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PANEL DISCUSSION

OPERATIONS UNDER THE KEOGH ACT

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DAVID G. SCOTT:

At the last meeting of the Society, the Keogh Act and the Treasury Regulations relating to it were discussed. At that time, it was believed that the regulations would be available to all of us by the time this meeting took place. These proposed regulations apparently are coming out in four instalments of which the first two sets have reached the public. As you are all aware, the first reaction to the Keogh Act was one of some disappointment to those who believed that it would provide a bonanza in the form of increased sales of life insurance, mutual funds, and bank services. As a matter of interest, I know one agency vice-president who consistently refers to it as H.R. 2½. Nevertheless, for those who can qualify, the act does provide a method under which funds deposited in qualified retirement plans can grow and appreciate income-tax free and under which taxable income can be deferred into the more or less distant future. There are optimists who believe that the legislation will be liberalized from time to time and that it may, as we develop our techniques, prove to be all that the protagonists of the bill expected from it originally. The members of this panel are covering a small area of the topic, and it is expected that some of the questions raised in the program will be discussed in addition by members of the audience.

At our last meeting, Al Pike, of the Life Insurance Association of America (LIAA), listed a number of questions of particular interest to the life insurance industry which had been raised by committees of the LIAA and the American Life Convention (ALC) and which were unanswered at that time. My own contribution to the panel is to bring his comments up to date, inasmuch as the proposed regulations have provided some of the answers which he was seeking when he spoke in March.

The first of these unresolved issues was related to the possibility of using existing life insurance and annuity policies to fund new pension plans benefiting the self-employed. This has apparently been cleared up by the new regulations in which the commissioner states that the contribution of property, other than money, under an H.R. 10 plan is a prohibited transaction between the trust and the employer if the plan covers employees, some or all of whom are owner-employees. As actuaries we are all aware of the practical problems that would arise if old contracts could be so used. For example, the question would arise whether the policy would be entitled to more favorable treatment given to qualified pension plans, since the contracts were not part of a pension plan at the time entered into. There would be the question of how to divide the policy if its cash value were in excess of the amount the self-employed person could contribute during the first year of the plan. Nevertheless, if existing policies are not to be replaced by new insurance with the attendant loss to the insured, some provision is necessary. As matters now stand, the hope that existing insurance and annuity policies could be used to help fund H.R. 10 plans seems to be gone unless the commissioner is influenced to change his position.

The second of the issues raised related to the definition of nontransferability of annuity contracts. The new regulations give considerable help in solving the problem of determining what is a nontransferable contract. They are not considered transferable simply because they permit an employee to designate a beneficiary in the event of his death to receive the benefits under a settlement option. They are transferable if the owner can sell, assign, or pledge as collateral for a loan his interest in the contract. The proposed regulations include examples of terminology which can be contained in the face of the certificate or annuity contract which will make them nontransferable within the meaning of the statute.

A third point is related to incidental life insurance benefits. The regulations provided that under a qualified plan, life insurance protection may only be provided if such protection is incidental, but they did not define what is considered incidental. The present guideline limitation insofar as pension trusts are concerned is that life insurance benefits are considered to be incidental if they are less than one hundred times the monthly pension. This apparently eliminates the possibility of using ordinary life and long-term endowments as the sole funding medium for the self-employed person's pension. In addition there still appears to be an area of doubt, inasmuch as it is not clear that cash values are excluded from the term "life insurance protection." The ALC and the LIAA have requested a clarification of the regulations so as to make it clear that it does not include the cash value of the policy and refers only to the net amount at risk.

The difficult problem of determining what is earned income when there is a possibility that investment capital may be deemed to be a material income-producing factor has not been cleared up by the new regulations. The old tax rulings, therefore, must continue to be the guide for those setting up up H.R. 10 plans.

One subsidiary problem has been cleared up, and that is that the contributions that a self-employed individual makes to the plan on his own behalf are not deducted from his income. However, the contributions made by him on behalf of his employees are a deduction in determining his earned income.

Al Pike raised the question of the applicability of the provisions of Mimeograph 5717 with respect to pension plans which terminate within ten years of their inception. This tax ruling is intended to prevent the possibility of discrimination in favor of some employees in the event of early termination of the plan. The new proposed regulations have a requirement that it must expressly provide that the early termination will not produce a discriminatory result, and this may mean that Mimeograph 5717 applies to H.R. 10 cases. The language required is complicated and lengthy and does not seem to have any real application to H.R. 10 plans. The ALC and LIAA have requested that there be no specific provision similar to H.R. 5717 required where there is no possibility of discrimination.

The proposed regulations do not provide a great deal of assistance concerning what provisions must be included in the written program. Apparently, the plan must include provisions relating to the eligibility and benefits of future employees. This would seem to be unnecessary for owner-employees without common-law employees at the initiation of the plan. Since the plans can be amended in a reasonable and nondiscriminatory way when the owner-employee does acquire employees, it would seem to be reasonable that this rule could be relaxed.

This summation of the points brought out at the earlier regional meeting indicates quite clearly that the regulations yet to come and revisions in those regulations are needed before we can state with precision just what are the rules for those who wish to establish qualified self-employed retirement plans or those who wish to advise others in this matter. Representative Keogh has indicated that he and Congress are interested in our difficulties in setting up H.R. 10 plans, so there perhaps is reason to believe that eventually we may have firm answers to all the questions raised.

ALFRED N. GUERTIN:

The Keogh Bill (H.R. 10), after twelve years of discussion in and out of legislative halls, was enacted as Public Law 87-792, the "Self-Employed Individuals Tax Retirement Act of 1962," on October 10, 1962. We are not here concerned with its history. Those interested are referred to two articles: (1) "The Keogh Bill (H.R. 10), Mutations of a Perennial Problem," by Manuel M. Gorman, Associate General Counsel of the LIAA, in the *Eastern Underwriter* (*Gold Book*), October 9, 1961, and (2) "The Keogh Act: Past, Present and Future," by Glendon E. Johnson, General Counsel (Washington) of the ALC in the *C.L.U. Journal* for April, 1963. We are concerned here only with questions of how we operate under the act.

Immediately following the enactment of the statute, joint committees, subcommittees, and special task forces of the ALC and LIAA began a study of the new act with a view to the determination of areas of uncertainty that should be settled by regulation, what procedures would be needed to qualify plans under the act, and what kinds of plans would so qualify. These studies resulted in the submission to the Internal Revenue Service on December 21, 1962, of a series of questions to be answered in the regulations expected to be promulgated. Suggestions for the proper answers under the statute were also submitted. On January 11, 1963, these were supplemented by three specimen plans designed to meet the requirements of the statute.

The three plans, designed to fund benefits without a trust or custodial account, were intended to be helpful in the preparation of regulations. They consisted of (1) a plan for the broadest possible use, either as a money purchase plan or a plan with fixed benefits; (2) an alternative plan designed as a fixed benefit plan; and (3) a plan to be used in the case of an employer without employees. It was thought by some that the three plans might be used by the Internal Revenue Service as examples of approvable plans. Other plans had also been submitted by individual companies. However, present procedures do not allow the approval of representative plans. If advance approval is possible, apparently, plans are approvable only by determination letter as such plans are submitted by individual taxpayers. It is hoped, however, that present procedures can be changed and that insurance companies might be able to secure approval of certain of their plans as such. It is still our hope that individual taxpayer submission and approval can be avoided.

Our procedures will be greatly influenced by regulations issued and to be issued pursuant to the act. The first set of proposed regulations was published in the *Federal Register* on April 5, 1963. A second set was published on April 22, 1963. Additional regulations will be forthcoming from time to time. Criticisms and comments may be filed with the Internal Revenue Service with the usual thirty days allowed in such situations.

The questions to which answers were sought by the ALC and LIAA through regulations to be issued are given below in the form submitted. Appended to each is a reference to such answer, if any, as may be found in the proposed regulations published April 6, 1963.

1. Section 401(g) states that "the term 'annuity' . . . does not include any contract or certificate issued after December 31, 1962, which is transferable . . . ." What specific provisions of the contract are necessary in order to make the contract nontransferable? (Section 401(g))
   Answer: The regulations, Section 1.401-9(b) and (c), specify exactly the form of endorsement needed to make a contract nontransferable, and an example is provided.
2. To what extent must the specific rules of Mim. 5717, setting forth limitations on distributions in case of early termination, be set forth in a plan under which the contributions to the plan are nonforfeitable and which does not provide for past service funding? (Mim. 5717; Section 401(d)(2))
   Answer: The regulations, Section 1.401–4(c)(1) and (2) take the position that the principles of Mimeograph 5717 need not be incorporated in the plan if it appears "reasonably certain" that there would be no discrimination in the event of early termination.
3. In what form may the annuity plan be expressed in a plan for an owner-employee?
   Answer: This question has not been answered and it is likely that it will not be answered. Not only is the question very general, but the answer would not seem to involve anything not already stated for pension plans generally.
4. May an annuity plan using individual contracts provide incidental life insurance protection without the use of a trust? (Section 72(m)(3)(A))
   Answer: This question has not yet been answered. We must look to future regulations.
5. Must a plan established for an owner-employee who has no employees provide for the coverage of future employees? (Section 401(d)(3))
   Answer: The regulation Section 1.401-12(b)(2) gives a positive answer to this question.
6. Can existing life insurance, endowment and annuity policies purchased and issued prior to establishment of a plan be placed under such a plan?
   Answer: The regulations, Section 1.401-12(k), indicate that existing contracts cannot be used. It is hoped, however, that on a showing that there are practical ways of doing this, a method may be found.
7. If outstanding contracts may be used, what forms of outstanding life insurance policies and annuity contracts may be so used?

Answer: Until an affirmative reply can be adduced in connection with the foregoing question, there is no appropriate answer.

8. May a contract loan be granted under an owner-employee qualified plan solely for the purpose of keeping the policy or contract in effect without disqualifying the plan? (Section 404(f))
   Answer: The existing proposed regulations do not answer this question.
9. If a custodian is used in connection with a plan holding life insurance, endowment, and annuity contracts, what rights and powers must the custodian have under a plan in which the contracts are transferable? (Section 401(f))
   Answer: The existing proposed regulations do not answer this question.
10. In the case of a custodial account holding life insurance and annuity contracts, should the life insurance company or the custodian make the necessary reports to the Government?
    Answer: The regulations, Section 1.6047-1(a)(1)(i), provide that a custodian is to be treated as a trustee for reporting purposes.
11. May a self-employed individual with one not yet eligible employee establish a plan for himself with the understanding that he will extend the plan to the employee when eligible with a similar understanding as to any other employees?
    Answer: The answer given to the fifth question should suffice here. It is exactly the same problem.

Comments on the Proposed Regulations published April 6, 1963, were submitted by the ALC and LIAA in a protest letter dated May 6, 1963. Suggested amendments included the points given below. It will be noted that a number of the items are directly related to the answers given by the regulations to some of the questions previously raised by the ALC and LIAA.

(1) Amendments to Section 1.401-4(c) to eliminate a requirement for incorporation of the provisions of Mimeograph 5717 in a plan when early termination cannot, by reason of the provisions of the plan, produce a discriminatory result.

(2) A technical correction to eliminate a requirement for nontransferability at establishment of a trusteed plan was suggested in connection with Section 1.401-9(c). It was pointed out that under Section 401(g), nontransferability in the case of a trust is required only at the time of distribution.

(3) The language under Section 1.401-10(b)(4) would prohibit use of past service to determine contributions. It was pointed out that the statute does not prohibit this provided that it does not produce discrimination or excess contributions. An appropriate amendment was suggested.

(4) An example to illustrate the definition of earned income in connection with Section 1.401-10 was suggested. This will be helpful in showing the application of the 30 per cent limit effective where a capital investment in the business is involved.

(5) Deletion of Section 1.401-11(c)(2)(ii), which would deny use of the classification provisions of Section 401(a)(5), a denial not sanctioned by the statute.
(6) Section 1.401-11(e)(4) would restrict calculation of return multiples referred to in Section 1.72-9 to the tables published in the regulations. It is asked that a life insurance company be permitted to use its own tables.
(7) Clarification of Section 1.401-12(c)(4)(ii) shows that the words "life insurance protection" actually mean the "amount at risk."
(8) Section 1.401-12(c)(4)(ii)(c) requires a provision in the plan relative to substitution of trustees that the substituted trustee must be a bank. That such a provision be required to be in a plan was objected to. Objection was also made to the requirement that the substituted trustee be a bank.
(9) Amendment of Section 1.401-12(e) so as to provide flexibility in defining the three-year period following which coverage of all employees is required.
(10) The requirement in Section 1.401-12(e)(1) that all employees must consent to be covered under a noncontributory plan was criticized on the basis that an employee acting with malice or under religious limitations should not be permitted to jeopardize a plan. An amendment was suggested.
(11) There is no provision which would permit transfer of contracts to a qualified trust. This omission would bar the use of existing contracts. We offered to submit suggestions about how this might be done.

In the letter of protest in which the foregoing amendments were requested, certain items were reserved for later discussion such as (1) definition of the term "increment" in Section 1.401-11(e)(i); (2) contributions to unallocated funds, Section 1.401-12(g)(1)(ii); and (3) distributions to beneficiaries other than employees, Section 1.401-11(e)(3) and (5). In addition, the problem of how to use existing contracts is being studied by a small subcommittee. A copy of the letter of protest was sent to all members of the ALC and LIAA. Copies will be supplied to others on request.

Comments on the proposed regulations issued April 24, 1963, were submitted in a letter of protest dated May 23, 1963. The suggested amendments were as follows:

(1) Amendment to Section 1.6047-1 so as to provide for the use of a new form, in lieu of Forms 1096 and 1099, for reporting of information with respect to owner-employees.
(2) Amendments to Section 1.6047-1(a)(2) so as to strike the words "or made available" wherever they appear.
(3) Amendment to Section 1.6047-1(a)(2) so as to eliminate the possibility of duplicate reporting in certain instances.
(4) Amendment to Section 1.6049-1 so as to eliminate the possibility that reporting relative to owner-employees be subject to Section 1.6047-1 and not to Section 1.6049-1.

The first proposed regulations so far issued deal with Section 401, relating to qualification of plans, and Section 405, relating to bond purchase plans. The second proposed regulations dealt with reporting requirements under Sections 6041, 6044, 6047, 6049, and 7207. Only Sections 6047 and 7207 were actually amended by the new law, but all these were affected by the reporting requirements of the new law. Hearings on both these sets of regulations will be held by the Internal Revenue Service on Thursday, June 13, 1963.

These regulations did not answer all the questions we asked on December 21, 1962, and the three plans submitted were not directly used in the regulations. Further results of these submissions may be seen in later regulations.

The Internal Revenue Service has not yet spoken on what is meant by incidental insurance coverage included in a Keogh plan. However, the rule set forth in Rev. Rul. 60-83, C.B. 1960-1, 157 specifies that insurance contained in an employee pension plan is incidental so long as the amount of insurance protection does not exceed one hundred times the monthly payment. The general integration of the new law with the provisions relating to employee pension plans lends validity to the presumption that this requirement will be extended to H.R. 10 plans. Hence it may be presumed that such a policy form as an endowment at 65 will not be permissible as a sole vehicle for the financing of pensions to self-employed persons, but the usual retirement income form would qualify.

The Internal Revenue Service has not spoken on the question of the use of insurance policies without a trust or custodial account. In any case, presumably PS 58 or a similar measure of the value of the insurance protection over the accumulation will be used. Other devices to eliminate the age-by-age approach have not been found. So far as I am informed, companies are not proceeding into this area until regulations clarify both questions involved here.

As I have indicated, the Internal Revenue Service has spoken in the negative on the use of existing contracts. It is held in Section 1.401-12(k) that the transfer of property other than money to a trustee is a prohibited transaction. The business is not yet ready to accept this. Efforts are being made to work out appropriate endorsements or clauses. A small committee arranged for by the ALC and LIAA is at work on this subject, and, if a solution is possible, presumably they will find it. Most companies have advised their field forces not to try to work out such situations for the time being.

On this subject the approach is to "wall off" the existing value of the outstanding policy for all purposes of a plan. Several methods have been suggested for doing this. All of them introduce difficulties, however. Some of them are the possible necessity to apply more than one dividend scale to a single policy, the increase of indebtedness on the "walled-off" portion as interest accrues so as to encroach on the "plan" portion of the value, and the separation of the reserve for company tax purposes into "pension" and "nonpension" portions. The complications here are evident.

Logically, but not necessarily conveniently, the subject matter of the Keogh Act fits into the provisions relating to qualified employee pension plans very well. The existing law dealt with pension plans covering employees. The existing law, therefore, excluded from coverage all self-employed individuals and all partners, regardless of the extent of their interest. The new law extends the application of the principle of deferment of taxes to both these classes, with the exception that self-employed individuals and those partners which fall within the category of owner-employees become subject to the special limitations under discussion here. In that sense, the new law may be regarded as merely extending previously existing concepts to additional classes of persons. The concept of dollar limitations is new.

There is indication that only a few companies are attempting to devise special individual contracts to meet the demand under this law. Apparently, most companies proposed to use their regular pension trust policies, that is, contracts of the retirement income and retirement annuity type. Underwriting rules can well be expected to follow those applicable to pension trust cases. It will be interesting to watch the emergence of new contract forms such as unit purchase plans, variable annuities, segregated account policies with or without equity investment features, and individual deposit administration plans. These would supplement the regular pension trust approach or be used with it. The use of voluntary additional contributions, not subject to the benefits of the act, except possible deferred taxation of earnings on the contributed funds, co-ordinated with benefits having tax benefit features will certainly evolve as they have in the pension trust field. All these new forms of contracts as well as others are sure to make their appearance if the complications of law and regulation can first be resolved.

The group annuity technique would seem to offer possibilities for covering the employer, whether he be an individual or a partnership, so long as all the eligible employees are covered. This seems to some to be a reasonably suitable device for covering organizations of such employers as well. Some see here the possibility that a group annuity contract may be sufficiently flexible for it to be administered without a trust or custodial account. They see a definite parallel to the established procedures for qualified employee pension plans. It would be expected that comparable plans would lend themselves to the administrative practices already in existence for employee plans. On the other hand, some companies fear administrative difficulties, particularly in association groups. Involved, for instance, is the allocation of dividends to individually vested benefits, with individual accounts being required to be maintained in what should be regarded as a group situation.

The reporting duties of an insurance company under an approved plan are not too clearly spelled out in the law. Where there is a trust, the trust will do the reporting. Where there is custodial account, according to the regulations, the reporting duties are assigned to the custodian. Obviously, the insurance company will have the burden in cases of contracts written without a custodial account or a trust. The fact that a trustee or custodian will have the responsibility to make reports will not relieve the insurance companies from responsibility to make information available to them for reporting. Generally, reports will be needed on distributions, probably on certain types of intervening transactions, and certainly with respect to the annual value of any incidental insurance benefits. If a system of determination letters is set up, presumably the insurance companies will need to provide data to be used as evidence of qualification of plans, particularly plans written without a trust or custodial agreement, just as they do now for qualified employee pension plans.

An amendment to Section 805(d) allows contracts written pursuant to the new law the same treatment, insofar as the company federal income tax is concerned, as is accorded qualified employee pension plans. Allocation of earnings on these policies so as to bring to policyholders the benefits of this income tax cut-out could very well take the pattern of practices followed in the pension trust field. The differing dividend formulas will take care of that. There are advantages and disadvantages to the use of the paid-up additions versus the accumulated dividend option here. Both receive deferred taxation. On the other hand, if existing policies were to be used, two dividend scales might be required to apply to the same policy. Whether nonparticipating policies will play a large part in this area remains to be seen. If so, tax complications could result unless a priori provision has been made for the value of the tax saving to be channelled to the insured persons as has been done in the pension trust field.

Just where the larger part of this business will be written remains to be seen. There is the field of individual doctors, accountants, architects, dentists—even consulting actuaries—to be cultivated, in fact, almost every class of small business that involves personal services. The exception could be the small contractor who uses union labor where a union pension fund is in existence. The three-year employee service requirement could even provide him with a vehicle. There are several basic ways of doing this business: (1) to write a case covering a single self-employed person along with his employees, if any; (2) to write partnerships along with their employees, if any; and (3) to write an unincorporated association of such persons. In certain partnerships, none of the partners will have a 10 per cent interest. Accordingly, the plan would avoid all the owner-employee limitations, and the plan would appear to automatically develop the characteristics of an employee pension plan. In other cases, inclusion of owner-employee partners would so increase the cost of the plan by reason of vesting requirements applicable to employees that the benefits to the owners would be voided. Techniques for covering groups under which all owner-employees would be excluded have been devised. The respective ingenuities of the actuaries and lawyers are at a premium here, and I have no doubt that they will be put to good use.

Available information indicates that very little business has yet been written. There have been very few attempts to "beat the gun." There has been very little flamboyant advertising. Experience under comparable legislation in Canada and England has not encouraged American companies to rush in with plans. In addition, the very complications of the act and the absence of regulations on important points have caused the more cautious companies to make haste slowly. A few companies, however, are very active, and it is hoped that some of them will tell us how they have approached the various problems in this field.

ESMOND B. GARDNER:

I deeply appreciate the invitation to be a member of this panel, and I hope I can be helpful in outlining the arrangements that banks can make for the funding of Keogh Act plans as well as some of the problems that are involved. We at Chase Manhattan regard the Keogh Act as a significant break-through in the field of pensions for an important segment of our economy, the self-employed, and we are, therefore, optimistic about its future. This is, of course, a long-term point of view, as we do not anticipate an overnight bonanza.

The Act provides that "owner-employee" plans may only be funded by making contributions: (1) to a custodial account with a bank which can be invested either (*a*) solely in mutual fund shares or (*b*) solely in annuity or life insurance contracts; (2) directly to a life insurance company as premium on annuity contracts (not endowment or life); (3) toward the purchase of the new United States government bond; or (4) to a trust which may be (*a*) invested by the trustee in its own discretion or at the direction of the owner-employee or his designee (here the trustee must be a bank) or (*b*) used to pay premiums on insurance contracts. Accordingly, this is a field in which there can be both competition and co-operation between banks and life insurance companies. The banks will likewise compete with and co-operate with mutual funds.

It will naturally occur to a bank that the trust method, regardless of whether the trust is invested in general securities, mutual funds, insurance contracts or some combination of them, does offer the following advantages of flexibility: Eligibility—entrance into the plan can be permitted at any time and it need not be restricted to one or more specific points of time during a year. Contributions can be made at any time and in any amount permitted by the Act. Distributions can likewise be permitted in lump sum, in instalments, or through purchase of annuity contracts. Investments can be made in any of the media or any combination of them and also the media can be changed from time to time. Transfers can be made by normal procedures to substitute trustee or to a different situs for the trust, to accommodate the self-employed individual

From this point on, I will have to talk about Chase Manhattan in particular, as there is not much uniformity among banks in this area. Some are enthusiastic and others are passive. Chase Manhattan is a large institution having both a wholesale and retail banking business (over one hundred branches), and it is in a metropolitan money center. Accordingly, we see, long-range, a real opportunity to be of service and therefore we expect to offer a full range of activities.

We are delighted to co-operate with a life insurance company in acting as custodian for annuity contracts or as trustee under a split funded arrangement, and we are presently acting in both those capacities. The arrangement is that we have agreed to act as custodian or trustee under the particular form of agreement, but there is no requirement that we be so designated so that any other bank willing to act can be designated. In setting our fees for these services, we have tried to be modest as possible in order to encourage the adoption of Keogh Act plans. Whether acting as trustee or as custodian, the fee for holding a life insurance company contract is $6 per annum if the premium is paid directly to the life insurance company and $9 per annum if the contribution is made to us and we then pay the premium. The annual fee as trustee for investing a trust is ½ of 1 per cent of the principal amount of the fund plus a charge of $3 per annum for maintaining an account for each individual.

We would also be glad to co-operate with mutual funds in serving as custodian. While we have not concluded such an arrangement at this time, the fee appears to be an annual charge of $5 per person if the custodian bank is also the transfer agent for the mutual fund; however, if the custodian bank should take over any of the duties usually performed by the transfer agent, then it would be entitled to additional compensation for those services, but it would be payable by the mutual fund so that the only charge to the Keogh plan would be the $5 per year per member mentioned above.

We are also accepting Keogh Act trusts from individuals. The simplest form covers an "owner-employee" who has no employees and who wishes only general security investments. Our suggested plan provides that the contribution shall not exceed the maximum permitted under the Act, and that if the contribution is found to exceed that maximum the excess will be returned upon request within four months. Complete investment provisions in the discretion of the trustee are included with permission to transfer the amount to a Chase Manhattan Bank pooled trust (the diversified fund would be used unless the owner-employee designates either the fixed income fund or the equity fund). The owner-employee is permitted to designate his beneficiary and to direct distributions, provision being made that no distribution can be made before age 59½ and must commence by 70½. The owner-employee may amend or terminate the plan and also may remove the trustee and designate a successor and the trustee may resign.

When the owner-employee does have employees, appropriate provision is included, setting forth the eligibility requirements which are stated as "the first of the month coincident with or next preceding the completion of three years of service" (notice it is next preceding instead of next following as in the usual pension plan). Provision is also suggested for voluntary contributions in case they are desired and also for the adjustment of the individual accounts to market values on a quarterly basis.

For those accounts which are to be on a split-funded basis, provision is made for the division of contributions between an insurance account and an investment account. The insurance account is directed by the trust donor, and the investment account is in the discretion of the trustee, again with permission to transfer the amounts to a Chase Manhattan Bank pooled trust (in this case, the equity fund would be used unless the trustee was directed to use the fixed income fund or the diversified fund). Incidentally, there apparently was considerable interest in the split-fund arrangement even before the Keogh Bill was enacted.

In addition to these types of Keogh Act trusts, it is expected that associations will be interested in creating appropriate plans which will be made available to their members. This would appear to be a natural development, but we have refrained from accepting such accounts until the

Securities Exchange Commission problem, mentioned later, is resolved.

Each of the suggested forms for these plans is set up as a deferred profit-sharing plan but could, of course, be easily adjusted to become a money purchase pension plan. We have not had occasion as yet to discuss a Keogh Act plan on a definite benefit basis.

Three of our major problems at present in connection with Keogh Act trusts are external—namely, the lack of complete Treasury Department regulations, the publication of the Unauthorized Practices Committee of the American Bar Association known as "Opinion A," and the jurisdiction of the Securities Exchange Commission. As you know, some tax regulations have been formulated and the rest are expected in July. We have not believed that the absence of regulations should be a deterrent to the establishment of plans. The Keogh Act was superimposed on the existing rules on pension plans, and therefore specimen plans and trust agreements could be prepared which (it was thought) would qualify. We proceeded on this basis with the knowledge that, if it became necessary in order to qualify, amendments could still be made before the end of the year. It is our hope, however, that helpful regulations will be issued in regard to constructive receipt.

The Unauthorized Practices Committee of the American Bar Association stated in Opinion A issued on June 17, 1961, that the rendering of specific advice or assistance in background exploration or in drafting of plan documents was considered the practice of law. In order to avoid any problem, it is our present procedure to make specimen forms of plans and trust agreements available only to attorneys designated by interested self-employed persons. Here, again, we are hopeful that some satisfactory way can be developed which will give ample protection to the individual and still permit the use of standard forms.

The Securities Exchange Commission has felt it necessary to require registration of pooled trust funds for Keogh Act trusts on the grounds that there is a "public offering" of a "security." It is my understanding that the Commission has always claimed jurisdiction over pooled trust funds, at least those for pension and profit-sharing-plan trusts, but had not previously found it necessary to require registration of them. The problem is one of dispute about jurisdiction between the Commission and the Comptroller of the Currency, and it is hoped that some satisfactory compromise can be reached, at least on a temporary basis, without the delay that might be incurred awaiting either legal or legislative decision.

As mentioned above, we have established some Keogh Act trusts, but since many problems could be involved in registration with the Securities Exchange Commission, we have not felt that we could pool the funds for investment purposes even though that might be advantageous for the trusts.

Although problems do exist and although the Act falls short of the original goal of its sponsors, it does provide some advantages, and there is hope that helpful amendments will be made in the future. Accordingly, we are optimistic about the future of Keogh Act plans and about the part banks will play in connection with them.

GEORGE V. STENNES:

I have been asked to discuss the part that the consultant is likely to play under the Keogh pension plans. In way of background, this legislation has been in process for approximately twelve years. At the time of its introduction it was intended to remove discrimination against self-employed individuals by giving them status for pension purposes. Over a period of years this was introduced by Keogh with various co-sponsors—Simpson, Reed, and Jenkins. It was endorsed by presidential candidates and seemed to be moving toward its original objective until the Treasury Department took exception and made it appear that the legislation was to favor self-employed individuals. It appears that the only thing consistent with the original bill is the name "Keogh," since the author has outlived the political or natural lives of three co-sponsors.

The Treasury Department was able to change things between 1959 and 1962 on a basis that appears to work against self-employed individuals compared to other corporate counterparts, and in addition, the Department took advantage of the opportunity to regain projected tax losses by placing restrictions on all plans. Fortunately, some of the proposed restrictions were defeated.

It is a personal opinion that it appears unlikely to cause a loss of taxes to any marked degree, and the intent of the Treasury Department appears to be to use this as a means of imposing restrictions in corporate plans. Therefore, I find it difficult to accept the idea that half a loaf is better than none. Apparently, we will have another opportunity to see if this is the intention of the Treasury Department when new regulations are proposed in Kinter-type plans.

In the twelve years of the development of this legislation there has been considerable active participation on the part of associations, since in the early phases this seemed to be the basis of coverage. There was considerable interest on the part of banks, lawyers, insurance agents, and others who would have a direct interest in the development of specific plans. However, restrictions in regard to eligibility, vesting, and the amount of contribution which was deductible make it less likely to hold a great interest for any groups. On the other hand, it appears desirable to continue to be informed on the legislation and regulations and their further development.

There are many factors contributing to a lack of interest in these plans besides the restrictions mentioned above. To many there appears to be a considerable degree of red tape in the establishment of legal documents required. The fees to be charged in the handling of plans combined with the lack of capital gains treatment make it less attractive. There has been considerable uncertainty of groups which might incorporate or organize as Kinter-type organizations, and it appeared desirable to wait for the outcome of legislation concerning pension plans for self-employed individuals.

There is less incentive for the self-employed to consider pension plans than in the case of corporations. The corporation head desires pension plans to aid in the replacement of workers and offer security to employees. Defensively, pension plans may be wanted by top management in order to provide personal financial security. As against this, the self-employed by the nature of his status is not as likely to see the problem with his workers or himself, since his self-employment can often be something which he looks upon as continuing indefinitely.

Other deterrents which are posed have been the general lack of interest on the part of advisers such as attorneys and others who have not appeared to encourage the development of plans by individuals. Naturally, with the regulations in a proposed status we should not expect too many people to express a tone of encouragement.

In a pool of consultants I find little if any interest expressed on the part of clients or prospective clients. On the other hand, there are a few major associations which have continued to express some interest in having consultants help with the development of plans. Because of the nature of the legislation it appears that the greatest interest to date would be in money purchase pension plans and in profit sharing, neither of which will require a great deal of service from consultants. It appears that the greatest interest would be for sales-type organizations and for these to use the legislation as a door opener to other sales. Naturally, they will also want to be in a position to move and be among the first if avenues are open to make plans more attractive. Perhaps this interest will tend toward security improvements in the legislation, which will make the plans more desirable.

I had been asked to discuss briefly the place that variable annuities might play in Keogh legislation. Those interested in promoting variable plans indicate that they expect to use this in connection with these plans when legal hurdles have been solved with respect to the variable products. We should hear more on this, perhaps from other members of the Society connected with organizations that have gone further toward the development of this type of plan.

Another subject on which information was requested is the part that mutual funds will play in the development of plans under this legislation. Since the stocks of mutual funds can be used under custodial accounts, this is being used as a tool in the advancement of mutual fund sales, as in the case of other types of selling organizations, and will be a considerable door opener for the purpose of other sales. There may be some question of the extent to which mutual funds can offer completed arrangements because of threats of improper law practice, but it does appear that the mutual funds can stand a chance of handling plans as simply as many insured plans with standardized documents. Many investment dealers have indicated mutual funds to be a good source of investment of Keogh plans in order to avoid fees involved in some other plans. In addition, a mutual fund which through its organization is subject to banking regulations can act as custodian under the proposed regulations, which gives an advantage not previously authorized or made evident.

DONALD M. ELLIS:

The provisions of Section 79B of the Income Tax Act of Canada, as they existed when the Bill was originally passed, were set out in considerable detail in *TSA* IX. These data were brought up to date by Mr. Hugh McLeod in *TSA* XI, at which time some of the developing experience was also set out. However, for purposes of our discussions today, I will repeat the bare essentials.

First, I would point out that under Canadian income-tax law, employee contributions to an approved pension plan, within certain limits, are exempted from income in calculating personal income tax. Section 79B extended a similar privilege to the self-employed and to employees not under approved pension plans or who contribute less than the legal maximum to approved plans.

The new law provides three vehicles that may be used for making deposits, in each case under a plan that meets certain statutory conditions: (1) life insurance policies; (2) deposits with a corporate trustee; and (3) investment certificates or contracts. In the latter two cases, the funds at the end of the accumulation period must then be used for the purchase of life annuities from an insurance company. The contract under which deposits are made must be registered with the Revenue Department and is known as a "registered retirement savings plan." An individual who is not a member of an approved pension plan may contribute 10 per cent of his earned income up to a maximum of $2,500 per annum. For a member of an approved pension plan, the dollar limit is $1,500, and his combined contributions cannot exceed 10 per cent of earned income.

We feel we are fortunate in the freedom which exists for using insurance policies. Any type of policy which contains a savings element can, in fact, be registered, and a formula is laid down for splitting out the cost of insurance from the savings element. Naturally, however, certain safeguards were deemed necessary by the Revenue Department.

To be eligible for registration, policy contracts must be modified as follows:

1. No policy loan may be allowed, and any automatic premium loan provision will be cancelled.
2. Any existing loan must be repaid before registration.
3. The policy must contain a provision prohibiting assignment.
4. The only dividend option which may be allowed is the accumulation option, and accumulated dividends may not be withdrawn.
5. The policy cannot contain any cash-surrender privilege.
6. The extended insurance option must be cancelled.
7. The nonforfeiture option must be reduced paid-up insurance.
8. On or before the insured's seventy-first birthday, the value of the policy must be used to provide the insured (or insured and spouse) with a life income. The period certain must not exceed fifteen years.
9. No instalment payments may be commuted or anticipated.

It will be noted that these restrictions do not alter the general nature of our contracts. It was quite possible to use our standard policy forms with an endorsement sheet which produced the necessary modifications. In fact, this has been the general practice of the companies, and the great bulk of the registered plans have been so written.

It is true that many of the companies also produced special policy forms for this class of business. Generally speaking, however, the main purpose of such special forms was to make it possible to vary the premium paid from year to year to keep within the 10 per cent maximum, and comparatively little business has been written on such plans.

Now a word about the basis of taxation of registered retirement savings plans. Exemption of contributions from taxation is intended to result in only a deferment of taxation and not a complete exclusion. Hence, payments out of a registered plan, under all circumstances, are taxable. The law provides a flat tax rate of 15 per cent with respect to death benefits prior to retirement. Annuity income payments are taxed as earned income in the hands of the annuitant, and any surrender payments are taxed as earned income subject to a minimum tax rate of 25 per cent. Both the 15 per cent tax on death benefits and the 25 per cent tax on surrender payments are deducted by the payor.

When an insurance policy is used, it is, of course, the savings portion which constitutes a retirement savings plan eligible for registration. Hence, as mentioned earlier, the premium of the contract is split into the savings and insurance elements, and similarly, the death benefit must be split into taxable and nontaxable parts. The basis of making these splits is not laid down in the legislation, but a standard practice has been agreed upon between the Revenue Department and the insurance industry. Under this practice, the taxable portion of the proceeds of an insurance policy is taken to be the greater of (*a*) the policy cash value, together with any dividends at the credit of the policy, and (*b*) the savings portion of the premiums paid to date.

I also mentioned that surrender payments are taxed at a minimum rate of 25 per cent. On first thought, this seems peculiar in that in order to qualify for registration a plan must contain no surrender rights. This apparent anomaly arises because our federal government has no jurisdiction over property rights, these belonging to the provinces. The federal government can refuse to register a policy which has surrender privileges but cannot later prevent the surrender of the contract if the parties concerned are mutually agreeable. So the only recourse is a tax penalty. In actual practice, we issue our policies with the table of surrender values filled in but with an endorsement to the effect that the policyholder has no right to surrender. Everyone knows, however, that we will allow the surrender value stated in the contract if the policyholder asks for it. The policy is then considered to be de-registered. We deduct the minimum tax of 25 per cent from the surrender value, turn it over to the Revenue Department, and advise them that the policy has been canceled.

Figures which I quote later show that insurance contracts represent roughly one-third of the savings plans registered under Section 79B each year. A larger proportion is accounted for by the trust companies.

Contributions received by a corporate trustee are placed in a retirement savings plan trust and on the direction of the participant are invested in one or more of the following types of funds: (1) a balanced fund (bonds, mortgages, common stock, etc.); (2) a fixed-income fund (bonds, debentures, mortgages, etc.); (3) an equity fund; and (4) a guaranteed fund where funds are placed in a guaranteed investment account or trust company certificates under which the rate of interest is guaranteed for limited periods. On retirement on any date prior to the participant's seventy-first birthday, the participant instructs the trustee to realize the assets of the trust. The proceeds are then used to purchase a single premium immediate annuity from an insurer licensed to do annuity business.

Participants in a trust company balanced fund, fixed-income, or equity fund are charged a fee of the order of $\frac{3}{4}$ of 1 per cent per annum, which is generally levied against the capital value of the fund before computation of unit values and thus represents a "built-in" fee. Where the funds are placed in a guaranteed investment account, no administration charge is normally made.

The number of savings plans registered under this legislation has been, I believe, generally disappointing. Probably the professional groups that were so anxious to get the legislation have made good use of it, but the self-employed, generally, have not responded in the numbers expected.

The accompanying table gives the number of plans which have been

	1957	1958	1959	1960	1961
Total registrations	32,000	17,100	17,100	17,400	17,100
Registrations through					
Life insurance companies	8,000	5,100	5,500	5,800	7,400
Government annuities	15,000	5,400	4,100	3,400	2,800
Trust and investment companies	9,000	6,500	7,500	8,200	6,900

registered each year—exclusive of 1962, for which figures are not yet available. As expected, the initial year had the greatest number of registrations, but after the drop in the second year, the number has remained remarkably constant. The total is small, though, in relation to approximately 665,000 new ordinary policies written by the insurance companies in Canada each year.

In some respects, the legislation in the two countries is similar. There are major differences, however, the main one being that in Canada any individual is free to purchase an individual plan. The maximum amounts of contributions and the conditions imposed do not vary markedly in the two countries.

After the formal panel presentations, the following topics were opened for informal discussion by the members:

I. What problems in the writing of contracts under Keogh Act plans are posed by the pending regulations? To what extent have recommendations been made by industry representatives for changes in the regulations to resolve these problems? What is the present stage of development of the additional regulations that are contemplated by Treasury officials to cover areas not included in the initial set of regulations? What further problems are they likely to present?

MR. DAVID G. SCOTT and MR. ALFRED N. GUERTIN discussed this topic in their panel presentations.

II. What plans of insurance and annuities will be appropriate for use under the Act? Are any new policies, individual or group, being designed? Have special policy provisions or riders been developed for use with existing policy forms? What are the prospects for use of short-form trust agreements and plan documents?

MR. ALFRED N. GUERTIN discussed this topic in his panel presentation.

MR. STUART J. KINGSTON: National Life Insurance Company is an individual policy company. We do not write group insurance or group annuities. We are active in the pension trust business, realizing approximately 18 per cent of our new premium volume from this source each year. We have a very flexible and economical line of policies for pension trust business. Nevertheless, we are not actively encouraging self-employed pension business. The rationale behind our attitude is explained in the balance of these remarks.

The Keogh Act and the Proposed Regulations issued to date provide a very limited degree of assistance to the self-employed in the formulation of their retirement programs. Only one tax advantage of corporate pension plans was left intact, namely, the tax-free accumulation of the retirement fund. One tax advantage, the deductibility of deposits, was cut in half. All other tax advantages were eliminated, namely, the estate tax exclusion, the gift tax exemption, and the $5,000 death benefit income tax exclusion. Unreasonably low limits were imposed on the size of such plans, and many further restrictions on plan design were imposed. In addition, it is required that all the previously existing pension restrictions be obeyed.

If capital is a material income producing factor in the self-employed individual's business, then his covered earned income for pension purposes may generally not exceed 30 per cent of his actual earned income. This means that very few prospects exist, because the actual earned income in such cases must be exceedingly high in order for a pension plan to generate a pension large enough to be worth the effort. However, businesses of this type should have no trouble incorporating, thereby making the superior corporate pension plan available.

If capital is not a material income producing factor in the self-employed individual's business, and this would generally be deemed to be the case for most professionals, then many prospects exist. However, in many cases, such prospects are awaiting Internal Revenue Service regulations, expected to be issued in the near future, concerning the status of professional associations and professional corporations now available in about twenty states. If the regulations make the superior corporate pension plan readily available to such professional associations and professional corporations, the number of professional prospects for a self-employed plan will decrease sharply.

Most professional men belong to professional organizations such as medical societies, many of which have offered or will soon be offering multi-employer plans designed to reduce administrative expenses and to take advantage of mass purchasing power. In the corporate pension planning area, multi-employer pension plans have the serious defect that the standardized provisions offered seldom suit the needs of each employer. However, in the self-employed field there is so little choice of plan design that this defect virtually disappears. Therefore, such mass plans greatly decrease the number of prospects for individually merchandised self-employed plans. However, because of the time it takes to launch a multi-employer plan, a number of short-lived individual plans may be generated.

In view of these considerations we have done very little to encourage our field forces to sell self-employed pension plans. We have kept our agencies informed on the subject and we have prepared a specimen self-employed pension trust. We have also prepared a format for making illustrations of self-employed pension plans. The format is rather complicated, due to the complexity of the law. We have not prepared a sales promotion kit for self-employed pension plans, and we probably will not do so in the future.

We feel that our negative attitude will save our field forces from financial losses which could very well result from a concentrated sales effort in this area and that this attitude will ultimately be appreciated. At the present moment, the degree of appreciation is not overwhelming.

MR. GATHINGS STEWART: At the Lincoln National, operations under the Keogh Act involve the use of two of our regular policy contracts plus a specimen trust agreement. The two policy contracts which may be used are: (1) an annual premium retirement annuity and (2) our five-star endowment annuities (retirement endowments).

The specimen trust agreement has the following sections: Section 1 provides for the establishment of the plan with appropriate references to the Keogh Act and to the Lincoln's policies. Section 2 gives the definitions of the employer and the employees and of the term "earned income." Sections 3 and 4 deal with the authority of the trustee and the trustee provisions. Section 5 defines the eligibility requirements for the employees. Section 6 deals with financing of the plan including benefit formulas, premium payments under the policies, and nonforfeitability of the contributions. Sections 7 and 8 deal with the distribution of the benefits and with other limitations required by the Keogh Act.

We submit specimen copies of the trust agreement for the benefit of the attorney of the self-employed person. This agreement contemplates the minimum requirements for our plan. Various state laws may require additional provisions. We also submit specimen policies and other forms for use in filing the plan with the Internal Revenue Service.

Nearly all the plans we have issued involve one life only. However, we have issued four plans involving employees and one partnership plan. Retirement annuities have been used in about half of the cases, and the five-star endowment annuities for the other half. We have given some thought to the use of group of association policies but find that there are a number of complications involved. Our sales people are optimistic about the use of the plan and feel that there is advantage in uniformity and simplicity of procedure.

MR. RAYMOND G. CRAPO: In contrast to most of the insurance industry, Variable Annuity Life Insurance Company of America (VALIC) had not made, at the time the Keogh Act (H.R. 10) was passed, any elaborate preliminary preparations for its sales effort in connection with this new law. This lack of advance preparation was not due to lack of interest bur rather to staff limitations. Naturally enough, VALIC is quite interested in this field, since the variable annuity is a natural product for H.R. 10 plans. (Apparently Congress felt this was true, also, since the Committee report on H.R. 10 specifically refers to variable annuity contracts as one of the acceptable methods of funding H.R. 10 plans.)

As indicated by the panel, since the law was an emasculated form of previous bills, most companies have decided to wait until all the regulations are out before establishing a positive approach. Also as indicated here, there has been very little H.R. 10 business written by insurance companies. On the other hand, once the bill was signed, VALIC went to work and developed what is called the VALIC H.R. 10 retirement plan.

The VALIC H.R. 10 retirement plan is incorporated in Schedule A of the application for an annuity and is contained in one page. Under this Schedule A the self-employed individual (or partnership) need only indicate his name on a line which identifies himself as employer and sole proprietor (or partnership), indicate the date the plan is to become effective, and sign the form, making himself subject to the limitations in his H.R. 10 retirement plan.

The plan itself specifies that all contributions under the plan will be applied by the owner exclusively to pay premiums for his VALIC contract, and the only modification which VALIC will permit in this H.R. 10 plan is the contribution rate.

The plan itself sets forth the eligibility of any employees other than the sole proprietor or partner, names the employer or partners the owner of each contract, specifies that the plan shall govern the exercise of rights in each contract but shall not otherwise change the terms of provisions of the contract, specifies the contributions to the plan, describes handling of excess contributions, sets forth the requirements for distribution, sets forth the conditions under which the plan may be amended, and provides that each participant's rights under the plan shall be nonforfeitable at all times. Just below the signature of the employer, in boldface type, is the warning that each participant must rely on his own legal counsel so far as this plan is concerned.

No other change may be made in the printed H.R. 10 plan, since the contract will include a guarantee that if the plan does not meet Internal Revenue Service requirements, VALIC will either amend the contract so as to meet Internal Revenue Service requirements, issue a new contract which will meet Internal Revenue Service requirements, carrying forth the value of the old contract, or if it is unable to do either of these it will return all premiums paid. The guarantee is contained in an endorsement included in any H.R. 10 plan issued meeting these requirements.

As for business in force under the VALIC H.R. 10 plan, it is still to early to draw any conclusions. As of this date VALIC has written only twenty-five H.R. 10 cases—most of them in the past month. The problem still exists of the stand taken by professional associations that their members should wait until all regulations are out. VALIC takes the position, of course, that its guarantee obviates this problem. Many associations would like to set up a plan for their members at favorable rates available only on a group basis. Presently, we are not in a position to offer a group contract to an H.R. 10 association.

III. What arrangements are banks, trust companies, and investment companies planning to make available for the funding of Keogh Act plans? What has been the scope of activity of consulting actuaries in the development of self-administered or noninsured plans? Do significant opportunities exist for co-operation between insurance companies and bank trust departments in the development of pension arrangements for either individuals or groups of professionals?

MR. ESMOND B. GARDNER and MR. GEORGE V. STENNES discussed this topic in their panel presentations.

IV. What are the essential provisions of Section 79B of the Income Tax Act of Canada and in what respects do they differ from the provisions of the Keogh Act? What plans are being offered by insurance companies in Canada, either by way of new policies or by amendment to existing policies? What plans are being offered by trust and investment companies? What volume of business has been written?

MR. DONALD M. ELLIS discussed this topic in his panel presentation.