefits self-employed individuals will be required to meet the more stringent self-employed requirement. Hence, a combined (benefiting self-employed and employees) pension plan, for requirements' purposes, will be considered as if it were two separate plans.

a greater opportunity for the frustration of Congress' true intention of encouraging private pension plans.

The first of these nine provisions relates to the method of funding. The same funding means as allowed on employees' plans is permitted in the self-employed plan with the same qualifications. However, if the trust form of funding is selected, the trustee must be a bank or a domestic building and loan association, although the self-employed may supervise and direct the investments, or, in lieu of this type of trustee, all of the trust's investments must be in annuity, endowment, or life insurance contracts with a life insurance company.<sup>37</sup>

The second provision relates to the requirement for employees' plans that the beneficiaries' rights vest no later than an employee's retirement. When self-employed<sup>38</sup> are benefited under a plan wherein employees are also benefited, the employee's right to the contributions must vest or become non-forfeitable under the plan as soon as they are made.<sup>39</sup>

The third through the sixth provisions all relate to the comparable non-discrimination requirement of employees' plans. The third requirement provides that all regular<sup>40</sup> employees who have been with the firm at least three years must be covered by the plan.<sup>41</sup> Of course, the plan may provide a shorter waiting period before coverage begins, but if it does, the waiting period must be the same for employees as it is for owner-employees.<sup>42</sup>

The fourth requirement is designed to insure that the plan is used by the owner-employee solely for retirement purposes and not simply to

<sup>37</sup> INT. REV. CODE OF 1954, § 401(d)(1).

<sup>38</sup> The Code uses the term "owner-employee" to designate the self-employed who provides a qualified pension plan for himself. This is because, under the Code, he has some of the attributes of an employer and some of the attributes of an employee. Note the conceptual similarity between the Code's concept of owner-employee in giving the self-employed the tax benefits of a pension plan and the states' methods of allowing professionals to form their own professional corporation and then hire themselves as employees of their own corporation. It should also be noted that the term "owner-employee," while generally considered to be synonymous with the term "self-employed," for pension plan purposes is not exactly so. It refers only to those self-employed who are owners of sole proprietorships or more than a 10% interest in a partnership. Thus, if only a partnership's employees plus those junior partners owing not more than a 10% interest are benefited by its pension plan, then the additional "part two" requirements would not be a requisite for a qualified plan and only the employees' plan requirements would obtain. The additional requirements then exist only when the pension plan benefits a sole proprietor or the senior (more than 10% interest) partners.

<sup>39</sup> INT. REV. CODE OF 1954, § 401(d)(2).

<sup>40</sup> That is, those who are not part time (less than twenty average hours per week) or seasonal (less than five average months per year).

<sup>41</sup> INT. REV. CODE OF 1954, § 401(d)(3).

<sup>42</sup> Treas. Reg., § 1.401-12(e)(2) (1963).

defer his income to years when he is in a low tax bracket, i.e., the pension plan must not be used throughout his working life as his own personal "do-it-yourself" income averaging scheme. The Code therefore provides that the plan must prohibit payments to the owner-employee before he reaches 59½ or is disabled.<sup>43</sup> The corollary provision is that the plan must specify that the owner-employee's benefits will commence at an age no later than 70½. The 70½ age limitation also applies to the benefits paid to the employees of the owner-employee.<sup>44</sup>

To further insure that the owner-employee will not discriminate in favor of himself at the expense of his employees, the fifth provision establishes the maximum contributions for which the plan may provide. If the pension is funded by the direct purchase of fixed premium life, endowment, or annuity contracts, then the limitation is the lesser of 10% of the average earned income<sup>45</sup> for the three most recent tax years prior to entering into the contract, or \$2,500. For plans funded in any other manner (where the contributions would not be contractually fixed as with insurance contracts) the limitation is simply the lesser of 10% of earned income<sup>46</sup> or \$2,500. It should be noted that the total of all contributions made on behalf of each self-employed individual may not exceed this limitation, so that if a self-employed contributes to two pension plans as an owner-employee, he still has only one limitation for the total contribution. This combination rule applies to all the limitations prescribed for pension plans benefiting owner-employees.<sup>47</sup> The Code also provides

<sup>43</sup> "Distributions" include not only direct payments to the owner-employee, but also his deriving of any benefits from the funds accumulated under the plan. Thus he may not receive loans against the insurance policies funded by the plan. He may not pledge securities or policies of the fund for his own personal debts. INT. REV. CODE OF 1954, § 72(m). His engaging in any business transactions with the pension's trust fund (e.g. buying from or selling to the trust or borrowing money from the trust) is similarly prohibited. INT. REV. CODE OF 1954, § 503(j). He may receive no compensation for services rendered from the trust. *Ibid.* In addition, the owner-employee may not use the deductions for the contributions he makes to the pension fund to create or increase a net operating loss for tax purposes for any tax year. INT. REV. CODE OF 1954, § 172(d)(4)(D). All of the foregoing prohibitions will be considered premature distributions (before age 59½) to the owner-employee, which may cause loss of beneficial tax treatment.

<sup>44</sup> In the case of the employee, the plan may provide that if his actual retirement is later than 70½, his benefits may begin at his retirement. INT. REV. CODE OF 1954, § 401(a)(9)(A). By these provisions, the Code insures that the plan will be used for retirement purposes. In the case of the self-employed person, however, his "retirement" may be difficult to ascertain and thus age 70½ is set as the maximum age at which benefits must begin.

<sup>45</sup> Earned income is not synonymous with gross income. Practically speaking, for the professional it will include only the amounts he earns from the rendering of personal services and will not include amounts earned as an employee, or from rents, royalties, annuities, trusts, or investments.

<sup>46</sup> *Ibid.*

<sup>47</sup> INT. REV. CODE OF 1954, § 401(d)(9)(A).

that the plan must expressly provide that if, in any year, the limitation is exceeded, the excess must be repaid to the owner-employee within a specified period. The absence of this provision, or the failure to follow it in practice, may cause the plan to lose its qualified status.<sup>48</sup>

There is one instance when an owner-employee would be allowed to contribute more than his single limitation, notwithstanding the strict rules regarding the limitation. Heretofore, both with the employees' pension plan and with the self-employed pension plan, the assumption has been that all contributions are made by the employer or by the owner-employee, who is considered as the employer of himself. All of the contributions, therefore, were considered simply as deferred compensation to the employee. It is both permissible and common practice, however, for pension plans to provide that the employee will also contribute (usually an equal amount) to the fund, separate and apart from the employer's contribution. The comparable situation with the self-employed plan allows the owner-employee to contribute, as an "employee," an amount in excess of the limitation which he may contribute for himself as "employer." He may contribute this excess amount only if he allows his employees (non-owners employees) also to make voluntary contributions to the fund. The amount of the excess which the owner-employee may contribute as an "employee" is also subject to a 10%-\$2,500 limitation. Thus, by allowing his employees also to make voluntary contributions, the owner-employee's limitation on contributions is actually doubled.<sup>49</sup> Of course, the tax benefits received by virtue of this excess contribution are much less than those attached to the first contribution. This is because the excess contribution, instead of being considered a deferred compensation to the employee from his employer, is simply a personal expenditure by the employee, as if he were depositing money in a savings account. Therefore, income tax is paid currently on these amounts and is not deferred, and neither the employer nor the employee, whether they be the same individual or not, is able to take a tax deduction on this excess contribution. The one tax advantage that attaches to this excess contribution is that the money is held by a tax-exempt pension fund, and its investments produce tax free gains. This would not be the case if that money remained

<sup>48</sup> INT. REV. CODE OF 1954, § 401(d)(8). This provision is actually a liberalization of the stringency of the contribution limitation, rather than an additional burden, since contributions may be made on behalf of an owner-employee during the course of a year. Due to the fact that the limitation is based in part on the total amount of the owner-employee's earned income for the year, whether or not the contributions exceed the limitation cannot be definitely known until the year's total earned income is known. Therefore, this repayment provision allows the owner-employee to correct any excess contributions he has made after he determines what his limitation is for that year.

<sup>49</sup> Treas. Reg. §1.401-13(a)(2) and (b)(3) (1963).

as the employee's personal investment. Upon retirement, the beneficiaries will receive the proceeds of those gains without income tax ever having been paid on them.

The sixth provision provides further rules against discrimination in favor of the owner-employee. Instead of establishing more stringent requirements, however, it actually operates to ease the anti-discrimination rules. Like the employees' plan, it permits the contributions to be made on a uniform rate to one's compensation, including that of the generally more highly compensated owner-employee.<sup>50</sup> Further, if those contributions are made solely to pay premiums on life, endowment, or annuity contracts, which require the payment of the same amount of premium every year, then it is sufficient that the premiums bore a uniform rate relationship to compensation at the time the contracts were first entered into. The fact that the fluctuations in compensation to employees and owner-employees causes the premiums to lose their uniform relationship to compensation after the first year of the plan does not render the plan discriminatory. Of course, the owner-employee may elect to change the policies so as to make the premium uniform in relation to present compensation, but he need not do this (unless, of course, he does it for himself, in which case he must do it for his employees).<sup>51</sup> This provision also stipulates that the contributions for those with less than three years' service with the firm may be less favorable than their counterparts with three or more years' service.<sup>52</sup> Finally, if the allowable contributions made on behalf of the owner-employees do not exceed one-third of the total allowable contributions made for all covered by the plan, the contributions made on behalf of each owner-employee and regular employee may be reduced by the amount paid in F.I.C.A. (Social Security) tax on behalf of each owner-employee and regular employee, respectively. This too will not render the plan discriminatory.

The seventh and eighth requisites of the part two requirements were probably written into the Code to insure that the plan would be established only by those currently employed and that its benefits would be used primarily to provide an income during retirement years. The seventh requisite places limits on who may establish such a plan. It states that such a plan may be established only by one who has earned income.<sup>53</sup> It should be noted that this does not only include those who are liable for Social Security self-employment tax.<sup>54</sup> It also includes ministers who elect

<sup>50</sup> Treas. Reg. § 1.401-12(f)(2) (1963).

<sup>52</sup> Treas. Reg. § 1.401-12(f)(5) (1963).

<sup>51</sup> Treas. Reg. § 1.401-12(f)(3) (1963).

<sup>53</sup> *Supra* note 45.

<sup>54</sup> A very few individuals who are liable for Social Security self-employment tax, to wit those liable by reason of INT. REV. CODE OF 1954, § 1402(a), will still not be considered to have earned income. Treas. Reg. § 1.401-10(c)(2)(ii) (1963).

not to be covered under Social Security and doctors of medicine, who, until the enactment of the Social Security Amendments Act of 1965,<sup>55</sup> were not covered under Social Security.<sup>56</sup> From this, it becomes apparent that only those who render personal services could set up a qualified plan, and that an inactive retired person, whose only income is derived from savings or investments, could not.

The eighth requisite prescribes the period of time over which the benefits of a plan may be distributed to beneficiaries. The plan must provide that its benefits shall be distributed over any one of the following periods: the life of the employee (including owner-employee), the lives of the employee and his spouse, a term certain not in excess of the employee's life expectancy, or a term certain not in excess of the life expectancies of the employee and his spouse.<sup>57</sup> In addition, if any benefits remain to be distributed after the death of both the owner-employee<sup>58</sup> and his spouse,<sup>59</sup> those benefits must be paid directly to the beneficiary within the period ending five years after the death of the surviving owner-employee or spouse, or be completely used to purchase an immediate annuity for the beneficiary within that period.<sup>60</sup>

The ninth and final part two requirement establishes the maximum deduction<sup>61</sup> which the owner-employee may take for the contributions that he makes on his own behalf as the "employer of himself."<sup>62</sup> The deduction is the smallest of the following: 5% of the owner-employee's earned

<sup>55</sup> Pub. L. No. 89-97, 89th Cong., 1st Sess. (July 30, 1965). This Act is commonly known as the Medicare Bill.

<sup>56</sup> Treas. Reg. § 1.401-10(c) (2) (iv) (1963). Cf. INT. REV. CODE OF 1954, §§ 1402(c) (4) and (5).

<sup>57</sup> Treas. Reg. § 1.401-11(e) (1963).

<sup>58</sup> This proviso does not apply to the remaining benefits on behalf of a regular employee. The balance of the eighth requirement would apply to even the regular employee, but only if that employee's benefits are received by virtue of a plan which also benefits owner-employees.

<sup>59</sup> Such a situation could only occur where the plan provides benefits for a term certain and the owner-employee and his spouse both die before the term certain is completed.

<sup>60</sup> INT. REV. CODE OF 1954, § 401(d) (7).

<sup>61</sup> Technically speaking, the "deduction" by the owner-employee is termed an "adjustment." This is to differentiate it from the "itemized deductions" for medical and dental expense, charitable contributions, interest payments, taxes, and a few other items. Thus, even though a professional elects to take the 10% standard deduction available to him in lieu of itemizing his deductions, he still will get the benefit of the "adjustment" for his pension plan contribution. To obtain this benefit, he must append Form 2950 SE to his tax return (Form 1040).

<sup>62</sup> *Supra* page 142. No deduction is allowed for any amounts voluntarily contributed by the owner-employee as an employee.

income, \$1,250, or 50% of the actual contribution for the year.<sup>63</sup> As can readily be seen, the allowed deduction will always be limited to one-half of the contribution made by the owner-employee. In addition, the self-employed plan does not permit a carryover deduction, i.e., a deduction in one year for an amount contributed in the previous year but not deductible in that year because of the deduction limitation. In other words, that portion of the owner-employee's contributions which is not deductible in the year made will never become so.<sup>64</sup>

Despite the more stringent requirements of the self-employed plan, as enunciated above, the tax benefits accruing to the owner-employee by reason of his establishing a private pension plan are still very definite. The owner-employee may defer inclusion of the plan's benefits in his gross income until actual receipt upon retirement, since the owner-employee is, like the regular employee, the beneficiary of a "qualified" plan,<sup>65</sup> like the employees' plan, upon fulfilling the necessary requirements, the fund, to which the contributions are made and from which the benefits are paid, is tax-exempt, and income from its investments is not taxable. However, unlike the employees' plan, the self-employed individual<sup>66</sup> does not have the benefit of the capital gains treatment for distributions made within one tax year of the beneficiary,<sup>67</sup> or the exclusion of the value of an annuity from the retiree's gross estate for federal estate tax purposes.<sup>68</sup> The avoid-

<sup>63</sup> Treas. Reg. §§ 1.404(e)-1(b)(c) (1963).

<sup>64</sup> Treas. Reg. § 1.404(e)-1(b)(3)(ii) (1963). Cf. INT. REV. CODE OF 1954, §§ 404(a)(d).

<sup>65</sup> In accordance with the provisions of section 72(n) of the Code, the owner-employer is required to pay tax only on that portion of his retirement benefit on which he has not previously (in the year of contribution) paid income tax. This would mean that the portion of his retirement benefit which is attributable to that portion of his contributions which were not deductible is excludable from gross income. For the same reason, sections 72(b), 72(m) and 72(n) provide that the beneficiary of a qualified plan pays no tax on amounts received, which are attributable to voluntary contributions made by the employee (or owner-employee as employee) separate and apart from the contributions made by the employer (or owner-employee as employer of himself).

<sup>66</sup> Whether or not he is an owner-employee. Owner-employee is defined *supra* note 38.

<sup>67</sup> For the comparable provision for employees' plans see *supra* pages 135-36. It should be observed that even though the self-employed has no capital gains benefit on his retirement benefit, Treas. Reg. § 1.72-18(a) (1964), he may avail himself of new sections 1301-1305, as added by the Revenue Act of 1964, 78 Stat. 19, 105. To obtain the income averaging benefit, Schedule G must be appended to Form 1040. In addition, under the provisions of INT. REV. CODE OF 1954, § 72(n)(2), and Treas. Reg. § 1.72-18 (1964), the tax on the distribution (if the distribution paid is the total distribution payable to the distributee and is paid within one tax year of the distributee) is limited to five times the increase in the distributee's tax caused by inclusion of one-fifth of the distribution in his gross income for that year.

<sup>68</sup> For the comparable provision for employees' plans see *supra* note 17.

ance of the accumulated earnings tax, of course, has no applicability to the self-employed plan, since the self-employed is not subject to that tax.

#### EVALUATION AND COMPARISON OF THE TWO PENSION PLANS

In order to better evaluate the respective merits of the two forms of business organization for the professional, it may be helpful to compare the provisions of their respective pension plans, as ordained by the rules of the Internal Revenue Code. As should be abundantly clear from the foregoing paragraphs, it cannot be said that the self-employed pension plan has greater tax advantages than the employees' plan. On the contrary, because of the additional nine requirements, the self-employed person still has significantly less retirement tax benefits than a regular employee, despite the fact that the purpose of Congress in enacting the Self-Employed Individual Tax Retirement Act of 1962<sup>69</sup> was undoubtedly to equalize, to some degree, the differing tax treatment for the two types of taxpayers regarding retirement.

Although each of the nine requirements for the self-employed plan places a restriction on that plan which is not placed on the employees' plan, the fifth and the ninth provisions appear to be the most severe restrictions. The fifth provision is the limitation on the amount that may be contributed on behalf of the owner-employee, and the ninth provision in effect restricts the deduction for that contribution to one-half of the contribution. These two provisions are really the two which continue the inequality of the two plans.<sup>70</sup>

Although this inequality exists at the present time, this does not mean, of course, that all professionals should or will rush into the corporate form of organization in order to be able to establish an employees' pension plan. In the first place, it is by no means certain that all professionals are able to incorporate, both because of state law<sup>71</sup> and because of the difficulty of achieving corporate status<sup>72</sup> for federal income tax purposes.

<sup>69</sup> *Supra* note 15.

<sup>70</sup> Witness the resolution passed by the Board of Governors of the Illinois State Bar Association on September 10, 1965. The resolution singles out these two provisions and urges their repeal. The resolution also states, in effect, that H.R. 10 provisions, as of now, "do little more than recognize in principle the inequity existing between corporate employees and individual proprietors and their employees with respect to private pension plans." Board of Governors of the Illinois State Bar Association, *THE BAR NEWS* 2 (Sept. 1965).

<sup>71</sup> As explained *supra* pages 134-35, in the absence of a statute allowing professionals to incorporate, professionals may be legally precluded from practicing their profession in the corporate form of business organization.

<sup>72</sup> See the Kinter Regulations, *supra* note 16. As an example, it is interesting to note that the Illinois State Bar Association, speaking through its Committee on Retirement Benefits, has apparently resigned itself to the assumption that persons who are ordi-

In addition, canons of ethics of the various professional associations may preclude incorporation.<sup>73</sup>

Professionals may not wish to attempt incorporation because of the possible resulting disadvantages in areas other than pension plans that may result from that incorporation. Although an entire volume might be written about the possible disadvantages of corporate form of organization, a brief mention will be sufficient to illustrate the reasons for careful consideration before incorporation by professionals. First, since corporations are limited to a deduction for "reasonable" compensation to employees,<sup>74</sup> employees who are also shareholders may be required to withdraw corporate profits in the form of taxable dividends rather than as salary. Since the corporation is also taxed on that same net income, there is dual taxation.<sup>75</sup> Second, there is possible liability for accumulated earnings tax<sup>76</sup> and the tax on personal holding companies.<sup>77</sup> Third, the corporation may become liable for federal unemployment tax.<sup>78</sup> Fourth, there will be loss of the income averaging device available only to individual taxpayers under section 1301 of the Code. Fifth, some states tax corporate profits but do not have an income tax on individuals. Finally, of course, the corporate form of organization will undoubtedly be more complicated, may require the payment of some additional state registration fees, and will mean more time taken from one's professional practice in order to deal with the complexities of corporate life.

It would, however, be painting an incomplete picture to merely enumerate the foregoing disadvantages and not mention the numerous advantages of the professional corporate form, in addition, of course, to the pension benefits. The corporate form affords continuity of life upon death of a shareholder and free transferability of interest. The maximum

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narily self-employed cannot get any tax-favored pension plan by attempted use of the professional corporation theory. See Illinois State Bar Association, *Annual Report of Committee on Retirement Benefits*, 54 ILL. B.J. 65, 66 (1965).

<sup>73</sup> For example, see Rule 11 of the Rules of Professional Conduct of the American Institute of Certified Public Accountants, which prohibits the practice of accounting in the corporate form of organization, reprinted in STETTLER, *AUDITING PRINCIPLES* 737 (1961). See also, A.B.A. Comm. on Professional Ethics, Opinion 303, 48 A.B.A.J. 159, 161 (1962). But see, 50 ILL. B.J. 904, 905 (1962); and 48 A.B.A.J. 379 (1962).

<sup>74</sup> INT. REV. CODE OF 1954, § 162(a).

<sup>75</sup> Of course, the corporation may elect Subchapter S treatment if it has no more than ten shareholders. This, in effect, removes the corporate tax in lieu of each shareholder's being taxed on his salary plus his proportionate share of distributed and undistributed corporate profits of the corporation. See INT. REV. CODE OF 1954, §§ 1371-1377.

<sup>76</sup> INT. REV. CODE OF 1954, §§ 531-537. See *supra* note 18-19.

<sup>77</sup> INT. REV. CODE OF 1954, §§ 541-547.

<sup>78</sup> INT. REV. CODE OF 1954, §§ 3301-3309.