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PANEL DISCUSSION

H.R. 10

A. 1. To what extent is coverage under H.R. 10 being provided under (*a*) individual policies and (*b*) group contracts? What problems are presented in each approach? If special plans are used, what provisions must be included?

2. If normal contracts are used, what modifications or endorsements must be made? What plans are generally used? If split funding is not used with normal contracts, how are increases in contributions handled? To what extent are trust or custodial accounts being used?

B. What has been the experience in obtaining IRS approval of master or prototype plans? What fixed-benefit formulas have been found acceptable? What contribution formulas have been found acceptable on (*a*) money-purchase plans, (*b*) fixed-benefit plans?

C. What information regarding H.R. 10 features must be obtained on applications or special administrative forms? To what extent should information be required as to qualification of the plan? To what extent should a life insurance company take responsibility as to whether the employer makes correct contributions from year to year?

D. What changes seem desirable in the restrictive provisions of H.R. 10 with respect to

1. The limits on contributions and the deduction of contributions of the self-employed;
2. Vesting requirements;
3. Use of existing contracts;
4. The 30 per cent rule for income earned on capital?

E. What is the market potential of H.R. 10 plans? How have these plans been received by the field force? To what extent has it been necessary to train the field in the complexities of this law? With what degree of success?

Boston Regional Meeting

Panel Members:

BRUCE E. SHEPHERD, *Moderator*
ERNEST J. MOORHEAD
FREDERICK E. RATHGEBER
HARRY WALKER

BRUCE E. SHEPHERD:

Our plans for this meeting involve informal discussion with no long speeches. We will try to cover the topics in the program but we will change the order of the items.

First, I will give you a little of the background of this particular statute. You might say it all started back around 1942 with the 1942 Revenue Act when provisions were made for allowing the tax deferment privilege for employee pension plans. It soon became apparent that that sort of a privilege, while very valuable to the employee and the employer who is interested in the employee, was not available to self-employed individuals. There naturally followed the idea that there ought to be some kind of statute that provided similar tax deferment privileges for self-employed.

It was not until about 1951 that the first bill was introduced in Congress to provide that kind of a tax deferment privilege, and I would like to read a very brief summary of what that original bill provided. It provided that a taxpayer might make such payments in any one year into a restricted retirement fund up to an amount of 10 per cent of his earned income with a maximum of $7,500 minus any employer contributions made on account of the taxpayer under a qualified pension plan. You see, it was not restricted to the self-employed in the first instance. The restricted fund had to be set up under agricultural, labor, industrial, or professional associations or similar organizations. The trustee had to be a bank and the assets had to be invested in securities legal for trust funds. There was not any provision for funding these arrangements through life insurance or annuity contracts. Except in a case of total disability, no distribution of the trust could be made before the participant reached age sixty, and the installment distribution from the restricted retirement fund would be taxed when received just as any annuity is taxed.

That was a fairly simple proposition. It had a lot of defects and was rather violently opposed by the Treasury. The opposition came partly because of the defects, partly because they thought that eliminating some discrimination between the employee class of pension plans and the self-employed might set up some other discrimination, and partly because they thought they would lose quite a bit of revenue. That general idea went through a great many changes between 1951 and the final enactment.

It was not until around 1960 that this idea really started to take hold, and it was because a few concessions were made by the Treasury in its thinking. Concessions were made on the other side too. The principal idea was, however, that this was a tax deferment privilege which was parallel to that already provided for employees under an employee pension plan. Thus they decided to amend the existing provisions for employee pension plans in the Internal Revenue Code to accommodate the provisions that were being proposed for the self-employed.

That I think will give you some idea of the background. One of the

conditions that had to be met by its proponents was the necessity on the part of the employer-owner, self-employed person, who had some employees of his own to provide a pension plan for his employees. That is part of the law finally enacted.

A number of restrictions had to be put in the statute for the purpose of making sure that the amount set aside ostensibly for retirement benefits was actually used for that purpose and to still provide enough flexibility in setting aside these funds so that the individual if he got into straitened circumstances could use what he set aside provided he paid some penalty in the way of a tax at the time of his take-down.

So when you think of this law and its complexities, I think you will find it will help to bear in mind what they were trying to do. They were trying to impose conditions on the employer to require him to provide pensions for his employees. They were trying to set restrictions and conditions on the accumulation of these funds and their distribution that would necessitate their use for the purpose for which they were originally intended unless some penalty were paid.

As a starter for our plans Mr. Harry Walker suggested that it would be helpful to learn from a sample group of companies what their experience was, what progress they were making in their H.R. 10 applications, and for that purpose he sent a questionnaire to about twenty companies and he got very helpful replies. To a considerable extent our discussion this morning will center around the replies that Mr. Walker has compiled as a result of this questionnaire.

We will start out by getting some kind of an answer to the first item on the program which concerns the extent of coverage under H.R. 10 being provided under individual policies, and, second, under group contracts. Mr. Walker will cover that subject as far as the individual contracts are concerned and Fred Rathgeber has some information under group.

HARRY WALKER:

As Mr. Shepherd indicated, I sent this questionnaire to twenty-one companies. The questionnaire contained questions designed, first, to elicit information and, second, to pinpoint some of the administrative problems in the H.R. 10 field.

The twenty-one companies indicated that a total of about 2,500 H.R. 10 policies had been sold up to the date of the questionnaire. On the average H.R. 10 plans that have been sold included one to two lives.

The average premium under contracts sold to date varied from $800 in one company to $2,000 in the company selling the largest policies.

These results are not surprising. First, as to the volume, it is my per-

sonal opinion that we have done better than we should have expected because the prototype plans designed by the companies and filed and approved by IRS were not approved until the last days of November at the earliest and the middle of December in other cases. The field forces of the various companies were not alerted to selling these plans until sometime in December so you have about two weeks' business sold in these companies.

The result as to the average number of lives per plan did not surprise me because H.R. 10, as it was finally enacted, provided very little inducement for an employer with several employees to buy into a plan like this. Take a man earning $25,000 a year with just one employee earning $5,000 a year. Assume this man is in the 40 per cent tax bracket. He has a 10 per cent plan contributing $2,500 a year for himself and $500 for his employee. $500 paid for his employee costs him $300 after taxes. This $300 is the price he pays to secure a tax deferment, not tax savings. His contribution is $2,500 and half of that, $1,250, is deductible from his current taxable income and this represents the tax deferment. The price he pays for that is $300 net for his employee, and he has to contribute $3,000 to secure this advantage.

FREDERICK E. RATHGEBER:

A lot of the impetus behind H.R. 10 was furnished by the professional associations so it is not surprising that a number of plans for professional associations have been established. The largest is the American Medical Association. The American Bar Association has a plan. The American Institute of Certified Public Accountants, the American Institute of Architects, and the American Association of Orthodontists are just a few others. The pattern seems to be, however, that very few members have signed up for these plans so far. The American Medical Association has a plan that has four insurance companies involved, Aetna, Mutual Benefit, Continental Assurance, and Occidental, with the Harris Trust of Chicago as Trustee. That plan through February 1964 had about 4,000 participants and about $6 million in contributions.

The American Bar Association plan has the Prudential as the insurer with the Continental of Illinois as Trustee. Through the end of 1963 that had only 639 participants and about $1 million in contributions.

So the general pattern so far is that the number of participants has been rather light.

MR. SHEPHERD: What kinds of contracts are being used for H.R. 10 plans? Are the companies making use of existing forms? Are they designing new forms? Are they modifying to some extent forms they already

have? Again, Mr. Walker's questionnaire dealt with that, and I will call on him to start that discussion.

MR. WALKER: We found from the results of the questionnaire that of the twenty-one companies one of them already had a contract providing for variable premiums to meet the need for a fluctuating income on the part of the owner-employee. Three other companies out of the twenty-one had adopted a special form of annuity contract with premiums that may vary from year to year. Six of the twenty-one companies have not adopted special contracts but have adopted riders to be attached to their regular forms that provide for varying premiums year by year.

I asked whether the companies used the forms that are regularly used for corporate pension trust sales or whether the companies used their regular individual forms that are not used for pension trust sales. I expected the answer in all cases to be that they used the corporate form except for the special forms adopted. I found to my surprise that three of the twenty-one companies were using their regular individual form rather than their pension trust form.

MR. SHEPHERD: Mr. Moorhead, do you want to comment on this too? I might suggest before you actually comment that you might care to introduce your associate who is sitting in the front row.

ERNEST J. MOORHEAD:

Mr. Chairman, what I am planning to say will fit under the question you have asked me as well as the question you told me in advance you were going to ask me. At the rehearsal for this panel—I think we should admit there was a rehearsal in case the subsequent proceedings do not make that obvious—at rehearsal, our Moderator determined to cover the past, present, and future of H.R. 10. I think we have to agree that he did a masterful job of explaining how confusing it is.

Mr. Walker modestly volunteered to cover the applications to individual business which the Equitable rather mystifyingly calls living insurance. I think the reason they call their product living insurance is that if William Shakespeare were alive today, he would be one of their policyholders.

Mr. Rathgeber said he would explain group insurance under his company's familiar slogan, "To more than 30 million people Equitable means Prudential."

These shrinking violets then invited this representative of a local

company to select any phase of the question not already covered that might be of interest to the audience.

What was that challenging question you just asked?

MR. SHEPHERD: I asked you to introduce Mr. Spencer.

MR. MOORHEAD: What Mr. Shepherd is suggesting is for me to mention that I have in front of me Mr. Thaxter Spencer, Associate Counsel of New England Life and Chairman of the ALC-LIAA Subcommittee on Pension Trusts of the Joint Legislative Committee of the organizations just mentioned. He has met frequently with the authorities in Washington on H.R. 10 problems. If the Moderator or anybody asks me a question and if Mr. Spencer nods, I will unhesitatingly answer yes. If he shakes his head, I will answer definitely not. If he looks puzzled, my answer may be lengthy but certainly noncommittal.

The question that I thought I was going to be asked was, If special policies are used, what provisions must be included? When shall I deal with that?

MR. SHEPHERD: You go right ahead. We are out of order anyway.

MR. MOORHEAD: Members of this audience should recognize that this infant H.R. 10 has in a short time developed an extraordinary vernacular all its own. When H.R. 10 experts get together they talk about master plans and prototype plans. They talk of custodial accounts, and they use a variety of words you cannot find in any dictionary.

Taking the first of these, master plans versus prototype, I think a neophyte would be inclined to think that these two approaches differ. It is important to understand the difference between them as to how they work and what they aim to accomplish. Actually, it seems to me, that the differences between these are procedural in nature and are far from being fundamental. They involve really differences in pieces of paper but are quite similar in what they accomplish.

The expression "trust versus plan" is used quite often. Perhaps it would be better if these were described as a plan with a trust and a plan without a trust. A plan without a trust is simply an attempt to reduce the procedural formalities to a minimum.

Assuming that special plans as described in this question mean flexible riders or flexible policies, we turn to the question of what provisions need to be included. I like to picture the H.R. 10 instrument when we are thinking of it in these terms as two linked but independent documents.

One is the life insurance policy which need not have any special provisions except that if a trust is not being used it is necessary to provide that the policy be nontransferable. Second, there must be some way in which the limitation on the payee and the pay out period can be provided for. The policy must contain, in other words, enough affirmative provisions to meet the requirements of H.R. 10 but there is no need to emasculate it. It does not hurt if the policy contains other provisions as long as the legal document prevents the policy from being used in a manner that clashes with H.R. 10. Thus the policy is part of the H.R. 10 package and the rest is the legal document that contains the H.R. 10 rules and regulations.

MR. SHEPHERD: Thank you. You referred to the use of split funding methods. Of course that type of funding has been used in the employer-employee type of pensions for some time. To what extent are split funding methods going to be used in H.R. 10 plans? Mr. Walker has accumulated some information on that subject.

MR. WALKER: There has been some question in the minds of many of us as to whether split funding would be permitted under the regulations because under a qualified plan, whether it is corporate pension trust plan or an H.R. 10 plan, the regulations limit life insurance benefits to so-called incidental benefits. The death benefit may not exceed 100 times the monthly income at retirement age. Under H.R. 10 there is a requirement that the benefits for the common law employees, the employees other than the employer, must be fully vested immediately. In the case of split funding the fund to the account of the individual employee must therefore be immediately vested. This would mean that the death benefit must include the employee's part of the separate fund. In that event there would be a total death benefit, the life insurance policy death benefit plus the employee's part of the fund, that would exceed 100 times the monthly income. For this reason many companies have been reluctant to include a split funded plan in their portfolios.

Of the companies questioned I found that they were about evenly divided on the question of providing a split funded plan.

MR. SHEPHERD: Yesterday, Mr. Spencer came up with some rather interesting information on the attitude of the Internal Revenue Service on the subject of split funding and the 100 to 1 death benefit ratio.

MR. THAXTER P. SPENCER:* In our regular corporate plans there is some doubt as to exactly what death benefit is permitted. Some of the

* Mr. Spencer is Associate Counsel of New England Mutual Life Insurance Company.

local IRS agents have been basing the rule on the total payment at death. However, there are others who base the rule on the amount of insurance at risk. As long as the insurance at risk does not exceed 100 times, they contend that it should not make any difference what the actual death benefit is.

There are two authorities in the IRS on this point. I think if anyone reviews Mr. Goodman's speeches and the IRS rulings, it leads us to the conclusion that the rule refers to the amount at risk. On the other hand, there are parts of the regulation which seem to refer to the total death benefit.

When it comes to the approval of H.R. 10 plans, I found no disposition on the part of the Treasury to prohibit a split funding plan. They therefore seem to be tacitly assuming that the death payment can include both the insurance face amount and the separate fund amount. This is a question that may arise and plague us in the future, but as far as I know no company has run into any difficulty on this point on getting IRS approval.

MR. MOORHEAD: I think it is desirable to recall that the use of auxiliary funds developed to serve two distinct purposes. One of them has no relevance at all to H.R. 10 and the other may have some relevance.

The original basis for the auxiliary fund system was for its advantages in discounting for future deaths and withdrawals. While that is very handy in a corporate pension plan, it does not make any sense at all in H.R. 10 if the benefits have to be fully vested.

The second purpose for auxiliary funds is to permit a policyholder to get the alleged benefits from investment in equities by placing his auxiliary fund money outside the life insurance company or using a life insurance company separate equity account if and when it becomes available. Investment in equities may be quite unsuitable in a very small plan. Therefore, we discourage the split funding system, and we have just a handful of cases using the ordinary life and auxiliary fund.

MR. SHEPHERD: What information regarding H.R. 10 features must be obtained on applications or special administrative forms? To what extent should information be required as to qualification of the plan? To what extent should a life insurance company take responsibility as to whether the employer makes correct contributions from year to year? Mr. Moorhead, would you comment on these questions?

MR. MOORHEAD: What special information must be obtained on H.R. 10 plans? The special information that must be obtained consists of what

is needed to determine the category of each applicant. That is whether he is what they call an owner-employer or whether he is a partner-employee. This is needed so the life insurance company will know what benefits to his employees he is required to provide and see that he provides them. Also, we need to know if this man is a tycoon who is involved in multiple ownership of unincorporated businesses so we can see to it that he will not fail to make the required provision for pensions for the other employees in the firms over which he has jurisdiction. Then we need, for the present at least, the assurance that the trust was in effect before the application was signed so the problem of existing insurance will not arise.

MR. SHEPHERD: Are there any special problems that arise in case of group insurance?

MR. RATHGEBER: On the question of information, basically the same questions have to be asked but there are some additional things you want to know. First of all, you need to know whether the master plan of the association has been approved by the IRS (and also by the SEC if needed). In addition, you want to know if the employer has joined the master plan.

MR. SHEPHERD: Mr. Walker, would you like to comment on this?

MR. WALKER: The only point I would like to add is the question about whether the companies should check to see whether the right amount of contributions is being made on behalf of the owner-employee and any other employee in the light of the compensation of the individual. The companies generally do not take any responsibility for that even where there is no trust or custodial account involved. Where you have a plan involving just the individual and the life insurance company, we leave it up to the individual and the agent to determine between them what the right amount of contribution is to be.

MR. SHEPHERD: How about the use of waiver of premium benefits and accidental death benefits? Is it the practice of the companies to permit the inclusion of those benefits in their H.R. 10 plan or not?

MR. WALKER: Of the twenty-one companies, nine responded to the effect that they permit both accident and waiver to be included in their H.R. 10 policies. Seven indicated that they permit waiver only, and five said they permit neither. Now waiving of premium benefits presents a problem because that involves a definition of disability which is quite different from the definition of what constitutes disability under H.R. 10, as it relates to the conditions under which an owner-employee can re-

ceive income prior to age 59½. He must be disabled, and the law has a much more restrictive definition of this than the typical disability waiver clause.

MR. MOORHEAD: I think the point that Mr. Walker makes is related to the underwriting attitude of the company as to which of these supplemental benefits are granted. In considering this question I addressed myself to the problem of whether inclusion of the benefits would in any way hurt the acceptance of the plan by the authorities. We have no reason to believe that the Treasury Department is going to worry about whether these benefits are in the policy or not. Certainly that is the precedent we have on the regular pension plans. Consequently, it appears that one can go ahead and include these benefits, provided that premiums for them are paid by the individuals themselves and not by their employer.

MR. SHEPHERD: What changes do you think are desirable in the restrictive provisions of H.R. 10?

MR. MOORHEAD: I think that the limitations that we now find in H.R. 10 are entirely consistent with those that one would expect to find when one realizes that the rules were promulgated by an arm of the Federal Government that showed itself at the very outset completely unenthusiastic about the legislation. As a result, the limitations are burdensome in both their procedural and substantive aspects.

I think that the first change I would suggest would be to eliminate the requirement that the employer must bring into the plan young, short-service employees with fully vested benefits.

MR. RATHGEBER: On this vesting requirement I think this is a clear case where the H.R. 10 people are in a much tougher position than the corporate people. I would be in favor of introducing an eligibility requirement such as a five-year minimum service period before the employee has to be brought into the plan.

MR. WALKER: I think the greatest retardant to sales of H.R. 10 plans is the fact that the owner-employee may deduct only 50 per cent of his contribution. That 50 per cent should be changed to 100 per cent.

MR. SHEPHERD: Now one phase of this question that I think most of us are interested in is what the potential market may be for these H.R. 10 plans. As Mr. Walker has pointed out, the early returns seem to indicate that we are doing pretty well when you take into account the short period

that has been available for sale and implementation of these plans. I would like to sound out the feeling for this potential market. Do you feel you will sell a fairly large number of these plans and your agents will be pleased with that product or not?

MR. MOORHEAD: I think we will all agree that the market for this type of plan depends on the answers to two questions. The first is, how many professional men and other self-employed will set up H.R. 10 plans and, second, how many of those who do will use the product we offer as opposed to the product offered by other organizations? I think we will find the competition from these other lines, including the Government bonds, to be quite considerable. I have the impression that our situation is in some respects similar to that in Canada; it has been indicated at previous Society meetings that they have been disappointed in Canada about the amount of life insurance that has been written on their corporate type of plan. Of course, it always has that door-opener advantage that is important to our agents and, therefore, it is up to us to provide them with the key that opens that door to sales of some other kind if these fail to accomplish their purpose.

MR. RATHGEBER: I think this might be a good time to mention a couple of the problems in the group field which do not exist in the individual field. One of the problems involves the recognition of equity among individuals in these plans. The contributions of the individuals have to be recognized, and if the company is on an investment year method of allocation of investment income, this has to be recognized in some way in its application to individual accumulations.

Another problem is to get adequate enrollment under these plans. It seems clear that enrollment has not been too good so far, and it is doubtful that you can motivate agents to work on individual enrollment with group type compensation. I think it is very clear also that the big appeal in the Association cases is for equity contracts of some sort and so I think the big market here is for some variable group annuity rather than the fixed benefit group annuity.

MR. WALKER: I think the future market for H.R. 10 will depend to some extent on what the Treasury Department finally adopts as regulations for the so-called professional corporation. These "Kintner" organizations under proposed regulations released in December of last year would not generally be permitted to set up qualified plans. If those proposed regulations should be finalized in that form, H.R. 10 may fare better

than if the Treasury Department decides finally to recognize these professional corporations.

I did want to add one other thing, Mr. Shepherd, concerning the extent to which existing policies can be used under H.R. 10 plans. None of the companies answering the questionnaire permits the use of existing policies, and there is nothing, in the regulations that have been promulgated so far, that will permit their use. The LIAA Committee has made proposals to the Treasury Department and has asked that existing policies be used. They have suggested a "walled-in" procedure, whereby the cash value of the existing policy at the time it is brought into an H.R. 10 plan and any increment in that value not arising from future premiums would be considered outside the H.R. 10 plan; any values attributable to premiums paid after the existing policy is brought into the plan would be included under the H.R. 10 plan. This suggestion involves administrative problems for the life insurance companies, but it seems to have considerable merit.

MR. SHEPHERD: Are you fearful that in the absence of some arrangement whereby existing policies can be used that there will be a tendency to twist old policies into new to take advantage of H.R. 10?

MR. WALKER: I am somewhat fearful of that, but I think that fear has been exaggerated. We should bear in mind that the only life insurance policy that can be used under an H.R. 10 plan, if you disregard split funding for a moment, is the retirement income type. The typical existing policies are on the ordinary life plan and would first have to be changed to the retirement income form; that would require a large cash collection to accomplish the change.

MR. MOORHEAD: I think that we should continue to do all we can to solve this problem of using existing policies and avoid the replacement of old policies with new. We are reasonably optimistic that something will emerge which may be a workable solution.

Chicago Regional Meeting

Panel Members:

ALAN A. GROTH, *Moderator*
LOREN G. LOGAN
ROBERT W. WALKER

ALAN A. GROTH:

Introduction

More than a year after H.R. 10 became the law of the land the final Regulations were published on October 14, 1963. There were but $2\frac{1}{2}$

months left to the end of the year, during which trust agreements, group annuity and individual policies, custodial agreements, pension plans and the like had to be drafted, adopted, and submitted for approval to IRS.

Although accurate statistics are not available on how many plans were submitted to the Internal Revenue Service for qualification prior to December 31, 1963, it has been estimated that there are fewer than 10,000 Keogh plans in banks throughout the country. These, together with the plans set up by insurance companies, covered probably but a minute fraction of the 10 million self-employed. Still, I believe that remarkable work was done by insurance companies, trusts, and by some professional associations by having any plans at all in operation prior to the end of last year. This was a brand new law containing entirely new principles of retirement planning, and much work had to be done along unfamiliar lines.

Today we shall discuss some of the problems that arose and some of the developments which have taken place during the last six months in connection with establishing and administering plans for the self-employed.

During the next hour, Mr. Robert W. Walker of Northwestern Mutual will discuss H.R. 10 plans funded by individual policies, and Mr. Loren Logan of Continental Assurance will cover H.R. 10 plans funded by group annuity contracts. After they have told you some of their experiences, I shall make a few remarks from the point of view of a consulting actuary who is and probably will be an almost disinterested observer of the H.R. 10 field.

LOREN G. LOGAN:

I would like to discuss these questions primarily from a group standpoint, with only occasional attention to the individual policy area.

It is doubtful if anyone, including the IRS, has valid statistics on the total number of self-employed covered variously under individual policies and group contracts. Individual contracts may well be ahead of group. However, the two best known professional associations in this country, the American Bar Association and the American Medical Association, have chosen forms of group contract for the insured part of their programs. The Bar is said to have adopted a group deferred annuity, while the Medical Association chose the deposit administration form.

My company insures a portion of the AMA deposit administration funding. The adoption of the deposit administration form may seem to create certain problems, but it seems to have been the logical vehicle under the particular circumstances involved.

It is understood that the American Medical Association has long maintained elaborate records on each member, and it may have been natural

to continue this pattern in its H.R. 10 plan. The invitation to bid indicated that complete records of the participation of each member in both the trust and the deposit administration contract would be kept at association headquarters. A separate set of detailed records at the insurer's office of individual accumulations would have been a duplication. Through deposit administration, the association seems to have been able to obtain rates and guarantees which for the near term appear most advantageous.

One problem under this form of contract is the preservation of equity between generations of members. The annuity guarantees applicable to funds deposited by all members may be exhausted by retirements of older members. This might seem unfavorable to the younger members. However, it is probable that competition will tend to keep future rates and guarantees attractive, and members retiring later on will be able to do so on an equitable basis.

The program promises to involve very little home-office expense because of the elimination of individual records prior to retirement. Annuity purchases can no doubt be made so as to minimize premium taxes.

One modification which was insisted on in the deposit administration contracts issued to the Association concerned options at retirement. There seemed to be great reluctance on the part of the Association to compel a member at retirement to accept solely a lifetime benefit. It was argued that many physicians are less interested in guaranteed monthly income than in managing their own capital in their years of retirement. As an experiment, our company decided to go along with the elimination of conventional restrictions against lump-sum settlements in this particular situation.

Speaking generally, we have made use of both group annuities and group permanent for H.R. 10 association programs. The underwriting of the latter type of contract on associations presents certain problems. In some leading states, group insurance may not be written on professional association membership, or may be written on such associations only under restrictions. It may be difficult to time the solicitation of the membership so as to preserve one or two entry dates a year. Guaranteed issue must be offered rather cautiously; however, our company so far has had better mortality among these groups than was expected.

Our experience on Internal Revenue Service approval on master or prototype plans has been quite mixed. There was a considerable delay on the first plan filed, and final approval was not obtained until February 27, 1964, and only then after a number of changes. For example, we were not allowed to include a withdrawal provision on voluntary contributions. A second prototype submitted early in March was approved in three

weeks. Both of these prototypes involved money purchase formulas. It is our impression that very few fixed benefit plans have been submitted.

As for qualification records, it might be mentioned that our company requires a copy of the initial qualification letter on all regular group pension and individual policy trusts. Our practice on group programs with H.R. 10 clients is probably not completely settled. On the AMA contract we expect to rely on the association to police qualification matters. It would be almost impossible to do otherwise. On certain other association plans involving group permanent or group annuities we expect to obtain evidence of individual approvals from each member. Once the initial approval period is past, each member will be more or less on his own as far as adhering to the proper contribution limits is concerned.

The market potential for group contracts on professional associations is still uncertain. Strong well-financed organizations as the AMA may well build up a substantial volume of contributions. The extent to which these contributions will go into annuities over the long term cannot be known. Initially, the members seem to have shown a strong preference for direct investment.

One problem on the use of group for professional association plans is the reaction of the insurer's agency force. Such programs cannot usually offer participation to a local agent or broker, and he may feel that his own market for individual policy sales is being restricted by the use of the group approach. In our own company, we have handled this problem by pointing out to the regular agency force that the group type of plan appeals to a different segment of the professional class and that many professional men will continue to insist on that type of service and counsel which can only be rendered locally through an individual policy sale.

ROBERT W. WALKER:

H.R. 10, the Keogh Bill PL 87-792, became the law of the land (or part of it) on October 10, 1962. It took effect on January 1, 1963, so we have a year of experience behind us. That year of experience has seen many meetings to discuss critical points. Nothing really got going, however, till the publication of regulations late in the year. Unfortunately, they did not answer all the questions. The purpose of this law was to provide for *self-employed individuals* essentially the same, or at least some of the same, tax benefits as are available to all other individuals through retirement plans established by their employers. The employees have distinct benefits under *qualified* retirement plans: the contributions are deductible as business expenses for the employer; they are not income to the employee. The "employee" of the individual employer, that is, the

individual himself, has not until now effectively secured any benefits. What was not taxed on the one hand was taxed on the other. He was the forgotten man. Keogh sought in part at least to set this right. Individualism may even rise again after having been well-nigh buried in conformism. Perhaps, though, the more correct view is that the common mold is reaching out to envelop even the individual through the guise of tax benefits. There is more truth than fiction in this. The original Keogh approach was simply to give the individual some tax relief. The final approved approach, however, places him in the guise of his own employee for retirement plan tax benefit purposes.

The efforts to make him a group give rise to the group and association approaches to capitalize on the benefits available. However—and it is a big however—there are many, many individual entrepreneurs, sole proprietors, and professional men who in their solitude must come to grips with the matter. Where they are members of a professional group—the AMA, CPA's, dentists or others—the group is doing the research, the selling, the drawing of the benefits to the attention of the membership. In other words, it is providing the impetus for creating individual retirement plans. Mr. Logan has touched on this portion of the populace. Where there is no such master organization, master plans are in the making in the home offices of insurance companies, banks, mutual funds, and others, to find a pattern for a suit that will fit the majority. But these suits have to be sold. They have to be fitted, and it appears as though the old, old story will be retold again. Insurance, retirement, and savings programs must be sold. People just do not stand in line to buy them. We may say there was a flurry of sales at the end of 1963. To be sure, there was. But the flurry overwhelmed no one. There was no blinding blizzard of applications. At least, I have heard of none. 100 cases here, another 90 there. Some are elated at the response; others are not, but that really is not surprising. Some go so far as to suggest that H.R. 10 may be the panacea for personal planning. But let us get a little more precise.

Now what were some of the problems and what have been some of the solutions? At the outset, one of the problems appeared to be that current contributions had to follow hard on current salaries. For level premium individual contracts, this was a seemingly insurmountable obstacle for a while. Level premiums simply do not follow variable salaries. Two solutions emerged. First, there was the three-year average earnings rule for the self-employed. This was a solution won from IRS. Second, contract modifications were made by the companies which saw the rise of the variable premium contract to meet this rather specific challenge. Actuaries do have imagination! Of twenty-one companies canvassed on the point of

whether a special form of contract was designed solely for use in H.R. 10 cases, six answered in the affirmative. One was quite proud of the fact that it had designed a contract some seven or eight years ago that was just the answer now for H.R. 10. It is not quite so clear just what purpose it served, however, in the meantime. It now seems to have a fine answer in this field. The need being met by these contracts was to provide a device to permit the pattern of the rather precise parallel of contributions to salaries. Benefits then follow along as the unknown end result.

The adoption of special contracts may not be the whole answer. They may well lead to further special problems. They are usually designed for a rather specific and probably fairly narrow purpose. These particular contracts were primarily written as annuity contracts. Since nothing is permanent here but change, any specially designed contract should have the flexibility necessary to roll with change. Change has already been introduced, and currently being considered is the inclusion of incidental death benefits and incidental other benefits, such as waiver of premium. The adding of these creates unique problems now being wrestled with. Most companies, rather I should say most of the companies canvassed, fifteen out of twenty-one have sought to adapt existing employee or pension trust policies. These contracts have been tested and proven in the larger field of individual policy pension plans for the relatively small employer. The odds are that they will fill the bill with the necessary adaptations to meet the current self-employed need. Some feel that a new pension tax mold is being cast for the individual and that this will be the ultimate mold to which all may be fitted, and moves in new directions with new contracts should be made cautiously—hence the seeming inertia. What are the standard plans now being used? The retirement annuity, the deferred annuity, retirement income, retirement endowment—the old familiar titles. By and large, these fit well with the average salary rules adopted. Adaptations using additional premium or deposit provisions for variable additives are essential and can be introduced without too great violence to existing routines.

One of the essentials of qualification for tax relief in the pension area is that funds applied to provide retirement benefits shall not be accessible to the individual for whose benefit they have been provided. This criterion is continued in H.R. 10. In the usual individual policy plan there is a trustee-owner of all contracts used to provide benefits. The self-employed has two hats, that of the employed and that of the employer. Access to his funds should be similarly withheld. This may be achieved through naming a trustee, but this complication is really not essential. The same effect can be accomplished and is accomplished by endorsement of the contract as

nontransferable and nonassignable to other than the original insurer and by making the contract subject to a written plan. This final step is an essential and integral part of the whole. The assignability to the insurer is retained primarily so that the contracts may qualify in the several states. The contracts continue to be insurance and annuity contracts and as such remain subject to the nonforfeiture and other state policy requirements. Some states are indeed quite conscious of this fact and assure one on inquiry that federal legislation in this area cannot be written into their policies as contract terms. One might say they are not only conscious of the fact, they are vehement concerning it. The endorsement procedure has proven satisfactory and is a simple continuation of existing routines in all instances.

Now a brief word on split funding. In the individual policy pension field this means the common "combination plan"—a life plan with an auxiliary fund and conversion privilege. According to the survey, most do not provide that split funding may be used, though it must be conceded that a significant number do. I think there is little need for split funding. In fact, since the cases we have seen in the individual policy field are but one or two life cases, we believe it an unnecessarily complex procedure in relation to the benefits gained. Again, I realize "complex" is a relative term. Where split funding is not used, the RA-RI Endowment annuity type of contract appears to be the answer. Contribution increases are handled generally through use of the additional deposit agreements described. The need for change is reduced by use of average salary formulas. The purpose, of course, is to reduce the number of small increments and small policies for administrative economies if nothing else. Note that we invariably plan for increments. Decrements do come into the picture too, but the need for concern is generally rather effectively met by use of the average salary formula. Where the split funding approach is used, in the typical money-purchase plan, the auxiliary fund provides a good depository for contribution increments along the way until the sum total of those increments provides a contract of minimum size.

In the individual policy area, trusts and custodial accounts are being used to some extent, but many plans are being operated through direct purchase arrangements under formally written plans. There must be a plan for qualification. The reason for this latter approach is that it is probably more economical since no trustee or custodial fees enter the picture. The trustee approach is probably next in popularity. It is used for the fully insured trust where an individual trustee has been named and fees do not enter the picture. The owner-employee may be the trustee. There is no prohibition against such a trustee, but it is generally recom-

mended that some third party be named to avoid any suggestion or suspicion of conflict of interest. The laws of the states cannot be ignored in this matter either. It is essential that these laws be reviewed before committing oneself to any preferred approach. I say "preferred approach" advisedly. An insurer may prefer to operate in one field, for example, direct purchase under a plan. It would be foolish to expect to be in this market and so restrict oneself. We all learn the hard way. Agents must at least have a choice; they cannot be made to fit a single mold, and this might just as well be recognized at the outset as later. It is much easier on the ulcers that way. To sum up, the canvass of twenty-one companies showed sixteen use the direct purchase approach—some in conjunction with trustee, some in conjunction with a custodial account, some in conjunction with both. Four companies apparently restrict themselves to trusteed plans alone and two to the custodial account approach.

What now has been the record of success in securing IRS approval of master or prototype plans? First, let us square away our terms. A prototype plan is essentially a plan which conforms to a model, a prototype. Each plan is an entity; the prototype is the master model from which each is built. A master plan, on the other hand, is an over-all program which is joined by the owner-employee. There is a plan, a joinder agreement, and one would expect a variety of electives. Under normal conditions, a variety of electives would be available. Under H.R. 10, however, the possibilities for electives are so few (eligibility and benefit range) and so restrictive that we, for example, have eliminated an elective in the eligibility area. The end result is that the master plan and the prototype plan are essentially the same in most respects. Of course, the prototype approach creates a trust or plan for administrative purposes. The master plan creates no trust but assuredly provides for a well-defined plan under which policies are issued. It is significant to me that in answer to the question, "Has your company filed *(a)* a master plan, *(b)* a prototype plan with IRS and if so, have you obtained approval?" nineteen of the twenty-one replies relate only to the prototype approach. Only two of this group have apparently considered the master plan route. Perhaps, and this is pure conjecture, the reason is this great similarity.

Now there are a couple of questions related to benefit formulas. Shall they be money purchase or fixed benefit? Most offerings by the companies seem to be money purchase. This perhaps follows from the fact that the law places a limitation on the amount of contribution which may be made for the owner-employee. Since the contribution limits are rather clearly fixed, it is probably natural that the most straightforward approach for IRS approval has been that which kept clearly within these

limits. Of the twenty-one companies queried, none advocated only a fixed benefit formula prototype. Three have provided in their prototype plan for what might be described as either a money purchase or a fixed benefit formula. The approach taken has been simply to set up a salary schedule formula related to a 20 per cent compensation bracket scale, subject to the 10 per cent–$2,500 limit for the owner-employee. On this basis, prompt approval was given.

It must be pointed out, and this is probably not peculiar to the individual policy case, that benefit formulas will probably have to meet more tests than the simple money purchase formula. The reason is a simple one: the age distribution becomes a critical element. A level benefit formula may become discriminatory simply because of age distribution. Though ultimate benefits appear reasonable, the contribution for the owner with a wide age differential from the remainder may be the major part of the whole. This of course may appear reasonable to him and to us. It may not be so reasonable to the tax folk. Frankly, since the great bulk of the cases are single life cases, I think the question becomes largely academic. Just as soon as the second life comes in, for example, the doctor's nurse or the lawyer's secretary, it is no longer academic.

The life company should not and does not assume any responsibility that the correct contributions are made each year. Its concern is related solely to its contract and that the premiums called for are paid. The plan itself is the responsibility of the employer and *his* advisors: his attorney, accountant, and tax advisor. They are the administrators of the plan terms. They are responsible for purchase of the policies required and contribution payments. No company surveyed indicated any willingness to assume any such responsibility. I understand, however, that in this field some companies are policing the business very carefully. Preunderwriting is based on data supplied by the employer. The plan specifications are geared to these data and so forth. I wonder if such a company is in fact absolved of responsibility that it has to all intent and purposes assumed? All too frequently we find people presume to advise and then duck the responsibility of that advice. This is not an actuarial topic perhaps, but I feel it is certainly a general industry topic.

From the point of view of the individual policy operation, the restrictive provisions of H.R. 10 do not create real problems. The issues, to me, are rather clear cut. For example, with regard to vesting requirements, who can seriously argue against them? Should vesting, however, be in terms of paid-up benefits or withdrawable taxable values? When funds come into use, they surely should bear their share of the tax burden. The problem, if there is one, is that of the small paid-up contract. Ad-

ministratively, it is a bit of a nuisance, but I tend to believe that it is becoming less of a nuisance than it once was, through electronics.

What now about existing individual contracts? It is a good question. This has been a difficult nut to crack. I do not believe it has yet been cracked. Not one company suggested that it was doing this. The problem seems to be to find an appropriate formula for separating the parts, i.e., what part of value comes from the pre–H.R. 10 contributions and what from the H.R. 10 contributions? As a matter of fact, from my own personal point of view, I see no reason to permit their use. The reason for their purchase must have been a valid one and is probably a continuing one. H.R. 10 intervention should not dilute that purpose. If there must be a choice of one or the other, make the choice a clear one; do not confound both programs with gymnastics. The ALC-LIAA appropriate committees are nevertheless still working with Treasury in developing an acceptable ruling covering the use of existing policies.

Limits on contributions are perhaps severe when compared with industrial programs. To the extent that they tend to set a restrictive pattern for all programs for the future, they should probably be removed. They seem to create no unique problems in the individual policy field, particularly if the companies keep themselves free of responsibility for determination of correctness of contributions in this area. Bills liberalizing this part of the law are pending in both the House and Senate.

The market potential seems to be viewed regularly with very rose-colored glasses. This seems to be a natural for the individual policy vehicle. It is a natural market for the individual policy underwriter. Why? Because the average case runs about one and a half lives with the vast majority in experience thus far single life cases. The program was designed primarily for the professional man. It should be used by him. It may be argued that it is complicated. Some agree; others do not. Suppose, however, that it is complicated; this type of business provides remuneration to the agent that is certainly worth the effort expended. Complicated or not, the average premium per policy is most encouraging to the companies. The average premium per contract is in the neighborhood of $2,000 coupled with an average policy of $20,000. A characteristic figure appears to be about $1,500. This type of business is good for anyone in the industry—agent or company—the sole question would appear to be whether there is enough of it. The results on this score are encouraging. The first flurry late in 1963 brought close to 100 cases to each of these companies without any particular sales effort. There were no campaigns; there were no firm products available. Admittedly, it may be a seasonal business with heavier sales toward the end of the year as financial results

emerge. The use of the average compensation or earnings approach should assist in levelling out the introductory sales pattern.

The plans have been extremely well received by our field force. The potential is good. Problems encountered have not soured them on the whole program. The prototypes and the master plans keep the complications within limits. Streamlining of procedures, forms, and the tools should smooth out the remaining rough spots. The problems that will emerge will be those created by the individualist, by the agent or the self-employed individual who must have something just a little different. The prototypes and IRS procedures just do not contemplate this. Once off the track of the prototype and the routines, the troubles will multiply, and they may not be little ones. We can at best advise. If our advice is not heeded, we would be well advised to think twice about issuance of contracts. Approval may not follow. Dissatisfaction, unwinding, and change will follow with great expenditures of those most valuable commodities, talent and time.

With conformity will probably come success. Without conformity will probably come chaos.

The market is great. It should be worked successfully.

ALAN A. GROTH:

Concluding Discussion

1. As Mr. Walker and Mr. Logan have indicated, most of the plans so far established are either parts of a master plan or follow a prototype plan. These approaches do not allow consideration of the specific circumstances of the self-employed. Undoubtedly it would be healthier in the long run to tailor plans for the needs of the individual self-employed.

Small firms with few employees probably will not be able to afford anything else but to use either a prototype plan or to join a master plan. In case of large partnerships, such as big law or auditing firms, individual planning is not only desirable, but it is also feasible because the expense of individual planning is not prohibitive. For these organizations we should offer something better than a prototype or master plan.

In connection with the plans established to date, little, if any, individual planning has been done. The most frequently used three basic contribution formulas are a money purchase pension plan, a profit-sharing formula providing for contributing a percentage of profit (preferably in excess of a minimum profit), and a combination pension and profit-sharing approach providing for the lesser of X per cent of the total compensation or Y per cent of profits in excess of a predetermined amount. It appears that most of the prototype and master plans introduced offer only one or possibly a

choice between two of these simple contribution formulas. Of the three major professional associations, the physicians and the CPA's adopted the money purchase pension plan formula, the lawyers offer both the money purchase pension and the combination of pension and profit-sharing approach. To the best of our knowledge, none of the master plans established so far incorporates the fixed benefit basis and only very few prototype plans provide for fixed benefit formulas.

Money purchase formulas have not proven to be satisfactory for meeting the needs of corporate pension planning. I believe the same will prove to be true for H.R. 10 plans. Sooner or later, fixed benefit formulas will have to replace the present formulas.

2. Another area in which some progress is desirable is the determination of the proper contributions to the plan. As far as I know, trust companies or insurance companies are not willing to assume any responsibility for determining the correctness of the contributions of the employer. This attitude may lead to chaos and disillusionment with the retirement plan.

Relatively meager experience so far indicates an unhealthy trend of selecting the insurance carrier and/or the trust company only on the basis of cost considerations. If the insurance industry and the insurance agents will not assist smaller employers in determining employer contributions and in preparing forms, somebody else will move into the vacuum. We shall be creating opportunities for other professions, and insured H.R. 10 plans will not be popular because they will be too expensive. It will be much simpler to go to a trust company and make relatively small deposits based on a safe percentage of earned income to be certain that the maximum contribution provisions were observed.

3. It is not too difficult to suggest what changes in the law seem desirable for the self-employed. It is not so easy to foretell what changes might be acceptable to Congress.

In order to evaluate what amendments may be adopted to H.R. 10, it is perhaps worthwhile to review briefly the legislative history of the bill.

The House bill required the self-employed to cover his employees only if he had more than three employees. The Senate changed this to the present provisions.

The original House bill included all self-employed earnings, i.e., net earnings from trade or business, including the return on capital. The bill as passed by the House changed this to earned income and introduced the 30 per cent rule, regardless of the relationship of income to invested capital. This rule was originally introduced with respect to income earned outside the United States for which the 30 per cent rule might be more

appropriate than for the income of a self-employed. It would be a reasonable rule that the excess of self-employed earnings over, say, 10 per cent of the invested capital should be treated as earned income.

The original bill provided a maximum of $5,000 contribution which was fully deductible. The bill as reported from the Committee on Ways and Means limited deductions:

a) for owner-employees with three or fewer employees to the lesser of 10 per cent of earned income or $2,500;

b) for owner-employees with more than three employees to an amount proportionate to contributions made for the employees without any dollar limitation; and

c) for self-employed who are not owner-employees any amount determined under a nondiscriminatory formula.

Under the Senate Finance Committee bill, this was changed to limit contributions of owner-employees to 10 per cent or $2,500, whichever is less, and to limit deductions to 100 per cent of the first $1,000 contribution and 50 per cent of the amount contributed over $1,000, resulting in a maximum tax deduction of $1,750. A self-employed who is not an owner-employee could contribute any amount determined under a nondiscriminatory formula. He could deduct, however, only as much as an owner-employee.

The Senate Finance Committee thus introduced the principle of treating the self-employed persons for retirement plan purposes as both employers and employees. This reasoning resulted in limiting deductions because only employer contributions are deductible under corporate pension plans. Later on the Senate floor, some of the senators, having in mind the physicians, referred to Social Security, under which half of the contributions are payable by the employer and to the Civil Service System under which the government and the employees are making matching contributions. Hence only half the contributions are deductible.

The validity of these arguments in case of noncontributory H.R. 10 plans may seriously be questioned.

It must also be noted that when the bill was first submitted, unions argued for permitting employees of corporations to make deductible contributions to a pension fund if they are not covered by an employer sponsored plan.

Using these congressional views as some indication of future possibilities, the following changes might be expected in a subsequent bill:

a) It is unlikely that the principle of including all employees with three years of service would be changed.

b) There is a good chance that the 30 per cent rule for determining earned income will be liberalized.

c) It is not likely that the entire amount contributed by owner-employees will be deductible. It is possible, however, that the maximum amount of contributions and deductions might be increased.

d) It is not likely that vesting requirements would be liberalized, as Congress has assumed that any contribution made on behalf of owner-employees is *ipso facto* fully vested. It is entirely possible that Congress will require some vesting in plans which cover only common law employees whether introduced by self-employed persons or corporations.

e) It is possible that employees of corporations not having employer sponsored retirement plans will be able to provide for their retirement from tax-deductible contributions.