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# REPORTS ON TOPICS OF PARTICULAR INTEREST

## THE SELF-EMPLOYED INDIVIDUALS TAX RETIREMENT ACT OF 1962

As those of you who follow such matters already know, after eleven years of active consideration Congress has now passed and President Kennedy has now signed into law the "Self-employed Individuals Tax Retirement Act of 1962," commonly called the "Smathers-Keogh Bill" or just plain H.R. 10. Beginning next year, this new tax law will grant income-tax deferment privileges—and, to some degree, tax abatement privileges—to self-employed individuals (including proprietors and partners of unincorporated businesses) with respect to moneys they put aside in the future into regulated plans for their own retirement. The new tax law for pensions for the self-employed works more or less in the same way as the present pension tax law does in granting tax advantages to employees with respect to contributions made by employers on their behalf into pension plans qualified under the Internal Revenue Code.

This new addition to tax law is quite complicated and quite restrictive, in ways which I am sure you will not want me to detail from this platform. Those with direct concern will want to read the statute in full for themselves, together with the forthcoming regulations when they appear some time well into 1963. At this point I will mention only two of the principal features of the law. One is a requirement that any self-employed person proposing to benefit from the Act must arrange for and finance a comparable pension plan, fully vested or fully "portable" as you say here in Canada, for all full-time employees with three or more years of service, under the nondiscrimination rules with respect to the lower paid as now apply to corporate pension plans, plus certain further limitations. This share-the-wealth-with-your-employees requirement will have particular application to lawyers and doctors—two of the principal groups behind enactment of the law—since they employ so many stenographers and nurses. The other point is a statutory limitation on the amount which a self-employed person may put aside into one of these pension plans for himself. This limitation is set at 10 per cent of annual "earned income," or $2,500 a year, whichever is the lesser, with tax-deferment privileges afforded for only half of what is put up (as if the self-employed were half their own employers and half their own employees). So the effective limit on the amount eligible for current tax deduction for an "owner-employee"

(defined as a self-employed person with more than a 10 per cent interest in his business or occupation) is 5 per cent of earned income, or $1,250, whichever is the lesser.

These two principal restrictions, and especially the one which requires self-employed persons, or owner-employees as most of them are called, to provide their full-time employees of three years or more with comparable pensions of their own are reasonably sure to dampen the enthusiasm of a great many self-employed persons for this law. In fact, this law as finally passed can be regarded only as a very lean measure of tax relief. It is certainly a far cry from the original "Reed-Keogh Bill" of 1951, which would have provided corporate pension plan type tax relief for the self-employed of up to $5,000 annually, instead of $1,250, and subject to only a very few restrictions other than that the money would have to be locked in a trust fund, or in an annuity, until retirement age. Later, when the "Reed-Keogh Bill" evolved into the "Jenkins-Keogh Bill," then into the "Simpson-Keogh Bill," and finally into the "Smathers-Keogh Bill" (the former cosponsors with Mr. Keogh having all died), new restrictions and limitations were gradually added, and, in 1961, a fundamental change of approach made by declaring, in effect, that self-employed persons are their own employers and their own employees for the purposes of the pension tax law, thereby indirectly bringing their pensions under the nondiscrimination requirements of Section 401 of the Internal Revenue Code. Some new restrictions were then added on top of these nondiscrimination requirements.

Despite these cutbacks in H.R. 10, as it has been numbered without change in all recent Congresses, and its consequent probable lack of too many customers, it is important that those of you who are associated with life insurance companies see to it that you or one of your associates is familiar with at least the principal features of the Act. If your company is in the pension business, there may be some new accounts to be had—not too many, I think, but certainly some. Whether or not your company is in the pension business, you may have a conservation problem on your hands with respect to your outstanding ordinary life insurance business on lawyers, doctors, farmers, and other self-employed persons. I have here a nearly full-page advertisement by a life insurance company whose name is familiar to all of you which appeared last week in the *Wall Street Journal* and which, loosely translated, says to the reader, "Get your H.R. 10 tax deductions here." If one of your present insureds is attracted by such an ad, you will want your trained salesmen and home-office experts to know the answers.

Here are a few of the important highlights of H.R. 10:

1. I have already mentioned that full-time employees of self-employed persons having three years or more of service must be included for fully vested pensions meeting usual nondiscrimination requirements of Section 401 of the Internal Revenue Code. An important detail is that, when more than one-third of the total deductible contributions are for "owner-employees," these nondiscrimination rules are augmented by a denial of the privilege of integrating with Old-Age and Survivors insurance (such as by excluding the first $4,800 of annual salary from consideration).

2. I have also already mentioned the fact that the maximum annual contribution for any self-employed person is $2,500, or 10 per cent of earned income, whichever is the lesser, with only one-half the contribution actually made being tax deductible on a current basis. An important detail, from the point of view of life insurance company actuaries, is that special provision is made for fixed premium life insurance and annuities by allowing the 10 per cent limit to be frozen in its application to the average annual income of the self-employed person for the three years next preceding the issuance of the last insurance policy or annuity, thereby avoiding the possibility of later disqualification of the plan because of payment of premiums which were once less than 10 per cent of earned income but which, because of a drop in income, later become more than 10 per cent of earned income.

3. Benefits must begin no earlier than age 60 and no later than age 70, nearest birthday, except for disability or death and except for certain earlier benefit payments made under tax penalty.

4. Capital gains tax treatment for lump-sum distributions, in lieu of pensions, is denied the self-employed but not employees of the self-employed.

5. Originally, when H.R. 10 was still pending in the House of Representatives, the bill required all trustees of pension plans for the self-employed to be banks. This requirement was not looked upon with much favor by individual policy pension trust writing life insurance companies customarily competing with banks for pension business. However, as the bill finally became law, an exception to the bank-trustee requirement was made for trusts funded exclusively by life insurance and/or annuity contracts. This exception presumably does not apply to individual policy pension trusts having side funds, to convert whole-life policies to endowments, when the side funds are invested outside the insurance company. This exception may or may not apply—we will find out when the regulations appear some time next year—to individual policy pension trusts having side funds held by the insurance company itself. Of course, the

intrinsic usefulness of such side funds may be quite impaired by the requirement that all pensions be fully vested.

The one really big open question for life insurance actuaries is whether life insurance policies already in force can be used to fund pension plans for the self-employed or whether the insured must start out all over again with a policy replacement. I have found no one who knows for sure the answer to this question, but in my opinion the answer probably is that it will be found quite impractical to use outstanding policies. For one thing, if an outstanding policy is transferred, say, by assignment, to a pension plan for the self-employed, its cash-surrender value presumably applies toward the 10 per cent of annual income limit as well as the current premium. We do not know this for sure, but that is what we think. If so, policies with cash-surrender values of any consequence may not be transferred. For another thing, reserves under outstanding life insurance policies transferred to a pension plan for the self-employed may not qualify for the special tax treatment of pension reserves under Section 805(d) of the Life Insurance Company Income Tax Act, because that section speaks only of reserves on policies under pension plans and trusts at "the time the contracts were entered into." These contracts will have necessarily been entered into beforehand. And, if you get over both these statutory interpretation hurdles, you will still have to contend with the sales argument that it is cleaner and less restrictive for the insured to start out all over again with a policy replacement. So I would say that this new law may produce almost as many replacement problems for the life insurance companies as it produces new business, especially when you consider the policies lost to uninsured bank-trusteed plans.

Some people wonder why the Kennedy Administration opposed this law from the beginning, although Congress finally passed it by overwhelming majorities. The best thinking seems to be that the Administration opposed it because it was not tied in with so-called "reform" of the existing tax laws with respect to standard corporate pension plans. What the Administration was probably thinking of by way of such tax "reform" is illustrated by Senator Gore's amendments (actually added to the bill in the Senate but later eliminated) to do away with the capital gains tax treatment for lump-sum distributions under all pension plans and to place ceilings on employer contributions toward anyone's pension. The second of these amendments, to place ceilings on employer contributions, was technically deficient in a number of important ways, but both of Senator Gore's amendments show which way the wind will probably blow in 1963 for the tax treatment of regular corporate pension plans.

Next year should be an interesting year for pension tax law.

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